Using Psychology to Sell Annuities

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Is resistance to life annuities partly irrational? If given the unbiased facts, would more retirees convert some of their wealth to sensible, inflation-adjusted life annuities?

Some behavioral finance experts think so. Or, to be more precise, they believe that the application of principles of psychology could boost annuity sales.

So, apparently, does Allianz of America, which responded to the Department of Labor's recent Request for Information on lifetime income options in 401(k) plans by presenting insights and recommendations about annuities from 10 behavioral finance experts at major universities.

UCLA's Shlomo Benartzi (above) collected the insights at the request of Allianz of America, which includes Allianz Life and Allianz Global Investors. In addition to providing a handy 10-point checklist for evaluating retirement income strategies, Benartzi catalogued 10 ways that psychology can affect annuity purchase decisions:

Framing. Receptiveness to annuities often depends on how they're "framed," says Jeffrey Brown of the University of Illinois. In one experiment, people were asked to choose between a life annuity paying $650 a month until death or a $100,000 savings account paying 4% annual interest. When the annuity was presented in terms of income ("consumption framing"), 70% chose it. When the annuity was presented in terms of investment returns ("investment framing"), 21% chose it.

Vividness. People are more likely to save for the future when they come face to face with aging-especially their own aging. Daniel G. Goldstein of the London Business School and others showed that people allocate twice as much to a retirement savings account after seeing "age-morphed" images of themselves as they will look when they are old.

Loss-aversion. Older people are more averse to loss and change than younger people, says Eric Johnson of Columbia. And that makes them shun annuities. In one experiment, nearly half of the retirees said that they would refuse a coin flip that gave them $100 if they won but cost them only $10 if they lost. In other words, they feared losses 10 times more than they coveted gains. In the case of annuities, the loss of liquidity looms especially large for them. To appeal to older people, guaranteed income products must be positioned as a way to gain more control over income and spending.

Cognitive impairment. Seniors have senior moments. When asked which numbers represented the biggest risk of getting a disease, 1 in 10, 1 in 100 or 1 in 1000, 29% of adults ages 65 to 94 got the answer wrong, according to Harvard's David Laibson. After age 60, he said, the prevalence of dementia doubles about every five years. Quality of decisions about credit begins to decline as early as age 53. These trends suggest that people should commit to guaranteed income products or systematic withdrawal plans while they can still make optimal decisions.

Bucketing systems. Bucketing may not hold water from a strictly mathematical perspective, but it apparently works for many retirees. Evidence shows that older people save more, and persist in saving, when their money goes into or comes out of accounts that are clearly earmarked for specific purposes. They tend to take less risk with the money in a “Pay the Rent” account than with the money in an account earmarked for purely discretionary purchases, says George Loewenstein of Carnegie Mellon University.

No one-size-fits-all default option. Conventional wisdom says that life annuities are a boon to people with modest savings, because mortality credits boost payout rates. But don’t be so sure, says Harvard’s Brigitte Madrian. If low-income retirement plan participants have no liquid savings other than their 401(k) accounts, maybe they shouldn’t buy life annuities. Before setting up distribution options, plan sponsors should beware of steering people toward sub-optimal default solutions. High- and low-income participants might require different default distribution options, she believes.

Evaluability. Watch out for those “teaser rates.” Many married people opt for single life annuities at retirement merely because they provide higher monthly payments than joint-and-survivor life annuities, he believes. But if they recognized that a single life contract will short-change the surviving spouse, they might act otherwise. To make informed decisions in the presence of several distribution options, participants need complete, symmetrical information, says John Payne of Duke University.

Active decision-making. Think about it: In a study of 100,000 participants in 100 defined benefit plans, Alessandro Previtero of UCLA found that, when forced to make an active decision between a lump sum and an annuity (as opposed to an inertia-driven or default decision), about half of participants chose life annuities over lump sum distributions. Annuities aren’t as unpopular as policymakers assume they are, he thinks.

Money illusion. Most people, and especially older people, don’t fully appreciate that the bread that costs $3.50 today might cost $7 in 20 years. This type of financial myopia accounts is partly to blame for low sales of inflation-adjusted life annuities, says Princeton’s Eldar Shafir. He believes that if people knew exactly how much the real value of a nominal annuity shrinks over time, they’d buy more inflation-indexed contracts.

Fairness. Annuities are just plain misunderstood. When people understand that surviving annuity owners are the de facto beneficiaries when members of an annuity cohort die, they perceive annuities to be more “fair” than if they think-as many people do-that the insurance company keeps the undistributed assets of those who pass away, says Suzanne Shu of UCLA.