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Tackling Longevity Risk
Removing Barriers to Innovation

Review of Retirement Income Stream Regulation

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Background

- Regulatory Influences on Retirement Income Stream Products
  - Superannuation law (mainly SIS regulations)
  - Tax
  - Social security rules
  - Prudential regulation
  - Consumer regulation
- July 2014 Discussion Paper
  - Commitment to remove barriers to retirement income stream innovation
  - Subject to no abuse or undue tax deferral arising from tax concessions
  - 16 questions asked
- Specific comments sought on:
  - Superannuation rules and product innovation
  - Deferred lifetime annuities
  - Minimum payment amounts for account based pensions in changing market conditions

•Actuaries Institute submission drafted by the Retirement Incomes Working Group for the Superannuation Practice Committee

Superannuation Rules and Product Innovation

Q1: What types of income stream products would enable retirees to better manage risk in retirement phase?

- SIS regulations currently cater for
    - Account based pensions – retiree assumes risks – investment choices available
    - Traditional annuities – product provider assumes investment risk during the life of the product, and longevity and inflation risk depending on the product.
- Strong need for products enabling greater and more flexible risk sharing:
    - Pooled annuities: Includes (but not limited to):
        - Group self annuitization
        - With profit (participating) annuities
    - Investment linked annuities
    - Guaranteed Minimum Lifetime Withdrawal Benefits
    - Deferred Lifetime Annuities (with full, partial or no investment guarantees)
    - Contingent annuities (e.g. on death of spouse, occurrence of a particular health event)
- "Annuity" used in a broad sense – nomenclature and classification issues

Q2: Existing SIS rules – impediments?

- Indexation Rules
  - Current rules only permit CPI, AWE or fixed annual amount
  - Do not envisage outworkings of experience variation
- No further contribution (ATO interpretations)
- Benefit payments at least annually:
  - Issue for deferred lifetime annuities
- “Minimum Payment Rules not defined beyond Account Based Pensions and Traditional Annuities

Q3: Changes to the SIS rules?

- Principles based – to the extent possible

- Broad principles:
    - Once commenced, payable at least annually (DLA's permitted – more later)
    - Based on product rules reasonably expected to provide regular income and disclosed to ensure the purchaser understanding of the income and how it will or may vary
    - Permit variations in income based on actual investment, mortality and expense experience but otherwise limited variation (apart from account based pensions where income within regulatory limits at retiree discretion).
    - The product provider is not required to provide guarantees but may choose to do so.
    - Unreasonable deferral of income not permitted
    - Minimum payment standards of some kind still required (more on this later)

- Pooled and I/L annuities - present a particular challenge

Q3 (contd.): Pooled and IL annuities – example approach

- The product provider certifies the product:
  - at launch and
  - at each subsequent product variation and
  - at change in the prescribed scenario
- Prescribed scenario test:
  - Real rate of future investment return on assets
  - Mortality basis
- Based on the product rules, for all possible purchasers and variations:
  - Product must return a level or decreasing real income under the scenario test
  - The minimum annual payment in the first year as percentage of purchase price is 1/a where a is the value of a lifetime annuity based on the prescribed scenario.
  - Subsequent variations in payments limited by the broad principles

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Q3 (contd.): Pooled and IL annuities - example

- Not a guarantee, merely a scenario test – consumer entitled to rely on the certification

- Considerations in setting the prescribed scenario
    - Real rate should be "risk free" – on Commonwealth Bonds – with perhaps modes deduction for fees/expenses
    - Mortality should be light – allowing for mortality improvements – ideally an annuitant/pensioner shape?
    - Reviewed every 2 years or at threshold changes in real returns

- Potential wider application of scenario for product consistency in relation to minimum payment standards.

Q4: Will changes lead to new products in the market?

- No certainty
- Pooled and IL annuities exist overseas and are purchased
- Longevity risk awareness growing

Deferred Lifetime Annuities (DLA's)

Q3: Changes to the SIS rules?

