Actuaries Summit
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20 – 21 May 2013
Hilton Sydney

Actuaries Institute

Post Retirement Funding in Australia

Retirement Incomes Research Group

Agenda

- The objectives of the RIWG and this paper
- The annuity puzzle
  - There are good arguments for annuitisation
  - The Australian system is unusual in *not* requiring annuitisation
  - Many retirees act *as if* they have annuities, but there are very few life annuities
- Classifying financial needs of retirees
  - Complex layers of which some could be met by annuities
  - Financial advice
- Products
  - Those not available in Australia
  - Comparisons
- Impediments to progress
  - How the system is framed
  - Regulations
- Future activities

The objective of the RIWG and this paper

- One of Institute's major policy objectives: "vibrant annuity market"
- RIWG to investigate retiree needs, alternatives, impediments and educational needs
- Members: Anthony Asher (Convenor), Patricia Berry, Andrew Boal, Richard Boyfield, Mike Callan, Jules Gribble, Curtis Heaser, Jeff Humphries, Graham Kelly, Wade Matterson, Tony Miller, Cathy Nance, Jim O'Donnell, Paul Scully, Paul Swinhoe, Brnic Van Wyk
- Discussion paper on current state of play – feedback would be appreciated

The annuity puzzle

- We expect but do not find them

There are good arguments for annuitisation

Why super?	Why annuitisation?
People are myopic and need (and indeed want) encouragement to save for retirement	It is difficult for retirees to determine how much they can spend in retirement.
Retirement saving encourages self-reliance & relieves the state of some costs of the elderly	Annuities (broadly defined) do the same
A properly regulated superannuation system provides protection to otherwise vulnerable individuals	The superannuation system offers better protection to the elderly with declining interest & skills, eventually including dementia.
A large pool of long term savings provides for an efficient capital market	Assets in super not required for immediate liquidity are available for longer term investment

Australia is unusual

Pillar	Description	Australian system element
0	Flat benefit funded from taxes	The Age Pension
1	Public pension plan	None
2	Mandatory occupation based plans	SGC without mandatory annuitisation
3	Voluntary pension plans	Contributions over and above SGC

The Australian system is almost unique, even amongst DC based systems, in not mandating annuitisation of pillar 2.

Retirees' financial assets switching to super

HOUSEHOLD MEANS	2010				Change since 2004			
$'000 (Nominal)	Age of reference person				Age of reference person			
	45–54	55–64	65–74	75 +	45-54	55-64	65-74	75 +
Financial inst.	33	45	47	63	68%	53%	10%	43%
Shares	27	26	28	61	82%	-21%	-3%	46%
Superannuation	136	231	176	64	45%	79%	162%	276%
Other financial	116	69	40	26	174%	-6%	-10%	16%
FINANCIAL ASSETS	312	370	292	214	88%	43%	56%	57%
Own dwelling	431	464	454	417	49%	45%	59%	46%
Other property	223	185	131	64	119%	87%	57%	42%
Other assets	123	133	115	83	26%	39%	26%	49%
TOTAL ASSETS	1088	1152	991	776	66%	49%	53%	49%
Total liabilities	-157	-101	-32	-7	78%	122%	118%	195%
NET WORTH	932	1052	960	769	64%	44%	52%	48%

