RatingsDirect®

The Longevity Dilemma: Why Australian Life Insurers Could Soon Be Writing More Annuities

Primary Credit Analyst:
Caroline Strahan, Melbourne (61) 3-9631-2185; caroline.strahan@standardandpoors.com

Secondary Contacts:
Michael J Vine, Melbourne (61) 3-9631-2102; michael.vine@standardandpoors.com
Oliver Herbert, London (44) 20-7176-7054; oliver.herbert@standardandpoors.com

Table Of Contents

The Longevity Dilemma: Why Australian Life Insurers Could Soon Be Writing More Annuities

Like so many other nations these days, Australia is grappling with the problems that accompany an aging population, especially the alarming prospect among the elderly of longevity risk or the risk of outliving their retirement savings. Similarly, the Australian government may face a steadily rising burden in its Age Pension scheme, which provides income support for eligible older Australians. In response, Australia's Financial System Inquiry (FSI) is considering a variety of possible ways to manage these challenges. Among the potential solutions the FSI has proposed is to make particular retirement income products, such as long-term annuities, compulsory (either at a certain level of retirement assets or at some stage in retirement). That would require affected retirees to allocate a portion of their privately accumulated "superannuation", or retirement savings, toward the purchase of such a product.

Standard & Poor's Ratings Services believes reform needed to manage longevity risk is still in the early stages of development and that it's difficult to predict its scope or to quantify the effect it might have on the demand for, and supply of, annuities. However, we do think Australia will ultimately wind up with a greater diversity of retirement product offerings. We expect the country's retirement income market to eventually shift away from a focus on investment products and allocated pensions to a more balanced mix, with a greater proportion of annuities (and potentially some yet-to-be-seen new products). Also, we think when analyzing the possible outcomes of Australian retirement reforms, it's useful to consider the U.K.'s experience. While annuities have been a longstanding feature of the U.K. retirement income system, reforms in that market are also moving to greater consumer freedom outside of annuity products. And yet another aspect of reform in Australia is likely to involve an increasing focus among regulators--and customers--on greater quality of, and accessibility to, advice or guidance for retirees in relation to longevity risk.

Overview

- We do not expect annuity purchases to become mandated, but we anticipate some tax and regulatory reform will be required to support meaningful growth in Australia's longer-term annuities market.
- Without reform, demand for annuities is likely to remain constrained, thanks to some currently inequitable tax treatment, the availability of the Age Pension government safety net, and limited flexibility in existing product features.
- Also limiting the supply of long-term (lifetime) annuity products now is a lack of profit incentive for life insurers, a shortage of high-quality domestic assets of longer-term duration, and restrictive regulations.
- Because Australian life insurers generally have very strong capital positions, we think in aggregate they could support a large amount of growth in longevity risk reserves and still retain extremely strong capital adequacy as measured by our insurance capital model.
- Australian life insurers will likely look to invest more in long-duration illiquid assets such as property and infrastructure to match growth in sales of longer-term annuities.

Compulsory Annuities Are One Option To Build Market-Based Longevity Risk Insurance

Australia's federal government set up the FSI in December 2013 to examine how the country's financial system could be positioned to best meet evolving national needs and to support economic growth. On July 15, 2014, the FSI released an interim report that set out its observations about how the current financial system is working, along with a range of options for change. One of the key focus areas relevant to life insurers was the inability of Australia's retirement income system to meet retirees' risk management needs, especially for longevity risk. In particular, the report highlighted that "the retirement phase of superannuation is undeveloped…" and "there are regulatory and other policy impediments to developing income products with risk management features that could benefit retirees."

