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Encouraging superannuation income streams with tax-free earnings to be taken in a form that provides longevity insurance

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Abstract
Australia's superannuation system allows those entering retirement to take their benefits in the form of an income stream which benefits from tax-free earnings. Currently, very few income stream benefits are taken in the form of a lifetime annuity even though such an instrument provides an excellent form of longevity insurance. The Australian Government is currently implementing changes that expand the tax-free earnings net to include Deferred Life Annuities and Group Self-Annuitisation Schemes. This paper finds that this is a positive move that will potentially benefit many retirees. The government is also considering implementing some behavioural tools which include a regime under which superannuation trustees choose a pre-packaged bundle of income stream products that include annuities. Members entering retirement would actively choose to adopt these products. It is argued that such a regime would be a negative policy development that would result in many retirees annuitising to a non-optimal extent.

Key words: superannuation, annuities, retirement policy, income streams

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1. INTRODUCTION

Australia has had compulsory superannuation for more than 20 years. During that time, the system has changed substantially. As the population ages, rules that affect the operation of the superannuation system for those in retirement will become increasingly important.

Under the current law, retirees able to access their superannuation are given close to unfettered freedom as to how they receive their funds. They can take their superannuation in any combination of a lump sum or a superannuation income stream, with the income streams option benefitting from tax-free earnings.[2] For those who choose to take all of part of their funds in the form of an income stream, only a small minority do so in the form of a lifetime annuity.[3] This is surprising, given that lifetime annuities provide a return free from investment and longevity risk, and if appropriately indexed, from inflation risk as well.[4] A risk-free income stream can be appealing to many retirees at a time in their life when their ability to earn income from labour is often limited.

Recently, there has been policy discussion and legislative changes regarding superannuation income streams, some of which has concentrated on increasing the uptake of life annuities and similar instruments. Specifically, the government has started the process of legislating to broaden the range of life annuities that are covered by the superannuation system and so benefit from tax-free earnings. There has also been policy discussion about behavioural techniques that could increase the uptake of superannuation income streams, and in particular encourage partial annuitisation of superannuation funds. Proposed behavioural policies include presenting those about to enter retirement with a pre-arranged package of income streams that typically include partial annuitisation as well as mandating certain disclosures on superannuation benefit statements.

Part 2 of this article describes the relevant current law, with an emphasis on superannuation income streams. Part 3 then examines the reasons for the traditional unpopularity of annuities in Australia and in many overseas jurisdictions. Part 4 critically evaluates reforms made to expand the range of annuity-like instruments that qualify as superannuation income streams that can benefit from tax-free earnings. Part 5 describes and evaluates proposed behavioural tools to harness the behavioural biases which could, among other things, increase the uptake of annuities. Part 6 concludes this assessment.

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[2] *Income Tax Assessment Act 1997* (Cth) ss 295-385, 295-390, 295-395, *Income Tax Assessment Regulations 1997* (Cth) reg 995.1.01.

[3] David Murray, Kevin Davis, Craig Dunn, Carolyn Hewson and Brian McNamee, *Financial System Inquiry Final Report* (2014) 120 <http://fsi.gov.au/files/2014/12/FSI_Final_Report_Consolidated20141210.pdf>.

[4] 'Investment risk' refers to the risk of assets under-performing more than expected (which includes declining in value). 'Inflation risk' refers to the cumulative effect of inflation reducing the consumption ability of an income stream over time. 'Longevity risk' is the risk of outliving one's retirement savings. See Janemarie Mulvey and Patrick Purcell, 'Converting Retirement Savings into Income: Annuities and Periodic Withdrawals' 2–4 (R40008 Congressional Research Service Report for Congress, 2008).

2. CURRENT LAW REGARDING SUPERANNUATION TAXATION

Australia's superannuation system is characterised by individual accounts. In most cases, employers must make compulsory contributions to these accounts where the employee earns at least $450 a month.[5] Employers' mandated contributions are currently set at a rate of 9.5% of salary, although from 1 July 2021 this will start to increase incrementally to 12%.[6] Voluntary contributions can also be made by the account holders and their employers.[7] Account funds are invested, and in general can only be accessed for personal use in retirement.[8]

Superannuation is subject to highly concessional tax treatment. Specifically, it is potentially taxed at three points. The first is when funds are contributed to the superannuation account, the second is when the superannuation investments earn a return, and the third is when funds are withdrawn from the superannuation system.

2.1 Superannuation contributions

Superannuation contributions paid by the employer, as well as tax-deductible payments made by individuals to their own superannuation accounts (both termed concessional contributions)[9] are taxed at the rate of 15% in the hands of the fund.[10] As of 1 July 2017 most individuals are able to make such tax-deductible concessional contributions to their own superannuation accounts.[11] Superannuation contributions paid out of post-tax income or savings are termed non-concessional contributions, and given that they are post-tax, are not subject to a contributions tax.[12]

2.2 Superannuation income streams and taxation of earnings

As a background to the taxation of superannuation earnings, superannuation accounts can be either in accumulations or income stream modes. Taxpayers will usually have their accounts in accumulations phase during their working lives, at which time the account can receive contributions. In general, taxpayers who reach their superannuation preservation age and satisfy a condition of release will be able to access their superannuation.[13] Previously the preservation age was 55, but is now rising incrementally to 60.[14]

A taxpayer who reaches the relevant preservation age and fulfils any other necessary conditions of release is allowed unfettered access to their superannuation funds;[15] they can take it in in any combination of a lump sum and income stream. The law does not prescribe a default choice for members regarding the form of retirement benefits to be taken.

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[5] *Superannuation Guarantee (Administration) Act 1992* (Cth).
[6] Ibid s 19(2).
[7] *Income Tax Assessment Act 1997* (Cth) ss 291-25, 292-90.
[8] *Superannuation Industry (Supervision) Regulations* 1994 (Cth) sch 1 Item 101, reg 6.01.
[9] *Income Tax Assessment Act 1997* (Cth) s 292-25.
[10] Ibid s 295-160.
[11] *Income Tax Assessment Act 1997* (Cth) ss 280-10, 290-150, 290-160 as amended by *Treasury Laws Amendment (Fair and Sustainable Superannuation) Act 2016* (Cth) sch 5.
[12] Ibid s 292-90.
[13] *Superannuation Industry (Supervision) Regulations* 1994 (Cth) Sch 1.
[14] Ibid reg 6.01.
[15] Ibid sch 1 Item 101, reg 6.01.

If a taxpayer withdraws funds in the form of an income stream, all or a portion of their accumulations account is converted into an income stream account. Such accounts cannot receive further deposits once created.[16] There are two main forms of income stream accounts: account-based pensions and annuities.[17] In reality, the overwhelming number of retirees choose an account-based pension.[18] In the case of an account-based pension, the funds are invested and the holder is allowed to make withdrawals at will.[19] However, account-based pensions are subject to age-based minimum withdrawal limits.[20] There are no maximum withdrawal limits. In other words, the operation of an account-based pension is in many ways similar to a superannuation account in accumulations mode, except for the minimum withdrawals and the account's inability to receive deposits.

The other income stream option is an annuity. Here the taxpayer uses a lump sum portion of their superannuation balance to purchase a regular annuity income stream.[21] Such annuities can be either term or life annuities.[22] A retiree with a life annuity will receive an income stream for the rest of their lives, meaning that their income is free from investment and longevity risk, and if indexed, from inflation risk as well.[23] The annuity payments are usually received regularly, and until 1 July 2017 had to be paid at least annually.[24] Annuity income streams can be either fixed or indexed to a set percentage, the Consumer Price Index (CPI), or to Average Weekly Earnings (AWE). If the income stream is linked to CPI or AWE, the indexation factor can be capped by the annuity contract.[25]

Earnings of accounts supporting a superannuation income stream (whether that be an account-based pension or annuity) are tax-free.[26] In contrast, earnings of an accumulations superannuation account are taxed at the rate of 15%.[27] This is still highly concessional compared with investments held in the name of a full-time salary earner, which are taxed at normal individual marginal tax rates, although some concessions are available for directly held investments, including the 50% discount to which most capital gains are subject.[28] Under recent legislation, from 1 July 2017 each taxpayer will be limited to assets worth a maximum of $1.6 million benefiting from tax-free income streams.[29]

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[16] Ibid sub-regs 1.05(1)(a)(ii), 1.06(1)(a)(ii).

