FEI Guest Speaker
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The Effect of Longevity Changes and Possible Future Health State Transitions on the Optimal Level of Annuitization for Retirees

Bio

Patrick L. Brockett holds the Gus Wortham Chair in Risk Management in the University of Texas-Austin’s McCombs School of Business. He holds joint Professor appointments in the departments of Finance, Mathematics, and Information, Risk and Operations Management. He is a former president of the American Risk and Insurance Association. He is currently the Editor of the North American Actuarial Journal and formerly served for nine years as Editor of the top ranked Journal of Risk and Insurance. He was President of the American Risk and Insurance Association, is an elected member of the International Statistical Institute, and is a Fellow of the Institute of Mathematical Statistics, the American Statistical Association, the Royal Statistical Society, the American Association for the Advancement of Science, and the Institute for Risk Management. His articles have won awards from the American Risk and Insurance Association, the American Statistical Association, the Society of Actuaries, the International Insurance Society, the Casualty Actuarial Society, as well as from the Faculty of Actuaries of Scotland and Institute of Actuaries in England. He publishes interdisciplinary research in many different journals. His current interests include financial and behavioral aspects of managing longevity risk.

Abstract

Economists have recognized at least since 1965 that, to best avoid running out of money later in life, retirees should convert far more of their assets into an income producing annuity at retirement than they actually do. In fact, classic rational choice theory predicts that, absent other motivations or constraints, retirees should optimally annuitize 100% of their wealth. The fact that retirees so rarely do what they ought to do is known as the “annuity puzzle.” This puzzle was well articulated by Franco Modigliani in his 1985 Nobel acceptance speech, when he said, “It is a well-known fact that annuity contracts, other than in the form of group insurance through pension systems, are extremely rare. Why this should be so is a subject of considerable current interest. It is still ill-understood.” This remains true today. Income annuities remain widely unpopular, even though they would help solve a variety of complex problems with which retirees struggle and which cannot be solved otherwise. This talk will discuss the interplay between increased longevity, the risk of outliving one’s savings, and the potential for costly transitions between health states faced by retirees attempting to rationally decide the optimal amount of wealth to annuitize. Retirees do have other factors that they trade off, such as wanting to give money to heirs, pay for future health care, etc., and we show how these factors partially explain the observed low annuitization rate. Using a life-cycle framework incorporating wealth levels, bequest motives and consumption floors created by government subsidies, we examine how increased longevity, in conjunction with an individual’s health state transition process, impacts annuity purchase decisions. Health state transition matrices are estimated from the Health and Retirement Survey (HRS) data. The effects of increased longevity on annuitization decisions are considered both when longevity is accompanied with increased time spent in healthier states (morbidity compression) or experienced by more time in unhealthy states (morbidity expansion). We find retiree annuity demand is rationally affected by wealth, initial health status and expansion or compression of morbidity. Wealthier retirees have higher annuity demand when future health state transitions are considered, and increased longevity increases annuity demand even more when retirees expect an expansion or slight morbidity compression. With health shocks and expectations of severe morbidity compression considered, the opposite effect might occur. For retirees with lower wealth, the consumption floor provided by governmental subsidies like Social Security will also create a decreased propensity to annuitize. Finally, we shall discuss behavioral aspects of the annuitization decision and newer behavioral research that sheds additional light on the annuity puzzle from a behavioral perspective.