With longevity risk in mind, lifetime annuities possess valuable product features. They can provide a "hedge and forget" solution by protecting policyholders' financial position against a potentially long lifespan and from having to actively manage their savings assets to generate adequate income. It is well-recognized that Australia's retirement income system is not well geared toward protecting retirees against longevity risk. That's because the lifetime annuities market is very small, and because retirees now often have to make investment choices without necessarily being well informed about the options, nor do they generally receive sufficient financial advice on longevity risk management. Other annuity products, such as immediate or term-certain annuities (which provide an income stream for a fixed term) and allocated annuities or pensions (where payments are drawn from a superannuation fund and are set at the discretion of the holder above government-prescribed minimum limits) have had stronger growth, but these do not protect against longevity risk given they may not last for the remaining life of a retiree. As of December 2013, total Australian life insurance statutory funds stood at A$242.41 billion, but only A$4.05 billion, or 1.7%, of assets were backing annuity products with longevity risk. By comparison, assets backing annuity products without longevity risk comprised A$9.99 billion. And by far the most popular retirement income product remains investment-linked funds, which were backed by assets of A$148.93 billion. Several life insurers offer capital or income guarantees as an add-on to their investment-linked fund products, but these also have limited ability to protect against longevity risk.

The small size of Australia's lifetime annuities market is a legacy of a tax and regulatory regime and market forces that have constrained supply and demand. These include a shortage of high-quality and affordable advice in relation to longevity risk management, unfavorable consumer biases and perceptions on annuity products and features, and a lack of incentives for life insurers to underwrite longer-term annuities. Among the key factors restraining demand is the widespread availability of the Age Pension as a safety net. However, from the Australian government's perspective, greater take-up of annuities with longevity risk insurance could help reduce its growing and significant funding requirement for Age Pensions.

The FSI is currently seeking feedback on the whole spectrum of potential policy options that could best respond to these challenges prior to releasing its final recommendations. Mandating retirees to purchase specific retirement income products, such as annuities, is just one option offered in its interim report. Others include maintaining the status quo (potentially with improved financial advice), introducing a default product option (with ability to opt out), or creating policies that encourage takeup or provision of annuities with longevity risk insurance. While the FSI compared the pros and cons of each option at a high level in its interim report, it did not appear to publicly favor one. Its eventual recommendation could largely depend on the feedback it receives from market participants. It is also not clear whether the government would adopt any of the recommendations that follow from the FSI. It is evident from the interim report that the trade-offs between each option are significant and essentially require the government to choose between higher longer-term funding costs for Age Pensions and allowing retirees the freedom of investment choice.

Where Might The Australian Annuities Market End Up?

Standard & Poor's doesn't expect Australia to pass laws requiring retirees to allocate all their superannuation funds to the purchase of an annuity. We think the government would be reluctant to take reform to this extreme, particularly because many retirees would be unhappy about losing their financial flexibility as well as having to lock into annuity payment streams at what may be historically low interest rates. As the FSI interim report noted, one of the key weaknesses of compulsory annuities is that it "restricts the ability of individuals to tailor their retirement plan to suit their specific needs." For this reason, in March 2014 the U.K. government announced reforms that would remove the compulsory requirement for pension funds to purchase any annuity (see box below).

Mandating the purchase of an annuity product with superannuation funds would also run against some recent trends in Australian government policy. For example, effective in July 2005, it introduced choice of superannuation funds legislation. Indeed, many Australian retirees appear to value investment flexibility highly. That's one reason for the rapid growth of the Self-Managed Superannuation Fund (SMSF) sector relative to the rest of the retirement savings industry, despite the proportionally higher administration costs these can incur.

The 2008 financial crisis' adverse impact on many superannuation balances have led to growing awareness of and demand from some retirees for annuity products that help protect them against market risk. For example, Challenger Life Company Ltd. (Challenger Life; rated A/Stable/--), the leading provider of annuities in Australia, increased its retail annuity sales by 200%, to A$2.799 billion, over the five-year period ending June 30, 2014. However, the majority of these sales relate to immediate term certain annuities, which are not set up to protect against longevity risk. For example, the average tenor of Challenger Life's new business sales of immediate annuities over fiscal year 2014 was 6.4 years compared to the average 21.6 years expected remaining life for a 65-year-old Australian female (according to the Australian government Actuary's Australian Life Tables 2005-07). There is now increased focus from retirees on managing their longevity risk as the population ages. Challenger Life has more recently seen stronger sales in its lifetime annuity products, which protect against longevity risk. For example, for fiscal year 2014 it generated lifetime annuity sales of A$613 million, up from A$46 million in fiscal year 2012, which represented 22% of its total retail annuity sales.