[17] *Income Tax Assessment Act 1997* (Cth) s 307-70, *Income Tax Assessment Act Regulations 1997* (Cth) reg 995-1.01. As discussed in Part 4 of this article, as from 1 July 2017, there is a third type of income stream which has its main requirements specified in *Superannuation Industry (Supervision) Regulations 1994* (Cth) reg 1.06A.

[18] Australian Prudential and Regulation Authority, *June 2016 Annual Superannuation Bulletin*, 21 <http://www.apra.gov.au/Super/Publications/Documents/2017ASBEXCEL201606%20-%20PDF.pdf>.

[19] *Superannuation Industry (Supervision) Regulations 1994* (Cth) reg 1.06.

[20] Ibid sub-reg 1.06(9A).

[21] Ibid sub-regs 1.05(1), 1.05(11A).

[22] Ibid sub-reg 1.05(11A).

[23] Mulvey and Purcell, above n 4, 2–4.

[24] *Superannuation Industry (Supervision) Regulations 1994* (Cth) reg 1.05 later amended by *Treasury Laws Amendment (Fair and Sustainable Superannuation) Regulations 2017* (Cth).

[25] Ibid sub-regs 1.05(11A), 1.05(13).

[26] *Income Tax Assessment Act 1997* (Cth) ss 295-385, 295-390, 295-395, *Income Tax Assessment Regulations 1997* (Cth) reg 995.1.01.

[27] *Income Tax Rates Act 1986* (Cth) ss 26(1), 27(1), 27A.

[28] *Income Tax Assessment Act 1997* (Cth) div 115.

[29] *Treasury Laws Amendment (Fair and Sustainable Superannuation) Act* 2016 (Cth) sch 1, pt 1.

2.3 Withdrawal of superannuation benefits

Although the earnings of superannuation income streams are tax-free, receipt of the income stream withdrawals in the hands of the retiree is potentially subject to tax. In the case of an account-based pension this will be the amount withdrawn, and in the case of an annuity this will be the annuity payments. To the extent that an income stream receipt can be traced back to non-concessional contributions, it will not be subject to tax;[30] this is referred to as 'the tax-free component'.[31] The rest of the income stream receipt will include portions traceable to the concessional contributions and earnings; this is referred to in the legislation as 'the taxable component'.[32] In general, taxable components received by those at least 60 years of age are tax-free,[33] while those received by those who have reached preservation age but are under 60 will be taxed at their marginal tax rate, subject to a 15% offset.[34] As the preservation age has been legislated to rise to 60, increasingly the overwhelming number of retirees who get income stream payments will not pay tax on them.[35]

3. ADVANTAGES OF LIFE ANNUITIES AND THEIR LACK OF POPULARITY IN AUSTRALIA

Life annuities are unpopular in Australia[36] and many other countries.[37] Specifically, although in dollar terms just over 50% of superannuation benefits are taken in the form of an income stream rather than a lump sum,[38] only about 7% of income stream accounts are annuities (including both life and term annuities).[39] The unpopularity of life annuities, despite their provision of a number of marked advantages, is known internationally as 'the annuity puzzle'.[40] A number of possible explanations for their lack of popularity have been suggested, although the relative importance of each reason and the precise ways in which the reasons relate to each other are far from certain.

3.1 Advantages of lifetime annuities

A traditional life annuity offers an income stream that is free from investment risk, longevity risk, and if indexed, to inflation risk as well.[41] Given that retirees are generally at a time in their lives where their ability to earn income from their labour is limited, it is logical that a risk-free income stream would be of value to many. Further, theoretically annuities can provide more income in retirement as compared to account-

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[30] *Income Tax Assessment Act 1997* ss 301-10, 301-15.
[31] Ibid subdiv 307-C.
[32] Ibid subdiv 307-C.
[33] Ibid s 301-10.
[34] Ibid s 301-25.
[35] *Superannuation Industry (Supervision) Regulations 1994* (Cth) reg 6.01.
[36] Murray et al., above n 3, 125.
[37] Jeffrey R Brown, 'Financial Education and Annuities' 181–82 (2008/3 OECD Journal: General Papers, OECD, 19 Feb 2009). Although Murray et al., above n 3, 125 claims that they are popular in many other jurisdictions, this is not necessarily the case in most jurisdictions where annuities are not mandated.
[38] Australian Prudential and Regulation Authority, above n 18, 12.
[39] Ibid 21.
[40] Jeffrey R Brown, Marcus D Casey and Olivia S Mitchell, *Who Values the Social Security Annuity? New Evidence on the Annuity Puzzle* (National Bureau of Economic Research, Working Paper No 13800, December 2007) <http://www.nber.org/aging/rrc/papers/orrc07-02.pdf>.
[41] Mulvey and Purcell, above n 4, 2–4.

based pensions.[42] This is due to the fact that a phased withdrawal product such as an account-based pension presents the retiree with a trade-off between under-consuming and thus self-insuring against the risk of living materially longer than their actuarially expected age, and not under-consuming but facing the real risk of running out of funds if one does live longer than actuarially expected.[43] A lifetime annuity, on the other hand, sidesteps this problem by in effect basing annuity payments on expected longevity, with those living longer than expected benefiting at the cost of those living shorter than expected.[44]

3.2 Reasons for lack of popularity

There are a number of reasons why life annuities are unpopular. Some of these reasons relate to the inherent nature of such annuities. These reasons include a desire to bequeath wealth,[45] wanting to maintain liquidity for unforeseen expenditure,[46] and the availability of other investment opportunities.[47] Further, a bequest motive need not in many cases rule out partial annuitisation of retirement funds, given that retirees do, to some degree, trade-off wealth to be used by themselves and for their heirs.[48] Also, the ability of many to receive the age pension further discourages annutisation as pre-existing annuities (such as the age pension) dampen annuity demand.[49] While it could be argued that the government could theoretically change this by drastically reducing entitlements to the age pension, the reality is that this is highly unlikely to occur, meaning that this could be considered a largely unchangeable reason for limited annuity demand.

There are, however, reasons for not annuitising which could to some extent be abated by government policies. One of these concerns the price of annuities,[50] given that the evidence indicates that the expected income stream of annuities exceeds their price.[51] This itself is attributable to several factors. The first is that annuity issuers have costs, and also need to make a profit. The second concerns what is known as the 'adverse selection' effect, which is a phenomenon resulting from asymmetrical access to

[42] Jeffrey R Brown, 'Rational and Behavioral Perspectives on the Role of Annuities in Retirement' (Working Paper No. 13537, National Bureau of Economic Research, October 2007) 4–6, 35.
[43] Ibid.
[44] Ibid.
[45] Jeffrey R Brown, Jeffrey R Kling, Sendhil Mullainathan and Marian V Wrobel, 'Why Don't People Insure Late-Life Consumption? A Framing Explanation of the Under-Annuitization Puzzle' (2008) 98 *American Economic Review (Papers and Proceedings)* 304, 307. But see Jeffrey R Brown, 'Private Pensions, Mortality Risk, and the Decision to Annuitize' (2001) 82 *Journal of Public Economics* 29, 56–58; Brown, Casey and Mitchell, above n 40, 11.
[46] Sid Browne, Moshe Milevsky and Thomas Salisbury, 'Asset Allocation and the Liquidity Premium for Illiquid Annuities', (2003) 70 *Journal of Risk and Insurance* 509.
[47] Moshe A Milevsky, 'Optimal Annuitization Policies: Analysis of the Options' (2001) 5(1) *The North American Actuarial Journal* 57, 65–66.
[48] Thomas Davidoff, Jeffrey R Brown and Peter A Diamond, 'Annuities and Individual Welfare' (2005) 95 *American Economic Review* 1573, 1583.
[49] Irena Dushi, and Anthony Webb, 'Household Annuitization Decisions: Simulations and Empirical Analyses' (2004) 3 *Journal of Pension Economics and Finance* 109, 131–34; Fedor Iskhakov, Susan Thorp and Hazel Bateman, 'Optimal Annuity Purchases for Australian Retirees' (2015) 91 *Economic Record* 139, 146.
[50] Monika Bütler, Stefan Staubli and Maria Grazia Zito, 'The Role of the Annuity's Value on the Decision (Not) to Annuitize: Evidence from a Large Policy Change' 27 (Discussion Paper No DP6930, Center for Economic Studies, August 2008); Brown, Casey and Mitchell, above n 40, 8.
[51] Jeffrey R Brown, Olivia S Mitchell and James M Poterba, 'The Role of Real Annuities and Indexed Bonds in an Individual Accounts Retirement Program' 58 (Working Paper No 7005, National Bureau of Economic Research, 1999) <http://www.nber.org/papers/w7005.pdf >.

