Discussion Paper

Exploring barriers to Australia's annuities market

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Australia will experience a significant outflow of money from superannuation funds in the next ten years as baby boomers move into retirement. However Australia's ageing population faces a relatively limited range of options regarding how to invest their life savings in a way that will provide the right balance of security and income.

The glut of money exiting Australia's superannuation system is substantial – with implications not just for retirees but for Australia's broader financial services, superannuation and pensions system.

The Actuaries Institute believes a deeper, more developed annuities market is vital to provide greater choices for people looking to sensibly invest their retirement savings – over what may be a 30+ year period for many. However a wide range of barriers need to be better understood and then tackled to help annuities enter the mainstream financial services system.

The Institute has recommended to Government a range of proposed changes to Australia's regulatory and taxation system to help overcome these obstacles.

The following discussion paper provides some additional insights into the status of Australia's annuities market and the barriers preventing the growth of this important sector.

Billions flowing out of super

The following table of APRA statistics shows a breakdown of Australia's superannuation assets held by Australians of various ages.

Table 5 Age segmentation of vested benefits by fund type

Year end June 2010

Entities with more than four members

($ million)

	< 35 yrs	35 - 49 yrs	50 - 59 yrs	60 - 65 yrs	> 65 yrs	Total
Corporate	7%	38%	37%	12%	7%	100%
Industry	16%	35%	29%	14%	6%	100%
Public sector [a]	7%	28%	32%	15%	19%	100%
Retail	7%	25%	27%	22%	20%	100%
Total	9%	29%	30%	17%	16%	100%
Total	88,958	291,017	303,048	168,740	160,074	1,011,836

As you can see:

- $329 billion of assets is vested in people over the age of 60 and a total of $632 billion is vested in people over the age of 50! That is over 60% of all fund assets could flow out of the accumulation phase and enter the retirement phase.
- In addition, there is around $390 bn of assets in the self managed superannuation fund (SMSF) segment, of which around $300 Billion is vested in members over aged 50. (*Source ATO Self managed super funds 2008-09. The SMSF is not regulated by APRA but by the ATO.)*

The expected outflow of money from the accumulation to the retirement phase of super means that those super funds who are well placed with suitable retirement options will be those most likely to retain their existing members, and perhaps even attract new retired members. On the other hand a lack of intelligent defaults for retirement will leave many super funds unable to retain members and many retirees without sufficient choice of products to protect themselves against their retirement risks.

Given that Australians are the second longest-lived population on the planet we need to allow retirees to insure themselves against longevity using products like deferred lifetime annuities. Most retirees start off in an account-based product which offers flexibility in the early, active stage of their retirement. Buying a deferred lifetime annuity on retirement (which starts payments say 20 years later) may be a cost effective way for a retiree to lock in an income above the Age Pension in their later years, which would be paid for as long as they live.The reality, however, is that few institutions offer these types of products - and the experience in other developed markets is that people do not buy these products without strong incentives of some level of compulsion. So what is the problem?

I believe there are four key reasons:

1. Lack of consumer awareness
2. Behavioural factors
3. Lack of incentives or compulsion, and
4. Legislative and political barriers.

1. Lack of consumer awareness

A 2008 paper by UNSW's Centre for Pensions and Superannuation, "Australia's disappearing market for life annuities" said:
"*…despite the large decrease in the money's worth of Australian annuities, and the withdrawal of tax-transfer incentives to encourage annuitisation, it would still be optimal for Australian retirees to annuitise all or at least part of their retirement wealth.*

We suggest that the very thin and fading market for life annuities in Australia may be due to lack of consumer awareness of the risks of not annuitising, as well as supply-side constraints."

So most retirees cannot work out that an annuity is their best option. Why not? Well admittedly the products can be confusing and many retirees do not get financial advice. However, there are also some deeper behavioural issues at play.

2. Behavioural factors

There are a range of behavioural factors that work against annuities, including cost; a strange approach to mental accounting that humans take; the well-documented tendencies towards loss aversion and overweighting the importance of unlikely events (e.g. dying unexpectedly early). Finally, there is the security blanket of Australia's Age Pension.

Annuities seem expensive

When the average person goes to buy a lifetime annuity they are confronted with the cost of their own longevity for the first time, and they are shocked. It is not cheap!

