



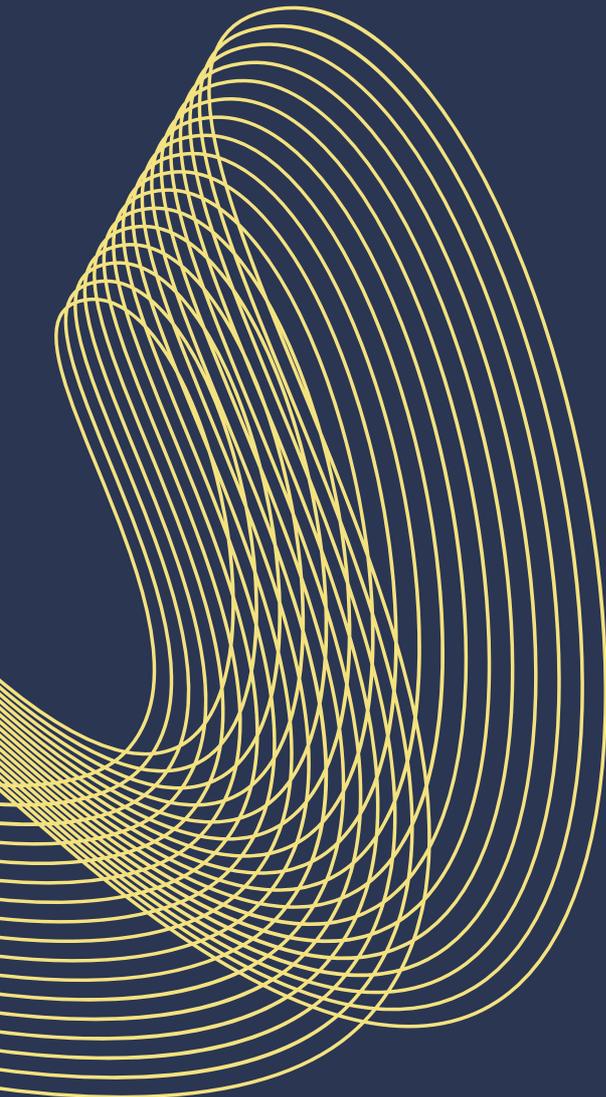
THE FEAR OF RUNNING OUT.

Lifetime Income and
The Annuity Puzzle.

By Stephen Huppert



OPTIMUM
PENSIONS



THE UNCERTAINTY OF FUTURE LIFESPAN AND THE FEAR OF RUNNING OUT OF MONEY IN RETIREMENT RESULTS IN RETIREES BEING OVER-CAUTIOUS IN THEIR SPENDING.

Australia is often called the 'lucky country', but as Australian life expectancy continues to rise to the third highest in the world, is it 'lucky' for our retirees?

The fact is our retirees are 'lucky' to make their retirement savings last and carefully managing longevity risk is crucial to confident spending and a fulfilling retirement.

While the Federal Government provides some protection against longevity risk with the Aged Pension, the amount is well below what most Australians feel they need to be comfortable in retirement. The fear of not having enough and the uncertainty of future lifespan results in retirees being over-cautious in their spending.

So, wouldn't it be great if superannuation fund trustees could offer their members a product that increases their confidence to spend no matter how long they might live, thereby providing a more fulfilling retirement?

These products do exist! Lifetime annuities provide income for life, but superannuation fund trustees are not offering them to members because they say they don't buy them.

Why don't people buy lifetime annuity products if they help them be more confident in retirement?

That's the annuity puzzle.

THE FEAR OF RUNNING OUT OF MONEY IS SIGNIFICANT FOR MOST AUSTRALIANS AS THEY PLAN THEIR RETIREMENTS.

The AMP Financial Wellness research indicates that close to 50% of Australians are concerned they don't have enough money for retirement. It's the most common fear experienced by retirees. Ben Hillier, AMP General Manager, Retirement Solutions, calls this fear 'FORO', the Fear of Running Out[1].