information in certain markets such as annuity markets.[52] Specifically, in the annuity market, annuity purchasers are skewed towards those who believe they will have high longevity, which leads to higher annuity prices due to longer payout periods, which then leads to a spiral of ever-higher annuity prices and the purchaser base being increasingly skewed towards those perceiving themselves as likely to have high longevity.[53] These two factors are interlinked, in that higher annuity prices due to costs and need to make a profit can increase the adverse selection effect.[54]

Another reason for low annuity demand that could be abated is that of incomplete annuity markets.[55] Specifically, in some cases there is an insufficient range of annuity products to reflect the needs of some retirees.[56] Examples include the fact that traditional annuity products do not give the holder access to the equity premium available on share investments, and that they only offer the holder a limited ability to liquidate the annuity in case of a consumption shock such as long-term nursing home care.[57] Further, there is some equivocal evidence that another potentially rectifiable issue negatively affecting annuity demand is that consumers lack education concerning how they operate.[58] There is also evidence that supply side constraints have limited the annuity market due to factors such as the limited ability of annuity issuers to insure against some of their risks.[59]

Behavioural reasons also contribute to low annuity demand, which also could in theory be abated to some degree by government policy. Specifically, research has indicated that people are loss-averse, and so disvalue a dollar lost more than they value a dollar gained.[60] This means that as far as annuities are concerned, people will be more averse to the risk of dying shortly after purchasing their life annuities, compared with the potential upside of outliving their predicted life expectancy and receiving more annuity payments than expected.[61] Further, an interrelated but separate factor is the human tendency to overweigh small risks,[62] meaning that people will perceive the risk of an early death to be higher than is actually the case.[63] Another interrelated behavioural factor is that buying annuities from large institutions is potentially viewed by a retiree as an unfair bet with that institution.[64]

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[52] George A Akerlof, 'The Market for "Lemons": Quality Uncertainty and the Market Mechanism' (1970) 84 *Quarterly Journal of Economics* 488.

[53] Amy Finkelstein and James Poterba, 'Selection Effects in the United Kingdom Individual Annuities Market' (2002) 112 *The Economic Journal* 28, 29–30.

[54] William Gentry and Casey Rothschild, 'Enhancing Retirement Security Through the Tax Code: The Efficacy of Tax-Based Subsidies in Life Annuity Markets' (2010) 9 *Journal of Pension Economics & Finance* 185, 190.

[55] Brown, above n 37, 15–17.

[56] Ibid.

[57] Ibid.

[58] Ibid 20–22.

[59] Hazel Bateman and John Piggot, 'Too Much Risk to Insure? The Australian Non-market for Annuities' in Olivia S Mitchell, John Piggott and Noriyuki Takayama (eds), *Securing Lifelong Retirement Income: Global Annuity Markets and Policy* (Oxford University Press, 2011) 81, 101.

[60] Daniel Kahneman and Amos Tversky, 'Prospect Theory: An Analysis of Decision Under Risk' (1979) 47 *Econometrica* 263, 279.

[61] Wei-Yin Hu and Jason S Scott, 'Behavioral Obstacles in the Annuity Market' (2007) 63(6) *Financial Analysts Journal* 71, 76.

[62] Kahneman and Tversky, above n 60, 280–84.

[63] Hu and Scott, above n 61, 76.

[64] Rami Hanegbi, 'Security in Uncertain Times: Policies for Increasing the Popularity of Life Annuities Among Retirees' (2013) 20 *Virginia Journal of Social Policy & the Law*, 473, 489–90.

Other interrelated behavioural reasons also contribute to diminished annuity demand. One of these is related to 'framing', in that people commonly perceive annuities as poor investments given that their discounted expected income stream exceeds their price.[65] In contrast, when people see annuities from a consumption perspective, they find them substantially more attractive because such annuities help maximise consumption, as they provide a form of longevity insurance, which alleviates the need for people to under-consume so as to self-insure against such a risk.[66] The importance of framing is reflected by international evidence that found that annuitisation rates are increased by retirement plan member benefit statements including predicted annuitised entitlements.[67] Another behavioural reason is that of 'mental accounting', in that a typical retiree upon purchasing an annuity will be giving up an entitlement to a lump sum in return for a series of comparatively low payments, which can instinctually seem like a bad deal.[68] This is related to another behavioural reason, that of the 'illusion of wealth', where at least up to a certain point, lump sums are subjectively perceived as more adequate for funding retirement than their annuitised equivalent.[69] Also worth mentioning is that one more behavioural reason for low annuity demand is the 'illusion of control', where some people have a bias towards overvaluing and overestimating the control that they have over a lump sum amount which leads to a reluctance to lose control of their funds through annuitisation.[70]

3.3 Reforms

In 2014 the government undertook an inquiry into the Australian financial system. Consequently, in mid-2014 the interim Financial System Inquiry Report ('Interim Report') was released,[71] followed by the release of the final Financial System Inquiry Report ('Final Report').[72] These reports included policy discussions regarding increasing the development and uptake of superannuation income streams.[73] Broadly, the Final Report's recommendations could be placed into two categories. The first type of policy recommendation involves expanding the range of annuity-like instruments constituting a superannuation income stream that can benefit from tax-free earnings.[74] The second type involves harnessing the power of behavioural tools. One of the behavioural tools suggested by the Final Report is to offer those about to enter retirement a pre-packaged collection of income streams, called Comprehensive Income Products for Retirement (CIPR). These would typically include annuities or annuity-like instruments.[75] Another such tool is to mandate superannuation benefit statements to include the member's income stream entitlements along with the amount of

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[65] Brown, Kling, Mullainathan and Wrobel, above n 45, 304, 305–07.
[66] Ibid.
[67] Shlomo Benartzi, Alessandro Previtero and Richard H Thaler, 'Annuitization Puzzles' (2011) 25(4) *Journal of Economic Perspectives* 143, 155–56.
[68] Ibid 157.
[69] Daniel G Goldstein, Hal E Hershfield and Shlomo Benartzi, 'The Illusion of Wealth and its Reversal' (2016) 53 *Journal of Marketing Research* 804, 805–09.
[70] Brown, above n 42, 25–26.
[71] David Murray, Kevin Davis, Craig Dunn, Carolyn Hewson and Brian McNamee, *Financial System Inquiry Interim Report* (2014) <http://fsi.gov.au/files/2014/07/FSI_Report_Final_Reduced20140715.pdf>.
[72] Murray et al., above n 3.
[73] Murray et al., above n 71, Ch 4; Murray et al., above n 3, Ch 2.
[74] Murray et al., above n 3, 120–21.
[75] Ibid 117.

accumulated funds.[76] The government stated, in its response to the Final Report, that it would participate in reform relevant to superannuation income streams.[77]

More detailed discussion relating to expanding annuity-like instruments that constitute superannuation income streams was covered in a 2014 discussion paper, which invited submissions.[78] After consultation, a further paper was released in 2016, making several policy recommendations about widening instruments that constitute superannuation income streams which benefit from tax-free earnings.[79] The government has recently enacted legislation which begins the process of implementing these changes.[80]

In contrast, the reform process concerning CIPRs is only in the preliminary stage. Recently, the government has released a discussion paper relating to the development of CIPRs, and invited submissions.[81] Any possible legislative reform will necessarily take some time to eventuate, and would not commence before mid-2018.[82] There have been no recent government announcements regarding mandating disclosure of income stream benefits on superannuation member statements.