Why is it so expensive?

1. Longevity is uncertain. Despite all the skills actuaries bring to the table, predicting life expectancy is not easy, and statistics are only really meaningful and useful when dealing with large groups, not individuals. When things are uncertain, insurers require contingency margins are required to protect themselves against adverse experience.

2. The major cost of a guaranteed income stream is actually the market risk – i.e. the volatility of investment performance, not the longevity risk. The cost of guaranteeing someone the same income over a long time period – regardless of market movements – is high.

3. It's expensive because it just IS. It's the value of future income payments over very long periods of time. An example will illustrate.

Take a 65-year-old man who wanted a retirement income – indexed – of $25,000 a year for life (ignoring the impact of the Age Pension):

If we just take the net present value of those future payments – that is, what they are worth today[1] – here's what we get:

- To fund this income for exactly 18 years through to his average life expectancy of 83, he needs a lump sum of $359,000.

- To fund this income for 40 years to his so-called "maximum" life expectancy of 105, he'd need a lump sum of $628,000.

- He doesn't know how long he is going to live … so if he has $359,000 how much can he spend each year?

    - If he expects to live to 83 he can spend $25,000 per year.
    - But if he expects to live to 105 he can only spend $14,300 per year.

[1] Present value of indexed income for exact term @2.5% real interest.

- A lifetime annuity of $25,000 p.a. will certainly cost him more than the $359,000 because most people will live way beyond current average life expectancies, and these figures ignore expenses, but it will not cost him as much as $628,000. In fact, if we had a functional, tax free annuity market, the pure cost of such an annuity would be in the order of $420,000[2] (plus expenses).

You can see how expensive these income streams are, simply given the time value of money over the long time periods we are talking about. It is a tough calculation for the average person to understand.

And this is before we even start talking about fees or the cost of market risk (because you're not able to get 2.5% real return guaranteed without taking on investment risk).

Another option is a deferred lifetime annuity (DLA). A DLA guarantees an income stream at some future time if you are still alive. For example you may buy a deferred annuity at age 65 to start from age 85 if you are still alive. You would then receive a pre determined income stream for life.

DLAs can be significantly cheaper because there is much less market risk to protect against. If you take the first 20 years of market risk out of the equation by starting the guaranteed income at 85 and it all becomes much more affordable. A deferred lifetime annuitant also benefits from the "mortality premium" in that some people die before the payments commence. So the 65 year old male in the example above would pay only around $103,000[3] (plus expenses) for a deferred lifetime annuity starting at age 85 and paying him today's equivalent of $25,000 (indexed) monthly for life.

But besides the expense, there are other behavioural factors working against us.

Mental Accounting

Mental accounting is where people tend to evaluate risky financial outcomes narrowly, relative to some reference point, rather than more broadly in terms of total net worth. A March 2007 working paper by Wei-Yin Hu and Jason S Scott, called "Behavioural Obstacles to the Annuity Market" states:

"…In the case of the annuity decision, a similar question arises whether the retiree recognizes the impact of annuitization on the retirement spending stream he can afford...having an annuity stream should allow a retiree to spend more in retirement, because the annuity's longevity insurance reduces the need for precautionary saving against long life. There may be a "broad frame" in which the retiree values the fact that the annuity guarantees income even when he has lived well beyond life expectancy and may have exhausted most of his assets, and at the other extreme a "narrow frame" in which the annuity is evaluated purely as a gamble in itself….

… It is more plausible that a retiree evaluates an annuity from the perspective "will I live long enough to make back my initial investment in this annuity?""

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[2] *No allowance for expenses or commissions. Purchased 20/2/12. 0% tax. Payments commence at $25,000 p.a. paid monthly and are indexed to CPI. Assumes a functional mortality market (which is not the case right now) and current APRA capital requirements.*

[3] *No allowance for expenses or commissions. Payments commence in 20 years at $25,000 p.a. in today's dollars, paid monthly, and indexed to CPI. 0% tax in deferral period (these annuities are currently taxed in deferral period). Assumes a functional mortality market (which is not the case right now) and current APRA capital requirements*

So rather than seeing a life annuity as a tool to increase retirement income, the retiree focuses on the possible gain or loss in the annuity payments compared with the cost of the annuity. What if they were to die after two or three years? They would have paid a large sum and received back very little.