Source ABS

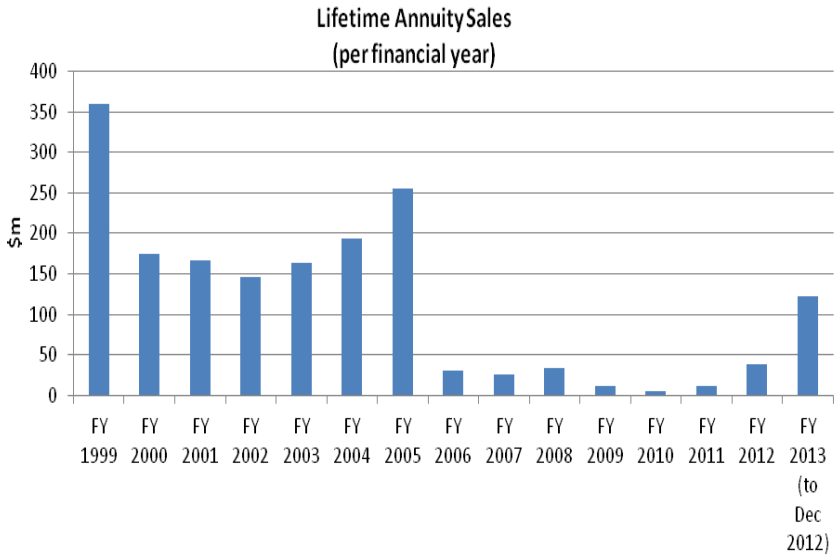
Many retirees act as if they have annuities

CENTRELINK CLIENTS	Average assets	Increased assets	Reduced assets
First five years of retirement	$140,000	51%	48%
Last five years of retirement	$75,000	38%	35%

Source: Anderson (2011)

Analysis of the Centrelink data finds considerable variation but that fewer than 10% of retirees spend more than half their assets over an 8 year period. Retirees are conservative, but many are slowly eroding their assets and so might benefits from longevity cover.

Resurgence in annuity sales?



Recent heavy advertising and the introduction of a liquidity option has led to something of a resurgence in life annuity sales but still at a very low level

Source: Plan 4 life

Classifying needs

- Are annuities really needed by anyone?

Financial needs (basic consumption)

Nature of Financial Requirement	Product or Strategy to meet this requirement	Product or investment available need	Comments
(*a1*) Regular Expenditures on things deemed necessities required now and through life (regularly occurring – at least yearly).	A low volatility, regular cash flow, linked to expense inflation and immunized against changes in other investment market conditions The Age Pension provides a de facto floor for this need.	A guaranteed lifetime CPI indexed annuity is the only product meeting this need. If an adequate buffer is kept, other investments may go some way to meeting these needs over the long term.	Un-anticipated periods of high inflation represent a significant risk. The opportunity cost of guaranteed annuities can be significant. Therefore great care is required, particularly by younger retirees, in classifying expenditures into category (a1).

Financial needs (supplementary consumption)

Nature of Financial Requirement	Product or Strategy to meet this requirement	Product or investment available need	Comments
(a2) Regular Expenditures (other)	Able to deliver a regular cash flow automatically. Cash flow may reduce in response to adverse outcomes.	Products meeting requirement (a1) are generally suitable – the main difference is that the probability of adverse outcomes can be higher,	The bigger the buffer over necessities, the more risk. This risk return trade-off is a fundamental decision. Longevity products with no guarantees possible.
(b1) Lump Sum Expenditures (necessities – able to be planned)	Security and liquidity of capital in real terms at the planned expenditure date. Continuous liquidity not essential.	Cash, term deposits or short term annuities. Reverse mortgages may also be suitable.	Assets to meet category (b) requirements especially can be held in or outside super. Keep the family home “in reserve”.

Financial needs (irregular)

Nature of Financial Requirement	Product or Strategy to meet this requirement	Product or investment available need	Comments
(b2) Lump Sum Expenditures - necessities – unforeseen or timing uncertain.	Continuous liquidity of a maximum single need. Reasonable stability of capital real values	Cash or other highly liquid and capital stable investment medium	Medicare covers necessary medical expenses
(b3) Lump Sum Expenditures - other. Also a general reserve	Can be less liquid and longer term.	Investment portfolio	Keep the family home “in reserve”
(c) Late in life – extra costs disablement related	Something of a mix between (b2) and (b3)	Investment portfolio	Insurance possibilities but not yet available
(d) Bequest	Significant discretion	Investment portfolio or life insurance.	Objections to investments being “lost” to an insurer.