4. BROADENING TYPES OF LIFE ANNUITIES

As discussed, the government has recently begun to make legislative changes to expand the class of annuities and annuity-like instruments that constitute superannuation income streams that can benefit from tax-free earnings.[83] Specifically, these policies are aimed at including Deferred Life Annuities (DLA) and Group Self-Annuitisation (GSA) schemes into the regime. It is worth examining how these instruments operate, the policy behind allowing these instruments to fall under the superannuation tax-free earnings net, and the implementation of the changes.

4.1 Deferred life annuities

A DLA is a lifetime annuity that commences payment only once the holder reaches a pre-determined future age.[84] For instance, a 65 year old, rather than purchasing an immediate annuity, could purchase an annuity that commences payments only when they reach 80 years of age.

DLAs have several advantages that make them potentially more attractive than immediate life annuities. The first relates to their lower cost. A deferred annuity

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[76] Ibid 267.

[77] Commonwealth of Australia, *Improving Australia's Financial System. Government Response to the Financial System Inquiry* (2015) <https://static.treasury.gov.au/uploads/sites/1/2017/06/Government_response_to_FSI_2015.pdf >.

[78] Commonwealth of Australia, *Review of Retirement Income Stream Regulation* (21 July 2014)<https://www.actuaries.asn.au/Library/Events/Other/2014/GovtRetirementIncomesDiscPaper.pdf >.

[79] Commonwealth of Australia, *Retirement Income Streams Review* (May 2016) 2, 10–12 <https://static.treasury.gov.au/uploads/sites/1/2017/06/Review-of-Retirement-Income-Streams.pdf >.

[80] *Treasury Laws Amendment (Fair and Sustainable Superannuation) Act* 2016 (Cth) sch 8.

[81] Commonwealth of Australia, *Development of the Framework for Comprehensive Income Products for Retirement* (December 2016) <https://consult.treasury.gov.au/retirement-income-policy-division/comprehensive-income-products-for-retirement/supporting_documents/CIPRs_Discussion_Paper_1702.pdf>.

[82] Ibid 8.

[83] *Treasury Laws Amendment (Fair and Sustainable Superannuation) Act 2016* (Cth) sch 8; Commonwealth of Australia, above n 79.

[84] Murray et al., above n 3, 126.

potentially covers a smaller portion of the retiree's life than an immediate annuity therefore it will cost substantially less than an immediate annuity. Consequently, because less money is spent on the annuity, less money is 'wasted' on the costs and possible profit margin that such an annuity entails.[85] In other words, because a DLA is targeted at the portion of a retiree's life where longevity is at its most uncertain, its costs are lower than an immediate annuity.

The second reason why a DLA is potentially more appealing than an immediate one is the fact that people have an innate tendency to overestimate small risks (and underestimate large risks).[86] These biases makes a DLA relatively attractive because the overweighing of the small risk of early death and the subsequent loss of the annuity purchase price is less relevant, as a DLA would not cover payments for the early part of retirement, regardless.[87] On the other hand, a DLA, like an immediate life annuity, still benefits from the bias of people tending to underestimate the large risk of dying before a very late age (such as 100) – a bias that contributes to making all life annuities more attractive than they would be without it.[88]

Overall, there appears to be a strong case for bringing DLAs into the tax-free earnings superannuation net. Ultimately, the primary purpose of superannuation is to provide retirees with an income in retirement.[89] As discussed, annuities play an important role in this by providing superior risk-free retirement incomes, as compared with account-based pensions. Given that DLAs can play an important role in providing longevity insurance, and are potentially more attractive to some retirees than immediate life annuities, they should be accorded the same tax-free treatment as immediate lifetime annuities.

4.2 Group self-annuitisation schemes

GSA schemes, as their name suggests, involve the pooling of funds by participants, with the survivors at any point in time receiving a regular income stream.[90] The nature of these schemes distinguishes them from traditional life annuities in two ways. Firstly, systematic longevity risk – the risk of community-wide life expectancies rising more than forecast – is passed on to the annuity holders, meaning that any such rise would lead to lower annuity payments.[91] Secondly, there is a greater investment risk, although this ultimately depends on how the annuity purchase price proceeds are invested.[92]

Due to their different characteristics, pooled annuities such as GSA schemes have several advantages over traditional life annuities. The first is that they are cheaper, and so carry higher expected incomes than traditional annuities.[93] One of the main reasons

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[85] Jason S Scott, John G Watson and Wei-Yin Hu, 'What Makes a Better Annuity?' (2011) 78 *Journal of Risk and Insurance* 213, 228–39; Benartzi, Previtero and Thaler, above n 67, 157.
[86] Kahneman and Tversky, above n 60, 280–84.
[87] Hu and Scott, above n 61, 76. But see Richard L Kaplan and Kate S Poorbaugh 'What's the Matter with Retirement Savers' (2014) 47 *Connecticut Law Review* 1281, 1309 where the authors argue that this feature is a negative of DLAs, as the annuity holder's fear of getting no annuity payment is only increased in a DLA as compared to a traditional annuity given that the DLA has a later commencement of annuity payments.
[88] Ibid.
[89] See Superannuation (Objective) Bill 2016 (Cth) s 5(1).
[90] Murray et al., above n 71, 4–27.
[91] Murray et al., above n 3, 125.
[92] Ibid.
[93] Murray et al., above n 71, 4–27.

for this is related to the passing-on of systematic longevity risk to the annuity purchasers. In a traditional life annuity, the annuity issuer, because it must insure against such a risk, needs to hold a larger amount of extra capital than would otherwise be the case, and this inflates the annuity price.[94] Although ways to outsource such risk have been suggested,[95] ultimately each has its own problems,[96] and at best this approach would only abate the situation to a relatively minor extent.[97] On the other hand, in a pooled annuity this risk is borne by the annuity holders. Further, a pooled annuity arrangement is by its nature akin to an agreement with other retirees. This is likely to add to their appeal, as people are much more likely to annuitise if they see the purchase of an annuity as a mutual collective agreement rather than an unfair bet with an insurance company.[98]

Other advantages of GLA schemes flow from the fact that currently Australian prudential regulations allow only life insurance companies to directly offer life annuities.[99] In essence, this means that apart from cases where superannuation funds have registered as life insurance companies,[100] in most cases superannuation funds that offer life annuities are merely acting as resellers. If the relaxation of rules includes allowing superannuation companies to offer GSA schemes, it could potentially increase their popularity. This is because enabling superannuation funds to offer life annuities directly to their members would cut out the 'middleman', and thus potentially reduce costs, and also because many of the popular superannuation funds are industry funds and thus not-for-profit and likely to lead to even further downwards pressure on the price of the annuities.[101] Further, a proliferation of industry fund offerings, given their non-profit nature,[102] would be likely to further strengthen the perception of annuities issued directly by these funds as a collective agreement between former workers and themselves, rather than an unfair bet with a profit-making organisation.[103] Also, people are more likely to trust those with whom they have had long-term positive dealings,[104] and as people have often had a longstanding relationship with their superannuation fund,

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[94] Andrew Ngai and Michael Sherris, 'Longevity Risk Management for Life and Variable Annuities: Effectiveness of Static Hedging using Longevity Bonds and Derivatives' (Research Paper No. 2010ACTL03, Australian School of Business, University of New South Wales Business School, 12 April 2010) <http://papers.ssrn.com/sol3/Delivery.cfm/SSRN_ID1587890_code858089.pdf?abstractid=1587890&mirid=1>.

[95] David Blake and William Burrows, 'Survivor Bonds: Helping to Hedge Mortality Risk' (2001) 68 *Journal of Risk and Insurance* 339, 347.

[96] Ibid 345.

[97] Michael Sherris and John Evans, *Longevity Management Issues for Australia's Future Tax System* (24 August 2009) 15 <http://taxreview.treasury.gov.au/content/html/commissioned_work/downloads/Longevity_Management_Issues.pdf>.

[98] Hanegbi, above n 64, 489–90.

[99] *Life Insurance Act 1995* (Cth) ss 9, 17, 20, 21.

