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Why Don't They Just Buy An Annuity?

By: Jim Helik

One of the notable features of **DC pension plans** is that, unlike more traditional **DB plans**, participants face longevity risk, which is the risk of a member outliving the funds that they have accumulated inside their **DC plan**. In other words, members are lacking the guarantee of a lifetime income that a **DB plan** provides. Of course, **DC** members can eliminate this risk by using their funds to purchase a lifetime income annuity.

Except that, in the real world, they don't. The number of plan members who voluntarily purchase an annuity is very small, according to one study "virtually zero." This is all the more striking in that the shrinking of **DB plans** over time has not resulted in an increase in individually purchased annuities.

Behavioural factors that examine how individuals actually make their financial choices, especially in cases involving risky outcomes, can help answer this 'annuity puzzle.' A new paper by Wei-Yin Hu and Jason Scott, both of the Wharton School, University of Pennsylvania, called Behavioural Obstacles to the Annuity Market looks at how people view the annuity decision and what this means for the creation of new annuity products.

'Mental Accounting'

A key part of behavioural finance is what is known as 'mental accounting,' which holds that risky outcomes are not always evaluated by people in terms of their outcomes for ending their total wealth, but often as choices that are more narrowly defined. For example, an individual facing a gamble that puts \$100 at risk should, according to classical economics, evaluate this risk in terms of the impact on his total wealth (which for most people should mean that making or losing \$100 makes no difference to their overall financial health). However, repeated behavioural tests have shown that people evaluate a \$100 gamble in isolation, the result being that they care more about winning (or losing) this relatively small amount of money than they should.

This has a major effect on the potential purchase of an annuity. Rather than viewing it as part of the overall financial planning for retirement, the purchase of an annuity is viewed in isolation. It is thus segregated into its own mental account. Thus, individuals evaluate an annuity from the perspective "will I live long enough to make back my initial investment in this annuity?"

Potential 'Loss'

This results in a few unexpected effects. Rather than worrying about outliving their money, individuals end up worrying about their potential 'loss' from an annuity investment if they die earlier than expected. In some surveys, individuals have stated that purchasing an annuity is the same as "gambling on their lives." Therefore, the purchase of an annuity is not seen as something that mitigates risk, but rather increases overall risk in retirement – and is naturally to be avoided.

There are other behavioural factors at play here, too. Investors, generally speaking, tend to overweight low probability events – in this case the low probability of suffering an early death after having purchased an annuity product. The near-complete loss of the initial investment in this case is viewed to be highly unpalatable by investors due to loss aversion – an investor's severe dislike of suffering a financial loss of any kind. These two other behavioural factors combine to work against the purchase of an annuity.

Many of these issues can be overcome through a 'period-certain' annuity which guarantees a minimum number of payouts even if the purchaser dies early. The vast majority of individual annuities purchased today have some guaranteed component which mitigates the perception of the 'risk' of dying too soon.

Actual Proof

Using a behavioural approach such as this gives us some insight into why annuities are unpopular, and it goes beyond simple reasons such as 'interest rates are low, so annuities aren't attractive,' and 'people can't understand the value of annuity payments.' Of course, the shortcoming of behavioural finance is the actual proof – mental accounting, the overweighting of small probabilities, and loss aversion might explain the unpopularity of annuities, or all of this could be due to yet another behavioural condition that is yet to be understood. In any case, there is work to be done in helping individuals overcome whatever biases they have against purchasing an annuity.

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