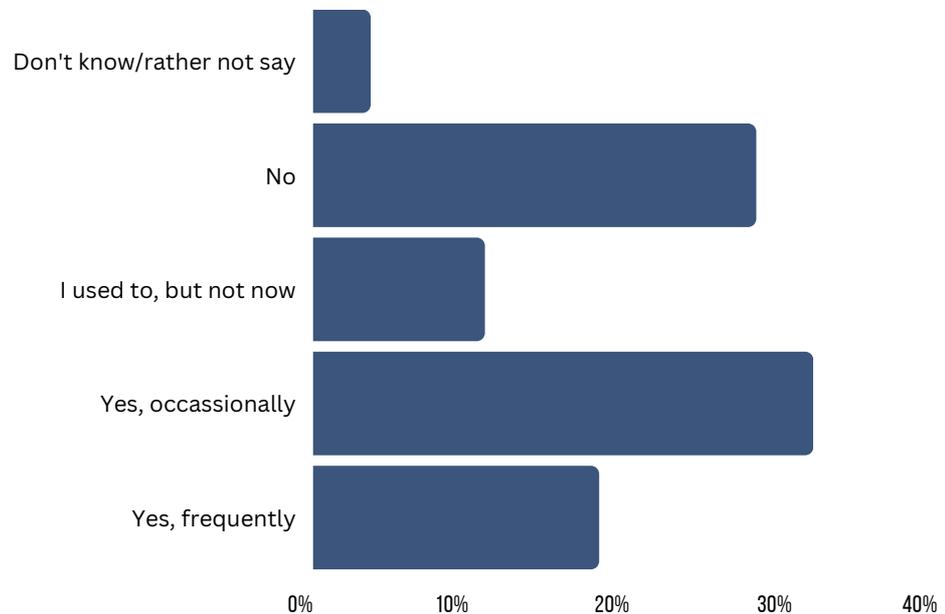
National Seniors surveys have consistently found that one of the highest priorities for older Australians is having a source of income that will last for life. Their 2019 Survey found that one in five participants

frequently worry about outliving their savings and investments, and over half agreed that they worried either frequently or occasionally (see Chart 1)[2].

The Retirement Essentials February 2023 Retirement Pulse Survey asked respondents who have yet to retire, about their biggest fear or concern as they plan for retirement. Sixty per cent replied,

"Will I have enough money?"[3]

CHART 1: DO YOU WORRY YOU MIGHT OUTLIVE YOUR SAVINGS AND INVESTMENTS?



SOURCE: NATIONAL SENIORS NATIONAL SENIORS SOCIAL SURVEY, 2019

RETIREMENT FORO

Retirement FORO can result in people making poor choices and lead to many retirees being overly conservative spenders rather than enjoying a higher standard of living.

The Retirement Income Review[4] reported that 83% of accounts in the pension phase were invested in account-based pensions that do not manage the risk of running out of money in retirement. FORO leads to many retirees relying on the statutory minimum draw-down rates as a default. That is, only drawing down the minimum to avoid running out of savings.

The Retirement Income Review concluded that if superannuation was consumed more efficiently in retirement, most people would have higher replacement rates and, consequently, a higher standard of living in retirement.

The simple answer to retirement FORO is a retirement product that can help manage longevity risk and give people the confidence to spend by providing a guaranteed income stream—a lifetime annuity.

ANNUITY SCARC(E)CITY

From 1 July 2022, the Retirement Income Covenant requires trustees to outline how they will help members, retired or nearing retirement, to, amongst other things, manage the risks they will face in retirement—and the mother of all retirement risks is longevity risk[5].

Many submissions to the Retirement Income Review raised the lack of retirement income products that provide longevity risk protection.

The recent 2022 State Street Global Advisors Global Retirement Reality Report asked Australians what they would like from their superannuation fund, and over 70% selected "A source of guaranteed income offered through your superannuation fund" [6] (see Chart 2).