[100] See, for example, 'Regulators must end the UniSuper farce' *The Canberra Times* (online)5 March 2013 <http://www.canberratimes.com.au/national/public-service/regulators-must-end-the-unisuper-farce-20130303-2fe1b.html>.

[101] HWL Hebsworth Lawyers, *Rules of the Industry Funds Forum* (21 July 2011) Industry Funds Forum, Rule 3.1 <http://www.industryfunds.org.au/Files/Uploads/File/About/RULES%20(21%20July%202011).pdf>.

[102] Ibid.

[103] Hanegbi, above n 64, 489–90.

[104] Wouter Poortinga and Nick F Pidgeon, 'Trust, the Asymmetry Principle, and the Role of Prior Beliefs' (2004) 24 *Risk Analysis* 1475, 1475.

they are likely to see an annuity purchased directly from that fund as a continuation of their relationship.

Importantly, to the extent that GSA schemes do provide cheaper annuities, this is likely to create a 'virtuous cycle' in which any adverse selection effects are less apparent, which then leads to even cheaper annuities.[105]

Overall, there is good reason to extend the tax-free net to GSA schemes, given their comparative price advantage for those willing to trade-off some risk. Further, in net terms, they present a lower behavioural disincentive to annuitise. Allowing people to enter annuity-like instruments is generally consistent with the purpose of superannuation, which is to provide retirees with retirement income.[106]

4.3 Recent government action

4.3.1 Background of recent reform

Originally, DLAs and GSA schemes were not regarded as superannuation income streams, and so could not benefit from tax-free earnings.[107] The case for widening the category of annuities covered by superannuation tax concessions was flagged in 2013, when the previous Australian Labor Party (ALP) government indicated that it would implement changes to allow DLAs to constitute superannuation income streams.[108] However, the current Liberal/National government announced, upon winning power, that it would not automatically implement the proposals but would rather consider the process as part of a broader review of retirement income streams.[109]

Later, in 2014, the Final Report of the Financial System Inquiry recommended that the law be changed so that DLAs and GLA schemes could benefit from the earnings tax exemption.[110] In its response, the government indicated that it would legislate to remove impediments to the development of income-stream products.[111]

Further, in 2014, the Retirement Income Stream Regulation discussion paper also raised the issue of DLAs and GSA schemes being brought under the tax-free earnings umbrella of superannuation retirement income streams, and invited public submissions on this issue.[112] This was followed in 2016 by the release of the final paper on Retirement Income Stream Regulation.[113] The paper recommended that DLA and GSA schemes should constitute superannuation income stream and so benefit from tax-free earnings.[114]

[105] Gentry and Rothschild, above n 54, 190.
[106] Superannuation (Objective) Bill 2016 (Cth) s 5(1).
[107] Murray et al., above n 3, 125.
[108] Bill Shorten and Wayne Swan, 'Reforms to Make the Superannuation System Fairer' (Media Release, 14 September 2010) <http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2013/020.htm&pageID=&min=brs&Year=&DocType=0>.
[109] Arthur Sinodinos, 'Integrity Restored to Australia's Taxation System' (Media Release, 14 December 2013) <http://axs.ministers.treasury.gov.au/media-release/008-2013/>.
[110] Murray et al., above n 3, 120–21.
[111] Commonwealth of Australia, above n 77, 13.
[112] Commonwealth of Australia, above n 78, 13–15.
[113] Commonwealth of Australia, above n 79.
[114] Ibid 2, 15.

4.3.2 Recent legislative changes for DLAs

The government has recently enacted legislation making widespread changes to the taxation of superannuation,[115] including implementation of the legislative measures necessary to bring DLAs into the tax-free earnings net as from 1 July 2017.[116]

Under these legislative changes, an annuity instrument can constitute a superannuation income stream despite not making payments in a particular financial year.[117] This means that the earnings of investments supporting such instruments can be tax-free even if those earnings only support future annuity payments. These legislative changes introduced a rule so that the DLA earnings tax exemption will only apply where a taxpayer is otherwise able to access their superannuation.[118] For example, a taxpayer who has reached preservation age but continues to work typically cannot access their superannuation until they either cease employment,[119] or reach the age of 65.[120] This will mean, for instance, that someone who is 61 and working, and has purchased a DLA that will start making payments when they are 75, cannot benefit from its tax-free earnings status until they satisfy a superannuation condition of release, such as ceasing employment on reaching the age of 65.[121]

There have since been further regulatory modifications to the income tax[122] and superannuation regulations[123] to complete the changes that enable DLAs to benefit from tax-free earnings. These include introducing the term 'deferred superannuation income stream' into the regulations.[124]

Given the strong case of allowing DLAs to benefit from tax-free earnings, the legislative and regulatory amendments to facilitate this appear to be a positive policy move.

4.3.3 Recent changes regarding GSA schemes

Consistent with the government's earlier announcements, the Explanatory Memorandum for the amending legislation that has implemented the legislative changes relating to making DLA earnings tax free also made it clear that future laws would be changed so as to make GSA scheme earnings eligible for tax-free treatment.[125] However, this amending legislation did not in itself bring GSA schemes into the tax-free net.

A framework for the proposed laws enabling tax-free earnings from GSA schemes was originally spelt out in the 2016 final paper on Retirement Income Stream Regulation.[126]

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[115] *Treasury Laws Amendment (Fair and Sustainable Superannuation) Act 2016* (Cth).
[116] Ibid sch 8.
[117] *Income Tax Assessment Act 1997* (Cth) ss 307-75, 307-80, 995-1.
[118] Ibid 307-80(2)(c).
[119] *Superannuation Industry (Supervision) Regulations 1994* (Cth) sch 1 Item 101, reg 6.01(7).
[120] Ibid sch 1 Item 106.
[121] Explanatory Memorandum, Treasury Laws Amendment (Fair and Sustainable Superannuation) Bill 2016 (Cth) [10.36].
[122] *Income Tax Assessment Regulations 1997* (Cth) sub-reg 995-1.01(1) as amended by *Treasury Laws Amendment (2017 Measures No. 1) Regulations 2017* (Cth) Sch 1, Items 7–9.
[123] *Superannuation Industry (Supervision) Regulations 1994* (Cth) regs 1.03, 1.05 as amended by *Treasury Laws Amendment (2017 Measures No. 1) Regulations 2017* (Cth) Sch 1, Items 11–15.
[124] Ibid sub-reg 1.03(1).
[125] Explanatory Memorandum, Treasury Laws Amendment (Fair and Sustainable Superannuation) Bill 2016 (Cth) [10.6–10.9].
[126] Commonwealth of Australia, above n 79.

The framework proposed in this paper utilised some simple rules to determine whether an annuity-like instrument should constitute a superannuation income stream. The main criterion was the maximum percentage that the holder of such an income stream could commute back to a lump sum.[127] This maximum percentage decreased with the period during which the instrument had made payments, and was proposed to be calculated on a 'straight line' basis, between the date of commencement of the annuity or annuity-like instrument and the holder's expected life expectancy.[128] Under this proposal, an eligible instrument that started payment to a retiree at age 75 where that retiree has a life expectancy of 85, could at most allow the retiree, when aged 80, to receive 50% of the price of the annuity as capital returned in exchange for giving up future payments. As these proposed guidelines only prescribed a maximum, it would be open for the annuity instrument to allow a smaller percentage to be commuted into a capital sum. An instrument which allowed no capital commutation would also fall within the guidelines.

The proposed guidelines were more relaxed in prescribing the maximum amount of capital that the annuity-like instrument can return to a nominated beneficiary upon the death of an annuity holder. Specifically, they allowed 100% capital return for half of the time between commencement of the instrument and the predicted life expectancy of the deceased.[129] However, after this halfway point, it was proposed that the schedule that was to apply regarding the minimum amount of capital that could be returned was the same as for a living annuity holder.[130]

The government has recently enacted these changes to the regulations to enable GSA schemes to constitute superannuation income streams that benefit from tax-free earnings. Specifically, changes made to the income tax[131] and superannuation regulations[132] have utilised the principles contained in the Retirement Income Stream Regulation paper to determine whether certain income stream instruments fall under the tax-free earnings net.