We think a number of tax, regulatory, and market barriers remain as discouragements to meaningful demand and supply of annuity products that offer longevity risk insurance. In our opinion, the inequitable tax treatment of annuities relative to superannuation pensions is a key factor limiting their demand. For example, unlike superannuation pensions, deferred lifetime annuities (DLAs) are not exempt from the Age Pension means tests and the removal of these exemptions resulted in a sustained steep drop in their sales. Between 2007 and 2008, the value of lifetime annuity market sales declined by 90%when all taxation incentives towards life annuities ceased for retirees aged over 60. DLAs, for which income payments are deferred for a given amount of time, could have more appeal to retirees because their deferral period can make them cheaper and they could be set up to complement an income-drawdown product.

However, given the government's strong focus on improving Australia's medium-term budget outcomes, we think any future tax changes in relation to annuities would be limited in scope to those that help place them on a more level playing field with superannuation pensions. Further, we doubt whether such tax reforms by themselves would lead to a substantial longer-term annuities market. We think other material factors would still constrain demand for these products, including:

- Shortage of high-quality and affordable advice on managing longevity risk, with most advice frameworks currently centered around investment products;
- Availability of a mean-tested Age Pension as a safety net combined with lack of default or mandated superannuation products;
- Lack of products and features that appeal to consumers, such as exposure to equity market growth, or ability to withdraw, bequeath assets, or control investments;
- Behavioral biases such as inertia and individuals underestimating their life expectancy and undervaluing future consumption relative to current consumption;
- Higher percentage of women at retirement age who do not have an existing financial planner or life insurer relationships.

We also believe a number of other factors restrict the supply of longer-term annuity products, including:

- Dominance of distribution channels for retirement income products by providers that have been making good profits selling investment products;
- Shortage of Australian dollar-dominated bonds with cash flows of longer-term duration, which could be used to match expected payments from longer-term liabilities;
- Uncertainties surrounding longevity risk and longevity improvement, and difficulty in reinsuring longevity risk at cost-effective rates;
- Annuities are a capital-intensive product. If the provider takes on longer-term inflation, market risk, and longevity risk, it will likely also take on credit risk from investing required reserves in bonds; and
- Regulations that could stifle product innovation, namely the inflexibility of Superannuation Industry (Supervision) Regulations 1994 (SIS Regulations) and the need to deal with multiple government bodies for approvals to offer new retirement income products.

We think the government would be more likely to develop policies that promote market-based coverage of longevity risk to help overcome some of these impediments and reduce its longevity risk funding burden, without the need for compulsory annuities. These could include:

- Mandating that retirees get financial advice about longevity risk;
- Removing tax and regulatory hurdles that discourage product development and demand;
- Issuing longer-dated government bonds, including inflation-linked, and/or longevity bonds;
- Developing publicly available industry-assured longevity data or indices that could help lower lifetime annuity rates by reducing some of the uncertainty for actuaries in pricing and reserving for longevity risk;
- Introducing a default or a tax-effective annuity product for a portion of superannuation funds or retirees; or
- Creating a longevity risk reinsurance pool funded by the industry and managed by the regulator.

Ultimately, we believe the government would have to require at least a default annuity product for a portion of superannuation funds or retirees to enable meaningful growth in the longer-term annuity market. This would be needed to overcome reliance on the Age Pension as a form of longevity risk insurance as well as consumer behavioral biases and/or unfavorable current perceptions of product rates and features. As FSI's interim report notes, Australia is currently "…unusual in neither mandating nor encouraging the use of income streams with longevity risk protection in retirement" as a number of countries with defined-contribution superannuation schemes have recognized the need for incentives or an element of compulsion on annuity products.

We also believe larger life insurers in Australia may lack sufficient incentive to strongly promote these products. Demand would have to stimulate growth and support adequate risk-adjusted returns. Australian life insurers have historically generated strong returns on equity and grown sales at double-digit rates from underwriting simple protection products, such as term life insurance and critical illness coverage, and from management or performance-related fees on unit-linked accounts and funds under management. These products arguably involve relatively less risk than underwriting longer-term annuities. That said, the profits annuity writers achieve could be attractive given more conducive conditions, considering the historical profitability of annuity products in other jurisdictions such as the U.K.

