‘Survival pessimism’ dulls the appetite for annuities

By Editorial Staff *Fri, Nov 6, 2020*

Those in their early 60s underestimate the chance of survival to 75 by more than 25 percentage points, on average, and those in their early 70s underestimate survival to age 85 by more than 15 percentage points, new research shows.

Add “survival pessimism’—not expecting to live very long in retirement—to the list of reasons (along with high costs, illiquidity and complexity) why relatively few older people buy life annuities, according to a new working paper from the National Bureau of Economic Research.

Researchers Cormac O’Dea and David Sturrock reached that conclusion after analyzing survey data from the English Longitudinal Study of Aging, a biennial survey of English households over the age of 50, in which individuals are asked about their expected lifespans with mortality data that reveal actual lifespans.

On average, individuals underestimated their lifespan during their 50s, 60s, and 70s. Those in their early 60s underestimate the likelihood that they will survive to age 75 by more than 25 percentage points, on average, and those in their early 70s underestimate survival to age 85 by more than 15 percentage points. Sturrock and O’Dea reported their findings in a new paper: “Survival Pessimism and the Demand for Annuities” (**NBER Working Paper 27677**).

Ironically, people in their late 80s tended to overestimate their remaining life expectancies.

Survival pessimism may explain why people think annuities, which reward longevity, offer poor value. The researchers estimate that 88% of individuals would view as unfairly priced an annuity that is in fact priced fairly for someone of their age, sex, and year of birth.

Depending on their attitude toward risk, however, even survival pessimists may still buy annuities they regard as overpriced rather than stay uninsured. The researchers apply a lifecycle model that accounts for individuals’ patience and their attitude to risk to estimate the demand for annuities.

In their model, individuals who do not discount the future [i.e., do not suffer from “present bias,” the tendency to value spending in the future less than spending in the present] at all would all purchase annuities if they knew their lifespans. When they base their decisions on expected lifespans, recognizing survival pessimism, however, the rate of annuitization falls to between 42% and 64%, depending on the individual’s aversion to risk.

For individuals with positive discount rates toward the future, the level of desired annuitization is lower, but the drop in annuity demand from survival pessimism is still substantial.

Low payouts because of market imperfections such as adverse selection in the pool of annuity buyers may also explain low demand, the researchers note. They estimate that the impact of survival pessimism on the demand for annuities is comparable to the impact of offering payouts that are 82% of the actuarially fair payout using population mortality rates. The effect of individuals underestimating their lifespans may have as strong an effect as these market imperfections.