Specifically, the new regulations apply from 1 July 2017 and specify four main conditions for such instruments to come under the tax-free earnings net.[133] Firstly, the taxpayer must have satisfied a specified condition of release, such as retiring after attaining preservation age or being at least 65 years old.[134] Secondly, after the payments commence, such payments must be payable for the rest of the life of the beneficiary.[135] Thirdly, payments from the instrument cannot be unreasonably deferred after they have commenced.[136] In other words, the terms of the annuity-like instrument must not make it overly likely that the beneficiary would not be entitled to payments for a number of years once the payments commence.[137] Fourthly, consistent with the principles in the

[127] Ibid 10–12.
[128] Ibid.
[129] Ibid 12.
[130] Ibid.
[131] *Income Tax Assessment Regulations 1997* (Cth) sub-reg 995‑1.01(1) as amended by *Treasury Laws Amendment (2017 Measures No. 1) Regulations 2017* (Cth) Sch 1, Item 9.
[132] *Superannuation Industry (Supervision) Regulations 1994* (Cth) regs 1.03, 1.06, 1.06A, 1.06B as amended by *Treasury Laws Amendment (2017 Measures No. 1) Regulations 2017* (Cth) Sch 1, Items 11, 16, 20.
[133] *Treasury Laws Amendment (2017 Measures No. 1) Regulations 2017* (Cth) Item 2.
[134] *Superannuation Industry (Supervision) Regulations 1994* (Cth) sub-regs 1.06(1)(a), 1.06A(3)(a).
[135] Ibid sub-reg 1.06A(3)(b).
[136] Ibid sub-reg 1.06A(3)(c).
[137] Explanatory Statement - Income Tax Assessment Act 1997, Retirement Savings Accounts Act 1997, Superannuation Industry (Supervision) Act 1993, Treasury Laws Amendment (2017 Measures No. 1) Regulations 2017 5–6.

Retirement Income Stream Regulation paper, there is a maximum amount of capital that the income stream can be commuted to. Specifically, the maximum commutation amount for life benefits is calculated on a straight-line basis from the date of the instrument's commencement to the actuarial life expectancy of the holder,[138] though for death benefits a full commutation is allowed for half that period.[139] For deferred instruments, the commencement day is the later of when it was acquired and the beneficiary fulfilling a condition of release such retiring or reaching the age of 65.[140]

This new framework allows annuity-like instruments such as GSA schemes that comply with its rules to constitute superannuation income streams. It also potentially allows a variety of other annuity-like instruments to constitute superannuation income streams. For instance, an annuity issuer could offer a hybrid instrument that on the one hand (unlike a GSA scheme instrument) insures against systematic longevity risk, but on the other hand gives returns based on investment return performance. Further, this scheme allows such annuity-like instruments to be issued directly by superannuation funds,[141] which, as discussed, has advantages as compared to traditional life annuities that can for the most part only be directly issued by life insurance companies.

Given the potential appeal of GSA schemes outlined earlier, this could potentially result in a much higher uptake of such instruments, as compared with traditional life annuity instruments. At the same time, while being consistent with the aim of the superannuation system currently being legislated,[142] this also reinforces the policy rationale of superannuation: that income streams are there to support the retirement of the retiree rather than providing a tool for intergenerational wealth transfer.[143] The main downside of the wide guidelines these new rules have is that there is a possibility that retirees may be presented with instruments that contain hidden risks and features of which they are not yet fully aware. Ideally, existing and future laws would minimise the risk of this happening.

5. USING BEHAVIOURAL TOOLS TO INCREASE THE ATTRACTIVENESS OF ANNUITIES

The government has flagged the use of behavioural tools as a way to increase annuitisation levels amongst retirees. These reforms have yet to be legislated and the process is at a much earlier stage of implementation than the expansion of the categories of annuities covered by the superannuation system. The main behavioural tool under consideration is to offer anyone about to retire a CIPR – a pre-arranged set of income stream products that typically includes annuitising part of the retirement funds.[144] This will not be implemented before 1 July 2018.[145] It has also been recommended that superannuation benefit statements include member entitlements were they to take their benefits in the form of an income stream.[146] Although this was suggested in a context

[138] *Superannuation Industry (Supervision) Regulations 1994* (Cth) sub-reg 1.06A(3)(d), reg 1.06B.
[139] Ibid.
[140] Ibid sub-regs 1.03(1), 1.06B(2).
[141] Ibid regs 1.03, 1.06, 1.06A, *Income Tax Assessment Regulations 1997* (Cth) sub-reg 995.1.01(1).
[142] See Superannuation (Objective) Bill 2016 (Cth) s 5(1).
[143] Commonwealth of Australia, above n 79, 11.
[144] Murray et al., above n 3, 117.
[145] Commonwealth of Australia, above n 81, 8.
[146] Murray et al., above n 3, 267.

other than increasing annuitisation,[147] there is evidence that certain income stream disclosures on benefit statements can increase annuitisation rates.[148]

5.1 Soft compulsion through CIPRs

The Final Report considered whether annutisation of superannuation funds should be mandatory, but recommended against it, stating that it would remove flexibility and result in poor outcomes for some individuals.[149] However, it did recommend a form of 'soft compulsion' (soft compulsion).[150] Specifically, it recommended that superannuation fund trustees preselect a set of income-stream products, and offer this set of products, referred to as a CIPR, to their members prior to them entering retirement.[151] For instance, a CIPR would have a combination of an account-based pension and an annuity or an annuity-type product.[152] The report argued that this would balance the flexibility of account-based pensions and the longevity and investment risk protection that annuities and annuity-type products have.[153] The annuity and annuity-type products could be immediate, deferred, or a combination of the two.[154] Upon retirement, the members could then either confirm that they wished to take their superannuation benefits in a form consistent with their preselected CIPR, or in the alternative take their benefits in another form that they choose.[155] Importantly, retirees would have to make an active choice upon retirement when electing to take the CIPR.[156]

The government stated, in its response to the Final Report, that it agrees to support the development of this regime of preselection of retirement income streams.[157] However, it made it clear that this policy was not ready to be implemented in legislation, and that when such a policy is implemented, it will take into account the future findings of current government inquiries.[158]

The Final Report's recommendations appear to be a radical change from the current law in its use of soft compulsion for income streams including annuities. This raises the issue of whether using this form of soft compulsion is a legitimate policy tool for increasing the uptake of annuities.

When evaluating the use of soft compulsion, it needs to be kept in mind that compulsion is a matter of degree. At its most extreme, in theory annutisation could be mandated for retirement savings, as has been the case in certain jurisdictions.[159] At reduced levels of compulsion, some degree of annuitisation might require the member to opt out of a default choice. In general, making something into a default choice that can be opted out of heavily influences behaviour for a range of decisions,[160] including retirement

[147] Ibid.
[148] Benartzi, Previtero and Thaler, above n 67, 155–56.
[149] Murray et al., above n 3, 126.
[150] Ibid 117.
[151] Ibid.
[152] Ibid.
[153] Ibid 121–22.
[154] Ibid 127–30.
[155] Ibid 117.
[156] Ibid.
[157] Commonwealth of Australia, above n 77, 13.
[158] Ibid.
[159] Murray et al., above n 71, 4–19.
[160] See, for example, Riccardo Rebonato, 'A Critical Assessment of Libertarian Paternalism' 37 (2014) *Journal of Consumer Policy* 357, 360 where it is pointed out that the dramatic difference in organ donor

decisions.[161] Although there is a partial safeguard in that if a default is drastically against people's interests, then they will generally opt out of it,[162] there is some evidence that default annuitisation can lead to people making annuitisation decisions that are not necessarily in their interests.[163] A softer form of compulsion than utilising a default option would be to require members to make an active choice to annuitise part of their retirement.[164] The proposed CIPR regime is an example of such a relatively soft type of compulsion and so could not be considered as having the same impact on decision making as a default.