Loss aversion

In a January 2007 article in Science Magazine called "The Neural Basis of Loss Aversion in Decision-Making Under Risk", authors Sabrina M. Tom, Craig R. Fox, Christopher Trepel and Russell A. Poldrack say:

"Many decisions, such as whether to invest in the stock market or to accept a new job, involve the possibility of gaining or losing relative to the status quo. When faced with such decisions, most people are markedly risk averse. For instance, people typically reject gambles that offer a 50/50 chance of gaining or losing money, unless the amount that could be gained is at least twice the amount that could be lost (e.g., a 50/50 chance to either gain $100 or lose $50).

Our dislike of negative outcomes is greater than the pleasure we get from positive outcomes. This further reduces the attractiveness of life annuities.

Overweighting the importance of unlikely events

We humans also overestimate the likelihood of unlikely events. The Hu and Scott paper above found that:

"… at age 65, there is a 2 percent probability of dying in the next year, but the decision weight on that outcome is an overstated 6 percent; this is the classic behavioural property of overweighting of small probabilities. For an immediate annuity, this means that the worst event's importance is overstated."

Availability of the Age Pension

And the last nail in the coffin of getting Australians to change their behaviour and purchase a lifetime annuity is that they already *have* a lifetime annuity – it's called the Age Pension. Whilst it is at a low level – around 25% of average income – I believe it has a large psychological impact. People know they have something to fall back on.

So there are some powerful factors here generating inertia.

Other factors

There are a few other factors that could also discourage retirees from purchasing an annuity. These include:

- Counterparty risk – the risk that the annuity provider the retiree has chosen (perhaps making that decision based on their capital strength) may collapse or be taken over or may sell their "book" of annuities to another provider who is not as financially strong. Given the long time periods over which lifetime annuities are paid, this risk is perceived to be high.

- Point in time sensitivity – the "price" a retiree pays for an annuity is very much dependent on interest rates at the time they retire. This is one reason lifetime annuities were popular in the late 1980s – interest rates were high so a retiree could "lock in" a good return, i.e.: a high level of regular annuity payments for life. In the current low interest rate environment, the price of annuities is much less attractive.
- Capital backing requirements - it's important to note that part of the reason for the apparent high cost of annuities is that the regulator, APRA, requires annuity writers to hold a large amount of capital to "back" the products. The trend at the moment worldwide is for capital requirements to increase rather than decrease. If they increase, this flows straight through to the price of annuities making them less affordable.

3. Incentives or compulsion?

Whilst more incentives to take out income streams would be good, I don't believe incentives will be enough to counter this powerful inertia.

I have heard arguments that the Government should make the purchase of a guaranteed income stream (such as a deferred lifetime annuity) compulsory for people with more than a pre-determined amount invested in superannuation.

I am not so sure. Compulsion is difficult…. do we need the nanny state because people don't know what's good for them? We certainly have that approach in the accumulation phase of superannuation with compulsory contributions. Should we carry it through into the retirement phase? If not compulsion, should we have intelligent defaults? For example retirees who have been in a MySuper default whilst working are transferred to an account-based retirement product that gives them flexibility with their capital and payments. However around 1/8 of their money is kept aside to pay for a deferred lifetime annuity (DLA) from age 85. Alternatively they could pay a "premium" each year from age 65 to 85 to purchase this DLA. Those who do not want this whole arrangement could opt out – so it is really soft compulsion.

With compulsion, either "hard" or "soft" as described above, there is a moral hazard in that the government needs to make sure there is not a default by the private company providing the guaranteed annuity. This could lead to higher capital requirements, or Governments needing to rescue annuity providers, or perhaps we could set up an industry-wide insurance pool to protect against defaults.

It would be more straightforward for the government to compel that individuals with assets above a specified amount not be permitted to take these as lump sums but must draw them down in regular payments. The downside is that this still leaves the individual, and potentially ultimately the government, to carry the longevity risk.

What happens in other countries?