Key to developing the Australian annuity market is whether insurers perceive demand is strong enough that they would be adequately compensated for taking on elevated risk. We think the Australian market could take some time and more reform to build, but we see promising signs in the growth of the immediate annuity market, development of new longevity risk products, and an increased focus from policymakers. As profitability in markets for other products such as group life comes under pressure, this may enhance the relative appeal of writing annuities. Rather than eventually replace investment products entirely as a retirement income solution, we think annuities would be used to support a minimum standard of living in old age. For example, annuities could be used in combination with an investment product or for retirees who wish to bequeath some of their assets now and want to ensure they will have a certain income stream later in life. As the Australian market stands today, we think growth in annuity sales would benefit incumbent annuity writers, such as Challenger Life, The Colonial Mutual Life Assurance Society Ltd. (rated AA-/Stable), and Westpac Life Insurance Services (rated AA-/Stable) that have brands associated with these products, distribution relationships, and sales and underwriting experience.

What Are The Credit Implications For Australian Life Insurers?

Capital requirements to increase

We expect capital requirements to increase for insurers that enter the longer-term annuity market because annuity products tend to be more capital-intensive than investment products and because of the generally higher downside risk involved in underwriting longevity risk relative to mortality and morbidity risk, as life expectancy improves. For example, a lifetime annuity product would attract higher regulatory reserves for at least retained longevity risk as well as capital charges for operational risk and asset risk in relation to assets that back retained longevity liabilities. In comparison, for investment products in which the investor bears the liquidity and market risk, prudential regulations require providers to hold a comparatively minor amount of regulatory capital for operational risk.

Longevity risk could also attract higher regulatory capital charges relative to mortality and morbidity risk, depending on the level of uncertainty in pricing and reserving for future longevity experience as viewed by the insurer's Appointed Actuary. Our current view of relative mortality, morbidity, and longevity pricing risk is exemplified in our insurance capital model charges, as shown below.

Table 1

Life Pricing Risk--Capital Charge By Rating Category Stress As A Percentage Of Net Sums At Risk

Risk	Market	Net sums at risk	AAA	AA	A	BBB
Mortality risk	Highly developed	<$1 bil.	0.372%	0.331%	0.302%	0.229%
Morbidity risk	Highly developed	<$1 bil.	1.117%	0.992%	0.907%	0.686%
Longevity risk	All	All	8.104%	7.236%	6.604%	5.000%

We have estimated the potential capital strain for our rated life insurers in aggregate if they were to increase their longer-term annuity portfolios. This would require them to increase the reserves they hold for longevity risk, which would incur additional longevity reserve risk charges as well as asset risk charges and asset-liability mismatch charges (depending on the extent of their duration mismatch). Our scenario assumes:

- Capital position and reserves are as of the last balance date of each life insurer. In aggregate, our rated life insurers had total adjusted capital of A$24.3 billion compared to total diversified target capital of A$15.4 billion, equating to a redundancy of A$8.9 billion at the 'AAA' level;
- No other change to capital position except for additional assets held for longevity risk, which are invested in property in Australia as a longer-term asset class;
- No additional asset-liability mismatch and no diversification benefits from an increase in longevity risk reserves and assets held;
- No further strengthening required in longevity risk reserves as a result of assumption changes or higher sales of capital-intensive product features such as minimum rate guarantees;
- No material change in value of in-force business relative to capital base and reserves; and
- We have not considered the impact additional longevity risk liabilities would have on the regulatory capital position of our rated life insurers.

Based on our scenario, which has a number of limiting assumptions in terms of asset allocation and asset-liability mismatch, our rated life insurers can support growth in longevity risk reserves by a multiple of around 7.1x and still maintain 'AAA' capital adequacy. The figures represent the industry in aggregate, so this analysis does not infer that this degree of growth can be supported at the level of the individual insurer.