It could be argued that this degree of soft-level compulsion leaves the ultimate choice up to the retiree, and so could be argued to preserve self-agency.[165] However, on the other hand, it still utilises behavioural biases to influence retirees to act in a certain manner, and thus could still be seen to be a form of compulsion.[166] Specifically, even though the proposed use of soft compulsion is one of forcing an 'active decision', and this falls short of having default participation, there is evidence that it would nevertheless bias people's decision making, compared with not being forced to make a decision.[167] Ultimately, any form of compulsion is a balancing act. On the one hand, the government uses various form of compulsion to act in people's own good, including mandatory seat belts, drug regulation, tobacco and cigarette excise, and compulsory superannuation contributions. On the other hand, people's self-agency is an important social value that should be preserved where possible, and this includes the arena of retirement decisions.[168]

Although the government has a role in alleviating some behavioural biases, the mere existence of behavioural biases is not itself sufficient to justify government intervention. In accordance with arguments for policies to be 'evidence based',[169] if the government is proposing to legislate 'nudging' tools in the name of making people act in their own self-interest,[170] it should only do so when there is evidence that that they are effective in getting people to act in a manner likely to increase their well-being. Such tools need

rates between Germany (12%) and Austria (almost 100%) is due to Austria having organ donation as its default that can be actively opted out of.

161 John Beshears, James J Choi, David Laibson and Brigitte C Madrian, 'How are Preferences Revealed?' 92 *Journal of Public Economics* (2008) 1787, 1788.

162 Cass R Sunstein, 'Nudges vs. Shoves' 210 *Harvard Law Review Forum* (2014) 210, 213.

163 Hazel Bateman, Christine Eckert, Fedor Iskhakov, Jordan Louviere, Stephen Satchell and Susan Thorp, 'Default and Naive Diversification Heuristics in Annuity Choice' (2017) 42 *Australian Journal of Management* 32, 49–50.

164 Richard H Thaler and Shlomo Benartzi, 'Save More Tomorrow: Using Behavioral Economics to Increase Employee Saving' (2004) *122 Journal of Political Economy* S164, S185–86.

165 Cass R Sunstein, Christine Jolls and Richard H Thaler, 'A Behavioral Approach to Law and Economics', (1998) 50 *Stanford Law Review* 1471, 1548–50.

166 John Beshears, James J Choi, David Laibson and Brigitte C Madrian, 'The Importance of Default Options for Retirement Saving Outcomes: Evidence from the United States' (Working Paper No 12009, National Bureau of Economic Research, January 2006) <http://www.nber.org/papers/w12009.pdf>.

167 Gabriel D Carroll, James J Choi, David Laibson, Brigitte C Madrian and Andrew Metrick, 'Optimal Defaults and Active Decisions' (2009) 124 *Quarterly Journal of Economics* 1639, 1670–71.

168 Australian Law Reform Commission, *Access All Ages—Older Workers and Commonwealth Laws* 8 (March 2013) <http://www.alrc.gov.au/sites/default/files/pdfs/publications/whole_final_report_120_.pdf>.

169 Ian Sanderson, 'Evaluation, Policy Learning and Evidence-Based Policy Making' (2002) 80 *Public Administration* 1; William Solesbury, 'Evidence Based Policy: Whence it Came and Where it's Going' (Working Paper No 1, ESRC UK Centre for Evidence Based Policy and Practice, October 2001).

170 Cass R Sunstein, 'The Ethics of Nudging' (2015) 32 *Yale Journal on Regulation* 413, 434.

to be held up to increased scrutiny when they are paternalistic and such tools depend on behavioural biases, as is the case with this proposal.[171]

With these principles in mind, soft compulsion to encourage annuitisation appears to be far from a positive policy step. This is because the ideal amount of annutisation is unknown, and various factors contribute to under-annutisation.[172] The very term 'annuity puzzle' in the literature, as well as the large number of reasons suggested for the lack of popularity of annuitsation is testament to this.[173] Further, the extent to which any given individual would benefit (or otherwise) from annuitisation is highly variable. The ideal amount of annuitisation appears to vary greatly according to individual circumstances,[174] including risk aversion, marital status, financial wealth,[175] bequest motive,[176] and consumption patterns.[177] These uncertainties combine to suggest that soft compulsion to encourage annuitisation is suboptimal policy, given the general lack of evidence that it increases welfare in the aggregate.[178] The use of such paternalism on the basis of the government and experts ostensibly having better knowledge than retirees regarding the use of retirement funds cannot be justified when the evidence suggests that they lack such knowledge.[179]

5.2 Disclosure of member benefits

There is evidence that where retirement fund benefit statements include projected annuitised income stream benefits in addition to lump sum balances there is a substantial difference in annuitisation rates.[180] It is logical that benefit statements that include the account holder's potential income stream is more likely to make them perceive the retirement funds as the source of an income stream rather than a source of a given amount of wealth. Consequently, there is an argument for superannuation fund statements not only to contain the current balance, but to also state the projected income stream in the event that the funds were converted to a life annuity.

The Financial System Inquiry Final Report recommended that superannuation funds be mandated to state members' projected income stream on their statements.[181] Although

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[171] Ibid 427, 429.

[172] See, for example, Dushi and Webb, above n 49, 137–38, arguing that annuitisation is suboptimal for a large percentage of the population; see also Brown, above n 40, 19–20, presenting evidence that many people do not benefit from annuitisation; compare Davidoff, Brown and Diamond, above n 48, 1588–89, arguing that annuitisation offers a large benefit to many people.

[173] Brown, Kling, Mullainathan and Wrobel, 'above n 45, 304.

[174] Davidoff, Brown and Diamond, above n 48, 1588.

[175] Dushi and Webb, above n 49, 132–33, 140.

[176] Brown, Kling, Mullainathan and Wrobel, above n 45, 307.

[177] Davidoff, Brown and Diamond, above n 48, 1587–88.

[178] See Peter D Lunn, 'Are Consumer Decision-making Phenomena a Fourth Market Failure?' (2015) 38 *Journal of Consumer Policy* 315, 327–28, where it is suggested that governments should provide empirical evidence to justify use of such behavioural tools.

[179] See Nicolas Cornell, 'A Third Theory of Paternalism' (2014) 113 *Michigan Law Review* 1295 where the author suggests that the benchmark for evaluating such paternalism is judged by the implied expression of the paternalistic policy.

[180] Benartzi, Previtero and Thaler, above n 67, 155–56. See also Monika Bütler, Stefan Staubli, Maria Grazia Zito, 'The Role of the Annuity's Value on the Decision (Not) to Annuitize: Evidence from a Large Policy Change' 8 (Discussion Paper No DP6930, Center for Economic Studies, August 2008) where the authors speculate that the reason the Swiss Pension System has high annutisation rates is partly due to the fact that much more space is devoted in benefit statements to annuity entitlements than to equivalent lump sum entitlements.

[181] Murray et al., above n 3, 267.

this was recommended primarily as a way to increase member engagement,[182] it has the potential to increase annuitisation rates, depending on the form of the disclosure. However, the Final Report's disclosure recommendation was made in the context of compliance with Australian Securities and Investments Commission (ASIC) regulations,[183] which are premised on funds being invested in an account-based pension rather than being annuitised.[184] Consequently, it does not follow that income stream benefits disclosed in such a manner would necessarily increase annuitisation rates.

If the CIPR regime is to be adopted, member statement forecasts could instead be based on the CIPR mix offered by that fund. As discussed, the proposed CIPR regime involves offering retirees a bundle of retirement products that typically only involve partial annuitisation (annuitisation including not only annuities but also annuity-like products).[185] This is likely to strengthen the CIPR regime and will further encourage people to take on a CIPR and so annuitise to the extent promoted by the CIPR of their particular superannuation fund[186], which might have little bearing on their individual circumstances. However, given that the CIPR regime appears to be suboptimal policy, another option might be for superannuation funds to disclose a full annuitisation figure on member statements. While full annuitisation might not be the ideal for many, given that such statements would also disclose the lump sum entitlement, this would without implicit bias allow retirees to decide to what extent they wish to annuitise. Unlike income stream projections based on the superannuation fund's CIPR, it would not make generalised assumptions about the best amount of annuitisation for each member – an important consideration, given the variability of individual circumstances.