Financial needs (advice)

- Navigate complicated tax and social security rules
- Ascertain risk appetite and special needs
- Make recommendations on:
  - Retirement
  - Consumption and savings
  - Investment mix
  - Product mix
- Need to deal with cognitive decline: 25% of those over 85 have dementia and research suggests that retirees and families are slow to respond and are vulnerable to poor financial judgement

Products

- Missing alternatives

Products not available in Australia

Product	Benefits to retirees	Comments
Deferred annuities	Benefits of allocated annuities with longevity protection	Need to manage the gap before vesting
Pooled annuities	Investment freedom with longevity protection	Absence of guarantee needs explaining
With-profit annuities	Investment participation with smoothing	Previously opaque
Impaired life annuities	Better deal for those in poor health or otherwise lower life expectancy	New underwriting technology now widely available

Comparison of alternative products (1)

	Term annuities	Bank accounts and term deposits	Dividend strategy	Account based pensions	G'teed Variable annuities	Lifetime Annuities – inf linked	Deferred annuities – inf linked	Pooled annuities – bond based	Pooled annuities – equity based
Consumption * (Couple of 65)	4.8%	4.8%	5.5%	5%	5%	5%	5%	6%	7%
Consumption * (Female of 75)	4.8%	4.8%	5.5%	6%	6%	7.5%	7.5%	8.5%	9.5%
Protection against market volatility	◑	◑	◔	○/◑	●	●	●	●	○
Reinvestment risks	○	○	◑	◑	◑	●	●	●	◑
Protection against Longevity risk	○	○	○	○	●	●	●	◕	◕

Comparison of alternative products (2)

	Term annuities	Bank accounts and term deposits	Dividend strategy	Account based pensions	G'teed Variable annuities	Lifetime Annuities – inf linked	Deferred annuities – inf linked	Pooled annuities – bond based	Pooled annuities – equity based
Protection against Inflation risk	◔	◔	◑	◑	◔	●	●	◑	◑
Potentially higher returns	○	○	●	●/◑	◑	○	○	◑	●
Liquidity or access	●	●	●	◑	◕	◔	◔	◔	◔
Bequest	●	●	●	◑	◑	◔	◔	◔	◔
Simple to understand	●	●	●	◕	◑	◕	◑	◑	◑

Impediments to progress

- Are there problems?

Financial advice (practice)

- ASIC report on personal advice (3% good, 40% poor)
- Need to communicate risk; calculators suggest increasing risks for higher pension benefits
- Funds do not illustrate pension benefits – ASIC CP230 may change this
- Longevity insurance not readily available.
  - Who can recommend annuities if few companies or funds offer them?
  - Standard approach is to add a few years to life expectancy

How the system is framed

What members are given	Obvious conclusion
Super benefits illustrated as lump sum	Lump sums are the intended outcome
Adding 5 years to life expectancy allows for longevity risk	It must therefore be an acceptable risk margin.
Calculators suggest that increasing investment risk is a way of meeting retirement targets	High equity component in retirement must be an acceptable approach
Risk aversion is measured by losses in individual years	Over the longer term equities will always outperform
Most funds, companies and advisors do not offer annuities (as they are expensive)	They cannot be worthwhile (and must really be expensive in spite of guarantees)
Limited discussion of impact of dementia and widow(er)hood	Not important

Regulation

- Fragmentation of the regulations (identified many times by others)
- Framing of the system as intended to generate lump sums to build wealth. So:
  - Illustrate pension not lump sum benefits
  - Explain future uncertainties and risks of equity
  - Focus on protecting the vulnerable elderly
  - Educate advisors appropriately
- Absence of significant number of products, so:
  - Amend SIS regulations to permit pooled and deferred annuities
- The asset test makes it impossible to automatically generate a level cash flow, so
  - Replace with a more appropriate test

Future actions

- Further research into :
  - Current post-retirement strategies (Centrelink assets, fund and SMSF drawdowns)
  - Risks associated with dementia and strategies to address them
  - Unfolding market for life and variable annuities
- Support Institute initiatives as requested
- Possible discussions with industry bodies, regulators and Treasury

Discussion

- What important facts and arguments have we missed?
- What do you think we should do?
- Would you want to contribute in some way?