The UNSW paper mentioned before compares Australia to Chile and Switzerland. Like Australia, those countries were pioneers of compulsory private contributions to pension funds, and we have remarkably similar systems in the accumulation phase. But here

the similarities stop. Chile and Switzerland both favour annuitisation in retirement and have some compulsion:

- In Chile retirees can choose a life annuity sold by insurance companies or a phased withdrawal sold by the pension funds (AFPs). Small lump sums are available in restricted circumstances. All annuities are indexed and must be paid at a fixed rate. Joint annuities are mandatory for married men (and other men and women with dependents). So far around two thirds of Chilean retirees have annuitised.

- Swiss retirees have the choice of a life annuity or a lump sum. Neither phased withdrawals, nor term annuities are available. All annuities are nominal and must be paid at a fixed rate. Married retirees, both men and women, must purchase reversionary joint annuities. Around 80 per cent of Swiss retirees take lifetime annuities and around 50 per cent have a combination of a life annuity and a lump sum.

In the UK, everyone who has a private (non-state) pension scheme was, until recently, required by the Government to buy a compulsory annuity with at least 75% of their pension fund (allowing for 25% to be taken as a cash lump sum). Since April 6th 2011 it is now possible to defer annuity purchase indefinitely as a result of revisions to income drawdown and introduced flexible drawdown legislation (similar to our "account-based" annuities and pensions in Australia. However, beyond age 75 you must have a minimum income of £20,000pa, known as a secured pension, if you want to continue with drawdown.

There have also been calls for compulsion closer to home in both New Zealand (with Kiwisaver) and Australia.

While removing barriers and providing incentives to take out income streams would be positive steps forward, there are good arguments to consider a system of intelligent defaults (i.e. soft compulsion) so that if a retiree does not choose, they are placed into an income stream product that allows flexibility and control of capital in the younger retirement years, then provides a guaranteed income for life in later years to supplement the Age Pension in old age. With the power of the grey vote it would be very difficult for any government to introduce hard compulsion in retirement. This brings us to the next reason Australia hasn't developed these products.

4. Legislative and political barriers

There are a range of legislative barriers to the development of the annuities sector. We don't currently have a very favourable environment in which to develop these products. The Actuaries Institute believes the Government needs to remove these barriers to retirement product innovation.

In its pre-budget submission on 27th January 2012 the Actuaries Institute called for the following changes:

- amend the Superannuation Industry Supervision Act Regulation 106, which is a block to the development in the annuities market of products which protect against the risk of individuals outliving their retirement savings and the market risk

of losing superannuation capital in retirement- that is, modernise the definition of an annuity to allow product innovation;

- reverse the unfavourable treatment of annuities under aged care and Centrelink rules – that is, make lifetime non-commutable annuities exempt from the Assets Test;
- allow annuities and deferred annuities to be issued as a component of an account based pension; and
- change the tax rules on deferred annuities so that, if taken out in the drawdown phase, the product is regarded as a pension (rather than a non-pension) for tax purposes– that is ensure that non-commutable retirement annuities are exempt from income tax like other retirement products.

The legislation should be flexible enough to allow innovative product development for retirees, with products such as deferred lifetime annuities but also new generation products like variable annuities that combine an account-based annuity with some level of protection against longevity and market risk. Current legislation is prescriptive and outdated, and needs to be modernised.

Governments are understandably nervous to impose compulsion or even a strong default system that can be seen to reduce the level of choice for retirees.

However Australian governments have a tried and true method for introducing changes of this nature that could easily be applied here – that is, introduce the changes for future generations of retirees.

We saw this approach recently when the Age Pension eligibility age was changed from 65 to 67. We didn't have rioting on the streets like they had in Greece. Why? Because the changes only applied to people retiring in future and those future retirees are still young and are not particularly engaged with their super.

On balance therefore, whilst there maybe some insurmountable political problems to make it compulsory for people to purchase (deferred) lifetime annuities, there are some very real options for the government consider phasing in a program of intelligent defaults that can be designed to suit the vast majority of retirees in "middle Australia".

Removing the legislative barriers to lifetime, deferred lifetime and variable annuities and drafting legislation flexible enough to accommodate product innovation, will enable insurers to develop efficient products that need to compete with the other options available to the retiree. With the baby boomers already retiring, we have run out of time to solve these problems. We do not have a moment to lose!

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