Table 2

Industry Scenario: Maximum Growth Of Longevity Risk Reserves Possible Within 'AAA' Capital Redundancy

	At 'AAA' level of capital adequacy						
Average capital adequacy	Diversified redundancy (% total adjusted capital)	Total adjusted capital (Bil. A$)	Total diversified target capital (Bil. A$)	Total diversified redundancy (Bil. A$)	Longevity risk reserves (Bil. A$)	Growth allowed in redundancy (Bil. A$)	Multiple of growth allowed for to retain AAA adequacy
AAA	37%	24.3	15.4	8.9	5.5	38.6	7.1

We think our rated life insurers can support this growth in longevity risk reserves given their already extremely strong capital adequacy in aggregate and the very small relative size of longevity risk reserves they currently hold.

Life insurers that underwrite mortality risk could also offset some of their regulatory capital charges for longevity risk to the extent these charges assume mortality and longevity risks to be uncorrelated. If these risks are not perfectly correlated, then the negative experience in one exposure has the potential to offset the positive experience in the other and thereby provide diversification benefits. For example, the regulatory capital insurance risk charge for future mortality risk and longevity risk assumes a 25% correlation between these risks. In our insurance capital model, we also assume only a 25% correlation between longevity risk and mortality and morbidity risks, but we also apply a 50% haircut to the resulting diversification benefit given the uncertainties around extreme longevity or mortality experience.

Diversification benefits could act to reduce demand by life insurers to reinsure their mortality risk, although this would depend on the rates available in the reinsurance market. In the U.K., where many writers of mortality risk also take on longevity risk, mortality risk is largely reinsured because competitive reinsurance pricing and the regulatory capital relief reinsurance brings makes this more attractive. We think it will likely become easier for Australian life insurers to reinsure their longevity risk as global reinsurers gain experience with this coverage in local and overseas markets. For example, in the U.K., longevity risk reinsurance is now a standard feature for annuity writers on large corporate pension schemes that wish to strip out the longevity risk and hedge their earnings so they are only exposed to the spread between returns on assets backing annuities and annuity payments based on current longevity assumptions. In Australia, we are aware of at least two separate longevity swap transactions underwritten by a global reinsurer, where the annuity provider pays the reinsurer fixed premiums and the reinsurer pays the actual annuity benefits, which can vary depending on survival rates. However, we think a deep and liquid wholesale capital market for longevity risk reinsurance still remains a distant prospect, without government-led incentives.

Life insurers could also be exposed to more earnings risk and/or higher capital requirements if they were to add or promote more flexible features in annuities to enhance their appeal to consumers. These features could include inflation indexation, minimum rate guarantees on variable rate annuities, the ability to withdraw or bequeath lump sums, or access to profit participation. Such features can lower future earnings and, as they add uncertainty to pricing and reserving, they can be expensive and capital-intensive. Our view of reserving risk for some of these features is exemplified in our insurance capital model charges, as shown below.

Table 3

Life Reserving Risk-- Capital Charge By Rating Category Stress As A Percentage Of Net Reserves

(%)

Product	AAA	AA	A	BBB
Immediate Annuities	0.7300	0.6500	0.6000	0.4500
Deferred annuities (without Guarantees)	1.0580	0.9400	0.8590	0.6500
Deferred annuities (with Guarantees)	3.2550	2.8910	2.6440	2.0000
Participating Annuities	3.2550	2.8910	2.6440	2.0000
Linked business with investment guarantees	3.2550	2.8910	2.6440	2.0000
Linked business with expense guarantees only	1.6280	1.4450	1.3220	1.0000
Linked Business without guarantees	1.0580	0.9400	0.8590	0.6500

Demand for longer-term assets, such as property and infrastructure, could increase

We expect insurers that enter the annuity market to invest more in property and infrastructure assets to lengthen the duration of their asset cash flows and hedge their inflation and market risk. Similarly, we also anticipate more demand for long-dated instruments, such as inflation-indexed bonds. Otherwise, annuity providers could incur higher regulatory capital charges in relation to asset-liability mismatch as well as volatility in cash flow and profit.

