Supply Side Resistance to Lifetime Annuities

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The annuity puzzle

• Behavioural biases, misunderstandings and vested interests
• Demand side exaggerations
• Supply side explanations

• To what extent could vested interests and provider and regulator biases and misunderstandings explain lack of supply, and discouragement of demand?
Bounded Rationality

• Behavioural biases
  – Utility models suggest a role for lifetime annuities
  – Absence of annuity demand blamed on framing, risk aversion, myopia …

• Misunderstandings
  – … value for money, longevity risks

• Personal interests
  – Commissions and funds under management
  – Complexity needs an explanation
Demand side exaggerations

- Materiality
- The bequest motive
- The precautionary motive/liquidity preferences
- Annuities are too risky
- Poor value for money
- Advice is too expensive
Immateriality doesn’t apply

- CIPR Consultation suggested + 30% from annuities
  - ASFA’s response questioned this – without explanation
- For shorter expectancies, life annuities pay more and insure more risk, so where are the enhanced annuities? (>30% of market in UK)

<table>
<thead>
<tr>
<th>LIFE EXPECTANCY IN YEARS (1)</th>
<th>ANNUITY INCOME AT 4% INTEREST (2)</th>
<th>YEARS TO 95% PROBABILITY OF SURVIVAL (3)</th>
<th>RATIO OF (3) TO (1) (4)</th>
</tr>
</thead>
<tbody>
<tr>
<td>30</td>
<td>6%</td>
<td>44</td>
<td>1.5</td>
</tr>
<tr>
<td>20</td>
<td>7½%</td>
<td>32</td>
<td>1.6</td>
</tr>
<tr>
<td>10</td>
<td>12½%</td>
<td>20</td>
<td>2.0</td>
</tr>
</tbody>
</table>
Bequest motive doesn’t apply

- Little evidence of actively planned bequests in mid-market
- Little survey evidence of bequests being high priority
- Evidence that bequest motive rationalises precautionary motive
- Bequest motives continue to be emphasised by industry (and academics)
Precautionary motive overblown

- Concerns about medical costs and aged care overblown (outside USA)
- Precautionary savings / liquidity requirements / buffer should be spent in emergencies and then rebuilt
- Theoretical and heuristic suggest buffer of 3 months to 2 years of spending
- Industry suggests $200,000 = 8 years of spending for those on the Age Pension
Annuities are not risky

• Clearly a framing problem
  – When seen as a consumption plan, risk is reduced both for individuals and the wider family
  – Statement “annuities are risky” is nevertheless repeated by advisors and institutions

• Concerns about the solvency of the annuity provider are valid but are overblown as they apply to all financial institutions

• Reputational concerns for the provider can be managed at the point of sale
Advice is too expensive

- Members do need personal assurance
- The scope and cost of advice blown out:
  - Choice of fund and investments (exit vs voice)
  - Complexity of tax and means tests
  - Intrusive regulation of financial advice
- System (compulsion, choice and complexity) seems designed to maximise opportunities for incumbents to extract fees
- Industry super slow to offer income illustrations
Supply side explanations

- Industry is conflicted because of threat to income
- Inappropriate financial metrics
- Regulatory complexity
- Managerial complacency
Industry is conflicted

<table>
<thead>
<tr>
<th>Pot size (excluding Lump Sums)</th>
<th>Number of annuity sales</th>
<th>Number entering drawdowns</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Regulated advice</td>
<td>Pension Wise guidance</td>
</tr>
<tr>
<td>&lt; £10,000</td>
<td>26%</td>
<td>540%</td>
</tr>
<tr>
<td>£10,000 - £29,000</td>
<td>19%</td>
<td>54%</td>
</tr>
<tr>
<td>£30,000 - £49,000</td>
<td>16%</td>
<td>51%</td>
</tr>
<tr>
<td>£50,000 - £99,000</td>
<td>14%</td>
<td>81%</td>
</tr>
<tr>
<td>£100,000 - £249,000</td>
<td>10%</td>
<td>104%</td>
</tr>
<tr>
<td>≥ £250,000</td>
<td>3%</td>
<td>43%</td>
</tr>
<tr>
<td>All pot sizes</td>
<td>7,548</td>
<td>10,739</td>
</tr>
</tbody>
</table>


- Advisors lost commissions, and now lower FUM and fees; because no longer a need to advise on amounts to drawdown or investments
- Funds lose FUM, either in insurers or retirees drawn down faster (because they leave no bequests)
### Inappropriate financial metrics

More profitable?
- A. Customer who costs $70 pays $100, or
- B. Customer costs $30 and pays $50.

If you choose B, you close rural branches, and discourage lower income clients (i.e. those who might want annuities).

More profitable if CoC 10%?
- A. $100m project that earns 20%
- B. $300m project that earns 15%

If you choose A, you avoid foreign markets, sell Australian insurance subsidiaries, and avoid capital hungry products like annuities.

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### KEY LONG TERM OBJECTIVES

<table>
<thead>
<tr>
<th>NPS</th>
<th>COST TO INCOME RATIO</th>
<th>ROE</th>
<th>EMPLOYEE ENGAGEMENT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Positive and #1 of Australian major banks for our priority segments</td>
<td>Towards 35%</td>
<td>#1 of Australian major banks</td>
<td>Top quartile</td>
</tr>
</tbody>
</table>

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7 Refer to key risks, qualifications and assumptions in relation to forward looking statements on page 7.
Regulatory complexity

• Cynical capture by incumbents
• Regulatory and industry inattention
  – Ongoing demand for more guidance
  – Shift of onus from industry to regulators

• ATO confuses mortality credits with additional contributions
Managerial Complacency

• Significant issue in literature
  – Berle and Means (1932) 25,000+ citations
  – Jensen and Meckling (1976) 100,000+ citations

• “Superannuation is biggest and among the best in the world”
  – Little evidence that funded pensions makes a significant difference
  – Compare Netherlands/Belgium; UK/France; Australia/NZ

• ‘Rivers of gold’ from contributions
  – SG debate
Challenges

If there are supply side obstacles:

• Trustees and advisors: focus on clients not size
• Government: simplify and give data to advisors
• Academics: investigate supply side more thoroughly