Abstract:
We use a purpose-designed survey to document significant perceived nonpayment risk in annuity, life insurance, and long-term care insurance markets from the perspective of consumers. That is, people perceive a substantial risk that insurance companies will not pay out as much as they should when they should. We find that nonpayment risk significantly predicts insurance product ownership, and that annuity and long-term care insurance ownership would be over 50% higher if products were perceived as risk-free. To interpret our measures and perform welfare analysis, we develop a new life-cycle model of the joint demand for these three products that allows for uninsurable nonpayment risk as well as incomplete markets along other dimensions. In particular we model a maximum purchase age, wedges in the price for buying and selling the asset, uninsurable out of pocket medical expenditure risk, non-negative insurance holdings, and a non-negativity constraint for wealth. The welfare costs of nonpayment risk—whether real or perceived—and other features of incomplete markets are large relative to a complete market benchmark. Taking these features of the products and market as given, the cost of suboptimal insurance ownership is much smaller than would be predicted by a complete market benchmark.