Demand could also increase from annuity providers for illiquid assets such as infrastructure loans, as has happened in the U.K., where these are viewed as providing an illiquidity premium for investors who are prepared to hold these assets over the longer term. Although infrastructure assets can be a good match for life insurers' longer-term liabilities, owing to their longer-dated lifespans and attractive yields, insurers' progress in making such investments may be thwarted by regulation project complexity, illiquidity, and a lack of suitable projects (see "Investing In Infrastructure: Are Insurers Ready To Fill The Funding Gap?," published July 7, 2014. Therefore, infrastructure assets have appeal, but are not necessarily straightforward to purchase and they tend to require significant in-house expertise to manage the exposure within risk appetite. Consequently, they would need to be sizable to make such an investment worthwhile, and we expect it would be confined to insurers of larger scale so that infrastructure assets would not dominate the overall portfolio. We think insurers that demonstrate investment expertise in longer-term asset classes have a comparative advantage in writing longer-term annuity products.

Again, the U.K. market can provide some insight into the extent to which Australian life insurers could shift their underlying assets if they start to underwrite significant levels of long-term annuities. As of year-end 2013, the typical annuity asset portfolio in the U.K. comprised around 20%-25% in other longer-term asset classes, which included equity real estate, mortgages, direct loans, and infrastructure. The remainder was mainly invested in corporate and government bonds and there was a very small allocation to direct property and variable interest instruments (<5% each). By comparison, our Australian rated life insurers remain largely invested in high-quality government and corporate bonds and cash, with some life insurers having an allocation to property assets.

Providing advice could become more complex

The FSI's interim report also highlighted that the quality of financial advice could be improved because consumers' decisions in relation to managing income and risks in retirement are particularly complex. If the annuities market is to grow on a sustainable basis and overcome lack of awareness and behavioral biases, we think it would need support from an advice framework that effectively provides guidance to retirees on managing longevity risk. However, we recognize the significant challenges in providing this advice on a cost-effective and affordable basis, but innovations in data mining, data analytics, and customer interfaces could assist.

Product diversity ultimately helps insurers protect against regulatory and market risk

Insurers who add annuities to their product set could also benefit from increased product diversity. This would help offset potential losses from other product lines as well as protect against regulatory risk. Longevity risk products provide a natural hedge to life insurance products that underwrite mortality risk and operate in different customer segments and markets. Further, as we have seen in other jurisdictions such as the U.K., insurers with diversified product lines have been much better placed to deal with unexpected regulatory reform.

As Australians continue to live longer, the issue of longevity risk will become more pressing without reform. However, there are no easy answers and there are some difficult decisions to make as government and retirees try to strike the right balance between flexibility of control and certainty of income.

Why Is The U.K. Market Moving Away From Compulsory Annuities?

Compulsory annuities using privately accumulated retirement balances have been a longstanding feature of the U.K. retirement income system. The existing stock of U.K. annuity liabilities is £260 billion as of year-end 2013, representing £21 billion in premiums. Of this, 45% were group or bulk annuities, and 55% were individual annuities. In a move the market largely didn't anticipate, the U.K. government announced that from April 2015, an accumulated retirement balance could be withdrawn as a lump sum (up to 25% tax-free and the remainder taxed at the individual's marginal tax rate) to give greater flexibility and choice to retirees.

The reforms reflect the culmination of a number of initiatives by the industry--pushed by regulators--to improve consumer outcomes at retirement. An interim report released by the Financial Conduct Authority (FCA) in February 2014 found that some parts of the U.K. annuities market were "not working well for consumers". In particular it found that, purely based on price, 80% of customers who purchased their annuity from their existing pensions provider could get a better deal by shopping around, with an average potential increase in income of almost 7%. Given that around 60% of policyholders buy their annuity from their existing provider, we view the impact as material. The FCA's findings could be pertinent to policy development for Australia's retirement income system.

Related Criteria And Research

Related Research

- Investing In Infrastructure: Are Insurers Ready To Fill The Funding Gap?, July 7, 2014
- U.K. Annuity Volumes Will Suffer Until Greater Clarity Emerges On Policyholder Response To Budget, March 25, 2014

Additional Contact:
Insurance Ratings Europe; InsuranceInteractive_Europe@standardandpoors.com