- DLA's may be purchased at any time:
  - Investment returns on backing assets tax free only after a specified age
  - Specified age is a well defined proxy retirement age
  - For example - could be preservation age, tax free age, age pension eligibility age

- Broad principles:
  - Benefits paid after vesting date subject to the same rules as annuities with no deferral
  - Minimum payment standards apply
  - Provider certification (if applicable) is at point of purchase, not benefit commencement

Q5: Only purchase a DLA with superannuation money?
Q6: Single premium only, or multiple premium also? What if premiums cease?

- DLA's may be purchased by non-superannuation money:
  - Superannuation concessional tax rates would not apply;
  - Ordinary life insurance tax applies to underlying investment income (akin to ordinary whole of life).

- Multiple purchase option should be available:
  - Broad superannuation income stream principles still apply;
  - Minimum payment or other standards can become complex;
  - Each premium purchases a defined amount of DLA – tests apply at this level.
  - If premiums cease – DLA amount purchased is then well defined

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Q7: Upper limit invested in DLA?

- Potential for undue tax deferral
- Alternative 1:
    - No restriction
    - Limitations on commutation and death benefits make DLA's unattractive as a tax deferral vehicle for wealthy investors (more later)
- Alternative 2:
    - A table of maxima – derived using the prescribed scenario with simplification and smoothing and judgment
- Possibility that:
    - Retiree exhausts available funds prior to commencement of DLA
    - Access to pension may not be available due to means test (DLA counts as asset)
    - Warning in PDS or SOA, or emergency commutability option

Q8/9: Should there be a minimum deferral period or maximum commencement age?
Q11: Death benefit permitted? If so, what restrictions if any?

- No minimum deferral period or maximum commencement age:
  - Not necessary as other mechanisms to ensure no undue tax deferral
  - If table of maximums applies, then in practice the maximum will be quite low for very advanced commencement ages
- Death benefit:
  - Potential for unduly tax favorable estate planning vehicle for wealthy
  - Should not exceed the purchase price, perhaps for a limited number of years
  - Death benefit reduces relative value as longevity protection

Q10: Commutable? If so, what restrictions if any? Required to be guaranteed?

- Commutability:
  - Not mandated – impacts on value effectiveness as longevity insurance
  - Restricted commutability may be necessary from consumer perspective
  - Limited to purchase price and a time limit post-purchase
  - A case for commutation on hardship grounds, subject to evidence of health
- Guarantees:
  - Should not be mandated - unnecessarily restrictive for product development
  - Consistency on wider stance for annuities generally

Minimum Payment Amounts (MPA’s)
Account Based Pensions
Changing Market Conditions

Background on MPA's

- MPA's were set in 2007 – given in table below
- Stated objectives - July 2014 Discussion Paper:
  - Ensure the account based pension is used to provide an income stream in retirement
  - Provide a steady real level of income over time, well beyond standard life expectancy
  - Ensure run-down of real value of funds held in concessional tax environment

Age of Beneficiary	Percentage
Less than 65	4%
65 - 74	5%
75 - 79	6%
80 - 84	7%
85 – 89	9%
90 – 95	11%
95 and above	14%

Background on MPA’s (contd.)

- Following GFC:
  - In 2008-9 MPA’s were halved
  - Response to MPA’s being based on account balance at 1 July (prior to major fall)
  - Half rate MPA’s continued for 2009-11, then 75% for 2011-12
  - Post-1 July 2012 at original levels

Q12: Appropriateness of MPA’s given changing financial conditions

- Suitability of current factors:
  - Real interest rates are the key
  - Set for higher real interest rates than currently prevail (3.5% vs <2%)
  - Providers of CPI linked lifetime annuities struggle to profitability meet MPA’s

- Suggested approach:
  - Review MPA’s periodically based on the prescribed scenario concept
  - Ensures consistency of principle with other products
  - A higher mortality rate may be justified for this compared to pooled, IL or traditional lifetime annuities.

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Q13/14/15: Adjustment for significant market downturn/upturn?

- Suggested approach:
  - Individual retirees may apply to rebase to more recent balance, if falls to, say <85% of 1 July level during the year.
  - MPA’s only vary in response to real interest rate changes (refer previous suggested approach).
  - MPA’s role in managing levels of tax concessions mean stability is important