Paying for Retirement: Enhancing the Allure of Annuities

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Australians have shown a marked preference for cashing out their superannuation nest eggs, rather than converting them to annuities. But that's not the case everywhere. In Switzerland, about half of the accumulated pension wealth is annuitised, partly due to the structure of its three-pillar pension system. However, the popularity of annuities among Swiss retirees has declined recently, and research by Monika Bütler, dean of the School of Economics and Political Science at University of St Gallen, reveals that means-tested benefits may be the cause. While experts contend annuities present an obvious solution to funding increasingly longer retirement periods, Bütler's findings offer insights for Australian policymakers who are grappling to find ways of encouraging an ageing population to fund its own post-working years. One good reason for Australians to reconsider annuities, as Bütler outlines to Julian Lorkin of Knowledge@Australian School of Business, is as an insurance against the government continuing to change the rules.

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An edited transcript of the interview follows.

Knowledge@Australian School of Business: Monika, first up can you please explain how people pay for retirement in Switzerland?

Monika Bütler: Yes, it's a bit more complicated than here. The Swiss have a three-pillar pension system. The first pillar is very common in European countries, it's a pay-as-you-go system and it provides a basic income stream in old age. The second pillar is a mandatory occupational pension system – it's fully funded and it's actually intended to top up first-pillar benefits to live a decent life. Then there are some tax-favoured third-pillar pension savings, and on top of all of this are means-tested benefits, which guarantee that everybody in old age has a decent life.

Knowledge@Australian School of Business: There seems to be more than a decent life in Switzerland where there's a guaranteed income in old age of 3000 Swiss francs a month, or roughly A$3250. That seems like a very large safety net.

Monika Bütler: It is large, but it is not as large as you might think because the cost of living in Switzerland is quite a bit higher than in Australia. So I would say that $3250 would come down to about A$2500 dollars in purchasing power parity, and probably less in bigger cities. But it's still a lot of money.

Knowledge@Australian School of Business: Even taking into account purchasing power parity, there must be debate in Switzerland about how much it's actually costing the state.

Monika Bütler: It's not really in the political debate at the moment, but people are starting looking into the area and realising it costs a lot more than they actually thought. The second pillar became mandatory about 25 years ago to make people save for a decent living on their own, and still the means-tested benefits have not decreased – rather they have gone up in recent years.

Knowledge@Australian School of Business: Means-tested benefits must be fairly expensive. What are the alternatives that the state is trying to push people towards?

Monika Bütler: Means-tested benefits are pretty expensive. There are actually two things that are being

discussed at the moment. One is providing insurance for long-term care – that's actually one reason why the means-tested benefits are so high. And the other is limiting the cash-out of second-pillar pension wealth to a level that allows people to really get the consumption floor provided by means-tested benefits. That means they would be forced to at least annuitise part of their accumulated pension wealth.

Knowledge@Australian School of Business: So the Swiss government is actually pushing annuities then?

Monika Bütler: It's not really pushing annuities. The Swiss system has a completely different history so the second pillar was actually first. There was no pay-as-you-go system until the 1950s, and most companies actually offered occupational pension benefits. So the people really see occupational pensions as a lifelong annuity and not predominantly as a cash-out.

Knowledge@Australian School of Business: Very few individuals annuitise voluntarily though. Why is this? Why are people not looking at this option unless they're really forced to do it?

Monika Bütler: No, they actually do annuitise to a quite large degree. About 50% of the accumulated pension wealth is annuitised – that's down from almost 100% 20 years ago – but still it's a lot higher than in most other countries. Usually higher income people annuitise while lower income people are more likely to cash out.

Knowledge@Australian School of Business: Why have we got this split between those people who have got a fair amount of wealth who really are looking at insuring to pay for old age, whereas those who are not so well off like to depend on the state?

Monika Bütler: My interpretation is that it has to do with the means test. If I'm a rich person and I get a decent annuity, I would have to spend down my money really quickly to get to a consumption floor that's at a much lower level than I would consider provides a decent life. For me – and others in good positions – it's not an option to run down pension wealth. For somebody who would reach the level guaranteed by means-tested benefits, there's no real incentive to annuitise. He or she is much better off just cashing out, spending the wealth and then applying for the means-tested benefit.

Knowledge@Australian School of Business: So, do means-tested benefits reduce the demand for annuities?

Monika Bütler: Well, you can never prove it. If you ask people they would say, "Ah no, that's not the reason I cashed out". But our data and the simulation we run with our model are pretty consistent. We actually predict that low-income people will cash out and we see exactly the same cash-out rates in the data.

Knowledge@Australian School of Business: So you have a fairly accurate simulation then. Can you explain how this works?

Monika Bütler: To simulate people's behaviour after retirement, including investment in risky and non-risky assets, we take inflation into account and we go through all the different portfolio choices. We then compare it to a situation in which a person annuitises their entire pension wealth, in which case there is not much saving to be done. So it's a fairly complicated set up, particularly to pick up all the different insurance motives people have.

Knowledge@Australian School of Business: But can it pick up moral hazard? I'm thinking here of people who don't mind how carelessly they live and spend freely as soon as they retire because they know that the state is still going to look after them.

Monika Bütler: Yes – that's central to the model, which is optimised from an individual point of view. If it's more profitable for me to cash out, I cash out. We call this moral hazard, and it is from the point of view of the state. But from the individual point of view, it's just optimal decision-making.

Knowledge@Australian School of Business: Is there any way to reduce the burden on the state?

Monika Bütler: Yes, there are two reasons for this burden: The first is that nobody has an incentive to annuitise because there is a quite huge help when people are in long-term care. And the second is that it

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would be good to actually avoid this thinking right from the start by forcing people to annuitise a higher degree of their pension wealth. You could also tighten the means test. If I compare the Swiss to the Australians, the Australians are much more generous. If you remove any wealth – if you just force people to completely deplete their wealth – quite a few more would actually voluntarily annuitise.

Knowledge@Australian School of Business: Have you done any simulations of the right level for this, to actually reduce those means-tested benefits?

Monika Bütler: It's difficult to say what is the right level. The means test in Australia is so generous that I'm not surprised the take-up rate for annuities is so low. For an individual, it's always better to have a generous means test – and for the state, it's just the opposite.

Knowledge@Australian School of Business: Politicians also have this dilemma of knowing that if they tighten up the means-tested benefit, fewer people will vote for them.

Monika Bütler: That's true – and nobody actually congratulates them on saving lots of taxpayers' money.

Knowledge@Australian School of Business: What's the alternative then? If we're designing a system from scratch – the Australian system obviously has some benefits in terms of forcing people to save for their old age, but as soon as they retire they can do whatever they want to. Whereas the Swiss system seems to be very carefully designed to try to ensure that, if people do have a lot of cash, they'll go for annuities. Is there any way we can combine the two?

Monika Bütler: That's a difficult question. It depends on what individuals prefer. When I talk to people here, I think it would be very hard to convince them to change the system – because they think if they are forced to save for old age, there should at least be some spending autonomy later. The Swiss grew up with a completely different system – it was always framed in terms of lifelong annuities. So we are actually used to translating our accumulated pension wealth into an annuity. It's much less difficult to convince them that annuitising is a good thing to do.

Knowledge@Australian School of Business: It seems almost as if, instead of having various different means-tested benefits or annuities, what we need to do is just communicate to people what is going to happen to them when they retire and why they need to save.

Monika Bütler: One point is that you never know what the government will do in 20 years. They could reduce the means-tested benefits. So an annuity would be insurance against the government changing the rules.

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