RETIREMENT INCOME INSTITUTE
Alliance for Lifetime Income

Who Should Read This Insight:
Consumers, annuity plan providers, policymakers

Institute Research Agenda Topic:
New takes on the annuity puzzle

Insight: HOW TO INCREASE ANNUITIZATION RATES IN THE UNITED STATES

Definitions of **bold key terms** are at the end of this article.

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Authors, Titles and Publication Dates of the Articles Addressed in the Insight
Hurwitz, Abigail. 2019. "Using Behavioral Insights to Increase Annuitization Rates: The Role of Framing and Anchoring." Brookings Institution, Washington, DC.

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IDEAS IN THE INSIGHT YOU CAN PUT INTO ACTION

Annuity plan providers can encourage more Americans to annuitize retirement savings by making two changes. First, they can reframe the decision to annuitize by focusing on terms like "income" and "consumption" rather than "investing" and "earning." Second, they can talk to investors about a minimal amount to **annuitize,** and so help them decide to take a first step toward **annuitization.**

PRINCIPAL INSIGHTS

As average life expectancy increases around the world, many countries struggle with how to address **longevity risk**. One way to manage this risk is to increase participation in annuity plans. Abigail Hurwitz's article reviews the evidence, both theoretical and empirical, while primarily focusing on evidence from Israel, the United Kingdom, and the United States. The author points out that the U.S. rate of annuitization is consistently low, then suggests a way to increase that rate by using a behavioral approach.

The author proposes reframing the decision of whether or when to annuitize by recommending a minimal level to annuitize. This reframing turns the decision around by describing annuities as an income stream and a way to fund future consumption rather than as an investment decision. Because investors have a tendency to over-rely on one piece of data or information when making decisions, they tend to decide in favor of the minimal annuitization value suggested.

In practice, retirees do not spend their savings evenly over their retirement years. Their inability to spend money smoothly over time, combined with their increased life expectancies and the shift away from traditional, employer-provided, **defined-benefit plans,** means that many retirees risk outliving their assets. Annuities provide regular monthly payments in retirement that can help retirees smooth their consumption. Despite their obvious advantages, however, too few Americans make annuities a part of their retirement saving strategies.

Previous studies have explored several reasons why so few Americans purchase annuities. One reason is that individuals might be put off by the cost of investing in an annuity. In addition, the status quo bias—which is the tendency of a decision-maker to not make a change, which in this case would mean to continue not participating in an annuity—could explain the reluctance to make the change. Risk aversion, demographics, and perception of life expectancy can also play roles in the decision whether or when to annuitize. Another possibility is that investors might lack confidence in the financial stability of the companies that sell annuities. Finally, there are psychological and behavioral barriers to annuitizing retirement funds, including the complexity of the decision to annuitize, the difficulty of parting with relatively large sums of savings, and the inability to predict one's own lifespan.

Although the United States can benefit greatly by increasing **consumer** participation in annuities, many policy researchers believe that using behavioral approaches would work better than federal mandates. In fact, annuities are not ideal for all retirees, and a mandate would create a rigidity that could prevent retirees from using their assets for expenses such as unexpected medical bills. A mandate might also increase administrative costs, and could lead to an unfair redistribution of wealth since annuities pool the risk of a retiree outliving her assets. In addition, annuities combine different individuals' risks of outliving their assets into one group, and so lower their collective risk of variability.

Hurwitz focuses her article on two behavioral approaches for increasing annuitization rates in the United States. (The author focused her paper on behavioral methods because of the roles that inertia and status quo play in keeping annuitization rates relatively low; therefore, behavioral methods are more likely to produce longer-lasting changes.) First, reframing the decision whether to annuitize by simplifying communication could help increase participation rates. Written communication from annuity plan providers should include words like "spend" and "payment" rather than "invest" and "earnings," as previous research studies have also suggested. Furthermore, when plan providers send annual reports to **defined-contribution plan** participants, those reports should clearly state both the investor's current balance and the amount of expected annuity payments that the balance could buy.

For this **framing** to be effective, the annuity plan providers or policymakers should couple the modified communications with clearly defined, standard assumptions that all annuity plan providers would use to calculate employees' expected annuity. (Of note, the recently enacted federal SECURE Act did add these kinds of "lifetime income disclosure" requirements to the applicable pension-benefit-statement reporting rules.)

Second, in addition to reframing the annuity decision, **financial professionals** should also suggest a minimal level for annuitization. Anchoring the decision by using a minimal level might influence consumers to annuitize at that level, which would lead to an increase in the demand for annuity plans. (When they are unsure, people tend to anchor their minds on the values suggested to them, a concept well-established by other research studies over the past 40 years.) An effective minimal level would be close to the expected value of annuitization. Finally, suggesting a minimal level could achieve many of the benefits of mandated annuitization—namely, protecting against the risk of retirees outliving their assets—without the disadvantage of implementing an inflexible and administratively higher-cost policy.

To learn more, visit the Retirement Income Institute at
www.allianceforlifetimeincome.org/retirement-income-institute

KEY TERMS ARE SOURCED FROM THE ALLIANCE FOR LIFETIME INCOME'S ANNUITIES LANGUAGE GLOSSARY AND INVESTOPEDIA

Annuitization: *The process of converting an investment into a series of periodic income payments by buying an annuity or beginning an income flow from an annuity.*

Annuitize: *When you turn your current account balance into a series of periodic income payments, either for a specific period of time or for your whole life.*

Annuity: *A financial vehicle for retirement that pays a regular, reliable stream of income to the annuity owner or a beneficiary each year, typically for the rest of the recipient's life.*

Consumer: *Someone who invests in annuities.*

Defined-benefit plan: *A defined-benefit plan is an employer-sponsored retirement plan where employee benefits are computed using a formula that considers several factors, such as length of employment and salary history.*

Defined-contribution plan: *A defined-contribution plan is a retirement plan that's typically tax-deferred, like a 401(k) or a 403(b), in which employees contribute a fixed amount or a percentage of their paychecks to an account that is intended to fund their retirements.*

Financial professional: *TA qualified person who can help you understand your options and make financial decisions to work toward your financial goals.*

Frame, framing: *Framing is how financial products are presented to consumers.*

Longevity risk: *The chance that you will live longer than your income will last.*

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