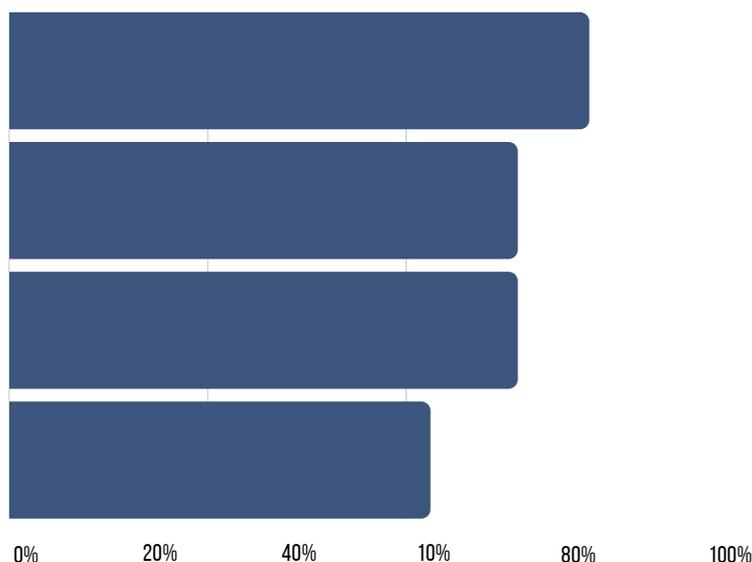
CHART 2: WHAT WOULD YOU LIKE FROM YOUR SUPERANNUATION FUND?

Product: A source of guaranteed income offered by your super fund.

Tools: A mechanism or tool (eg retirement income calculator) to help you.

Advice: Access to 1:1 financial consulting

Education: In-person or web-based town-hall style informational forums



SOURCE: STATE STREET GLOBAL ADVISORS. GLOBAL RETIREMENT REALITY REPORT 2022

So what's holding superannuation fund trustees back? Why aren't they offering lifetime annuities to their members wanting confidence in retirement and protection against FORO?

THE ANNUITY PUZZLE

This conundrum is not a uniquely Australian phenomenon. Since at least 1965 and the seminal research of Menachem Yaari[7], economists have recognised that despite the potential benefits of lifetime annuities, many are hesitant to purchase them. This is known as the annuity puzzle.

Many explanations have been proposed, including the fear of losing control of finances, a desire to leave something to beneficiaries, nervousness about relying on an institution to pay an income for what might be decades into the future, and concern about the cost.

Annuities tend to be complex financial products and difficult to understand. Research by the Melbourne Business School Orford Initiative suggests that while people are interested in annuity products, they find choosing between specific products too difficult[8] highlighting the critical role of guidance and financial advice in encouraging people to use annuities more.

Another explanation for the annuity puzzle is that people tend to underestimate their longevity. There is strong evidence that this underestimation of longevity explains why people choose not to purchase annuities. If you are helping people plan for retirement, ensuring they adequately understand life expectancy and their future lifespan will help them make better choices about retirement products[9].

A related factor is mortality salience, the acknowledgement that death is inevitable. "You have to think about dying—that's part of the annuity process, and when people do that, it turns them away." Gergana Nenkov, Carroll School of Management Associate Professor of Marketing.[10]

MORE ATTRACTIVE FRAMING

In recent years, researchers have examined the behavioural economics of retirement savings, focused on improving the understanding of how people make decisions about retirement products. The term framing is used to describe the way choices are described and presented. When choices are presented in a way that highlights the positive or negative aspects of the same decision, it leads to changes in their relative attractiveness. Framing is discussed in Tversky and Kahneman's development of prospect theory which is a theory that explains how individuals decide between two options that involve differently perceived probable outcomes[11].

Several researchers have been exploring the way framing might be used to increase the attractiveness of annuities[12]. For example, research has found evidence that annuities are more attractive when presented in a consumption rather than an investment frame.[13]

The consumption frame uses the terms "*spend*" and "*payments*" and only mentions the money generated each month. The investment frame uses the terms "*invest*" and "*earnings*" and discusses technical product features. Respondents consistently prefer annuities as a financial product when presented in a consumption frame.

This is the approach adopted by QSuper (now Australian Retirement Trust) for their lifetime income product. Rather than referring to longevity risk, the message is that the product provides "income for the rest of your life, so you can enjoy life after work with confidence"[14].

An extension of the consumption versus investment frame is to frame an annuity as a form of insurance. We all use insurance to protect important possessions such as our houses and cars. We also insure our lives to make sure our dependents are looked after. A paper by Jeffery Brown et al asks, "*Why Don't the People Insure Late Life Consumption?*"[15]

This paper looks at why lifetime income product providers don't use the consumption and insurance frame and concludes that "in a consumption frame, annuities are viewed as valuable insurance, whereas in an investment frame, the annuity is a risky asset because the payoff depends on an uncertain date of death".