5.3 Government response to calls for behavioural policies to encourage uptake of income streams

5.3.1 Response regarding CIPRs

The government has recently released a discussion paper which spells out a proposed framework and implementation system for CIPRs. This paper is called the Development of the Framework for Comprehensive Income Products for Retirement ('CIPR Paper') and it invited submissions on a variety of related issues.[187] The basic framework is consistent with what was proposed in the Final Report – that superannuation trustees offer those entering retirement with a CIPR, which will consist of a mix of income stream products.[188]

The CIPR Paper makes it clear that CIPRs are not instruments to promote the use of annuities over other instruments.[189] Rather, in general they are aimed at combining a

[182] Ibid.
[183] Ibid.
[184] Australian Securities and Investments Commission, *Regulatory Guide 229: Superannuation Forecasts* (November 2014) 9–11 <http://download.asic.gov.au/media/2257747/rg229-published-13-november-2014.pdf>.
[185] Murray et al., above n 3, 117.
[186] See Benartzi, Previtero and Thaler, above n 67, 155–56, which presents overseas evidence that retirement benefit statements that include income stream projections based on full annuitisation are correlated with higher annuitisation rates. It could be speculated that benefit statements that include income stream projections based on partial annutisation would promote some degree of annutisation, though research does not appear to have directly examined this issue.
[187] Commonwealth of Australia, above n 81.
[188] Murray et al., above n 3, 117.
[189] Commonwealth of Australia, above n 81.

'package' of account-based pensions and annuities as well as annuity-like products.[190] The annuity-like products includes DLAs and GSA schemes.[191] The paper suggested that there be minimum requirements, such as the CIPR providing a higher income than would be expected from a taxpayer using all their money to convert to an account-based pension (the gulf between the two having a minimum percentage).[192] The paper left open the question of whether the long-term aim should be to mandate that all larger superannuation funds offer CIPRs or merely to facilitate their ability to do so.[193] It also left open the question of how each trustee will get approval for its CIPRs; specifically, whether it will do so with a regulator, a third-party like an actuary, or according to a self-regulating regime.[194]

The CIPR Paper appeared to be of the view that for simplicity, there are strong arguments for each superannuation trustee having only one CIPR on offer.[195] Though it was not fully closed to the possibility of funds offering more than one CIPR, it suggested that the main problem with such a regime would be the difficulty of matching different CIPRs with different cohorts of members.[196] With the more highly preferred system involving only one CIPR per superannuation fund, the main requirement for that CIPR would be that it benefited the 'majority' of members.[197] This approach would be reinforced by the fact that the 'safe harbour' protection against breaches of fiduciary duties arising from offering a CIPR would be afforded to trustees that offer a CIPR which, along with complying with other minimum requirements, is of benefit to the 'majority of the members'.[198] The only exception suggested by the CIPR Paper to this 'one size fits all' approach is that this 'safe harbour' protection not be extended to trustees that offer CIPRs to those with low superannuation balances or those with a terminal condition.[199]

As discussed, although CIPRs are not intended to be pure annuity products, they are intended to include an annuity component,[200] meaning that the intention is to use a measure of soft compulsion to annuitise retirement savings. Also, as discussed, soft compulsion towards annuitisation is on balance suboptimal policy. The evidentiary problem noted earlier – uncertainty about the ideal proportion of annuitisation – is equally applicable to what is proposed in the CIPR Paper. Added to this is the substantial discretion proposed in the CIPR Paper to be given to trustees regarding the makeup of the CIPR: the extent to which the CIPR is made up of an annuity; the types of annuity-like instrument;[201] the minimum guarantee period of the annuity-like products in the CIPRs;[202] and whether such CIPRs will be joint or single[203] are all proposed to be in the discretion of the trustee of the superannuation fund. This will result in a situation where CIPRs can vary widely from one superannuation fund to

[190] Ibid 22–24.
[191] Ibid 18.
[192] Ibid 17.
[193] Ibid 27–28
[194] Ibid 29–30.
[195] Ibid 24–25.
[196] Ibid.
[197] Ibid 15.
[198] Ibid 27.
[199] Ibid 34.
[200] Ibid 22–24.
[201] Commonwealth of Australia, above n 81, 22–24.
[202] Ibid 42.
[203] Ibid 43.

another. It is unclear how the membership of one large superannuation fund will differ from another, and how this will justify the variations between CIPRs. The two inter-related issues of substantial uncertainty about the ideal amount of annuitisation and the likely marked differences in CIPRs on offer both reinforce the likelihood that the proposed regime in the CIPR Paper will result in suboptimal outcomes for many.

Further, the particular regime promoted in the CIPR Paper adds a twist to the related issue canvassed earlier regarding the dramatically different annuitisation needs on individual retirees. Specifically, the fact that each superannuation fund should preferably only have one CIPR, which need only advantage the majority of those to whom it is offered, could disadvantage a substantial minority of members even if it is presumed it would advantage the majority. Such a one size fits all approach, which needs only to ostensibly advantage 50.1% of the membership, necessarily accepts the trade-off that many might be disadvantaged by it. In addition, the CIPR Paper takes no account of the impact that the age pension has on annuity requirements. As discussed, pre-annuitised wealth dampens annuity demand,[204] and modelling indicates that this is specifically applicable to potential recipients of the Australian age pension.[205] As the age pension is means tested, such modelling has found that those with lower superannuation balances are more likely to be negatively impacted by annuitisation than those with higher balances.[206] While such research was based on traditional annuity products,[207] it is logical that it would also apply to annuity-like instruments such as GSA schemes. This is a further reason why the one size fits all approach of the CIPR Paper is ill-suited to a heterogeneous group of retiring superannuation members. While advocates of soft compulsion may argue that that those disadvantaged by such a regime can choose to not to enter into it,[208] that argument ignores the strong likelihood that inertia and lack of understanding will mean many people do elect to go with it, given the evidence that forcing people to choose does lead many to make a decision in the affirmative.[209] Further, the CIPR Paper's reservations regarding a system where superannuation funds offer multiple CIPRs (based on the difficulties of matching different CIPRs with different cohorts)[210] have strong validity, meaning that such an alternative might result in even worse outcomes.

5.3.2 Response regarding member statements disclosing income stream benefits

The government, in its official response to the Financial System Inquiry, has accepted the Final Report's recommendation on this issue, and stated that member statements should include retirement income projections, as long as it is practicable and cost-effective to do so.[211] At this stage there have been no other developments regarding this issue, and no details about when and how it is proposed to be implemented have yet been released.

[204] Dushi and Webb, above n 49, 131–34.
[205] Iskhakov, Thorp and Bateman, above n 49,146.
[206] Ibid 152–53.
[207] Ibid 142–43.
[208] Richard H Thaler and Cass R Sunstein, 'Libertarian Paternalism' (2003) 93 *American Economic Review: Papers and Proceedings* 175, 178–9.
[209] Carroll et al, 'Optimal Defaults and Active Decisions', above n 167, 1670–71.
[210] Commonwealth of Australia, above n 81, 24–25.
[211] Commonwealth of Australia, above n 77, 14.

6. CONCLUSION

Lifetime annuities have the potential to provide retirees with a secure, low-risk income in their retirement. Such security can positively contribute to their financial and emotional wellbeing. The implemented laws aimed at increasing the breadth of annuity-like instruments that can benefit from the tax-free earnings regime from which traditional life annuities have been benefiting is a very positive move. They will assist retirees in obtaining cheaper, more flexible annuity-type instruments, and although this will in some instances be at the cost of increased risk, for various reasons such instruments will potentially appeal to many.

On the other hand, the proposed regime of offering CIRPs to those entering retirement is suboptimal policy. Such a proposal aims at using people's behavioural biases to point them towards the retirement decisions that are best suited for them. However, for a variety of reasons discussed in this article, such a regime is likely to result in a degree of annuitisation that is far from ideal for many. Further, depending on the instruments offered in a particular CIPR, there may be little chance for a retiree to reverse their decision to annuitise their retirement savings.

There is definitely much policy work to be done regarding the retirement phase of the superannuation system. It is hoped that any future changes will be based on common sense and evidence, given their potential impact on people's wellbeing.