Superannuation funds and financial planners are very comfortable talking to their members and customers about investment products. The aim is to build up a nest egg for retirement.

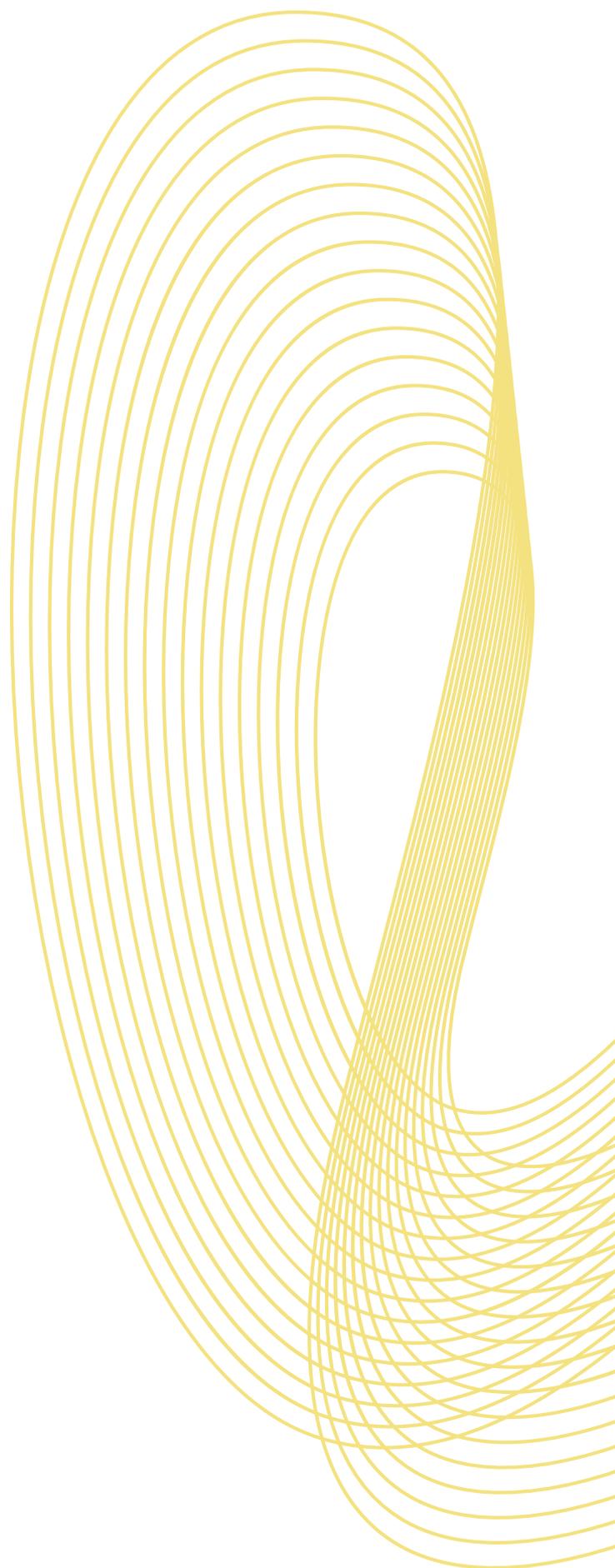
A change in the language from saving for retirement to spending in retirement is required. It also requires additional personalised information about the individual.

NOT THE END.

We need to tackle the annuity puzzle. The Retirement Income Review observed that "without longevity protection people would not have the confidence to completely use their assets." The transition to retirement is complex, and individuals have many decisions to deal with, not just financial product ones. When helping members with their retirement planning, superannuation funds would do well to heed the advice of Moshe Milevsky, Professor of Finance at York University and widely acknowledged global annuity guru, to "balance emotion and math." [16]

Similarly, David Bell, Executive Director of the Conexus Institute, calls for "further work is needed on both rational and behavioural reasons, as well as the interaction between the two." [17]

Optimum Pensions looks forward to continuing its work and partnering with superannuation funds, financial advisors and the Government to advance this research, including the implications for talking about retirement product choices, how individuals think about longevity risk and how information about these topics is best presented.





ABOUT THE AUTHOR

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