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Investment & Longevity Risk
A need for improved quality & greater diversity of pension products in Australia

Executive Summary

- The rise of self managed superannuation funds (SMSFs) highlights current product offerings are not catering to the investment needs of investors.
- While many trustees of SMSFs no doubt enjoy the challenge of asset allocation and selection there are potentially many looking for greater diversity of product specifically targeted towards the income/retirement phase.
- Longevity and investment risk along with successful marketing campaigns from the likes of Challenger and AMP have seen inflows into annuity and guaranteed retirement income products (GRIPs).
- The GFC and subsequent "de-risking" of portfolios along with the marketing success of some of these products has created a environment where, particularly with current low interest rates, many investors are potentially underweight risk assets.
- A product that provides some certainty of future cash flows along with the capability to invest some capital into riskier assets with enhanced earnings potential could be appealing to investors.
- Lifetime annuities (Challenger) and GRIPs (AMP, Macquarie etc.) provide some options but ultimately deliver only partial and expensive solutions.
- The recent success of deferred income annuities in the US may foreshadow a similar opportunity here in Australia if government policy changes extend tax breaks to deferred lifetime annuity products.
- Deferred lifetime annuities (DLAs) when imbedded in or offered in conjunction with other products could offer a more comprehensive investment solution for the retirement phase.
- The Henry Review recommendation that given the nature of these products, they should only be provided by prudentially regulated entities could place Life Insurers in an enviable position.
- The Financial System Inquiry's interim report notes:

"Although individuals are concerned about outliving their savings, few retirees use income stream products with longevity risk protection, and there is a limited choice of these products,"

Jeremy Cooper, chairman of the former Labor government's Super System Review noted:

"As observed, Australia is the only developed nation with a compulsory retirement savings but no decumulation structure. We are a laggard by world standards and are being trumped by Chile, Canada, Sweden, Denmark, Singapore, Israel, and the Netherlands - this needs to change,"

Background

- Australia introduced compulsory superannuation in 1992 effectively moving from an existing limited employer defined benefit system to an employee contribution scheme.
- Subsequent growth has seen Australia become the fourth largest superannuation investment pool globally with $1.8 trillion(June 2013) under management and projected to grow to $7.6 trillion in 2033.
- The majority of industry participants since inception have concentrated on accumulation products with limited focus and innovation in the pension phase.
- A trend towards growth/demand for pension products in Australia could enable the Life insurance industry to participate in this growth sector.
- Government measures aimed at simplifying the tax, age pension means tests and regulatory arrangements for retirees have over the years removed incentives to purchase life annuities.
- Recent volatility in investment markets has highlighted the dangerous shift from a defined benefits to defined contribution scheme as those nearing, at or post retirement age suffer potentially significant capital drawdowns.
- Further, the Deloitte report (Dynamics of the Australian Superannuation System The next 20 years: 2013-2033) notes: "The projections here indicate that the government, the industry and society need to consider ways of encouraging retirees to take their superannuation as an income stream or annuity rather than a lump sum, to help address the demographic challenges of adequacy".
- The Coalition government has undertaken to actively encourage innovative retirement products designed to minimise market risk, inflation risk and longevity risk.

An ageing workforce & population

- At present 15% of the population is 65 and over, this will increase to 20%(5.8m) in 2033 a 75% increase.
- By 2033 there will be a 100% increase in Australians over 75
- Subsequently the ratio of working age to retiree age Australians will move from 4:1 to 3:1 by 2033.
- At present 50% of retirees expect to live past 86 years suggesting retirement outcomes rather than wealth creation will increase in priority.

Current dynamics

- Currently no compulsory requirements, default options or extended tax advantages to purchase an annuity.
- Deferred Life Annuities (DLAs) are seen as a potential product opportunity if tax concessions are extended
- Joe Hockey has previously stated his commitment to developing a larger annuities market in Australia.

- Government is now conducting a review of all post retirement products.
- Challenger – "the only retirement income specialist in the market"
- For FY14 Challenger sold $613 million lifetime annuities, up from $257 million in FY13 and $46 million in FY12.
- Challengers total annuity sales were $3.38 billion for FY14, up 8% on FY13 with lifetime annuities moving from 12% of total sales in FY13 to 22% in FY14.
- Currently of the $72bn of funds flowing into retirement less than 0.6% is going into lifetime income products.
- Academic research papers have projected "assuming all impediments are removed, reaching a level at some point in the future where total annuity sales (lifetime and deferred) are between 2-4% of total Superannuation assets".

Other observations

- AMP North product net flows remain strong (GRIP)
- Challenger acquires Bendzulla Actuariel, a SMSF services firm Dec 13'
- EBX (Endowment Bond Exchange) launched 2013
- Nobel Laureate William Sharpe recommends defaulting retirees into annuities.
- Challenger CEO Brian Benari:
  "Challenger has recorded five straight years of retail annuity sales growth, and has unambiguous expansion prospects. It's time to change gears so we can capitalise on the opportunities before us."
  "Lifetime annuity sales growth has been phenomenal, hitting $613 million from only $46 million two years ago. But the post-retirement market remains largely untapped, because this year saw more than $66 billion a year flow from the savings phase to the pension phase of super.
  "Similar growth opportunities await our boutique funds management business".
  "Challenger is uniquely positioned to capture a healthy share of super and retirement flows over the next twenty years".

Product Providers with longevity & Investment risk protection
Lifetime annuities & Guaranteed Retirement Income Products (GRIPs)

- Challenger Lifetime annuities - Liquid Lifetime, payment indexation, 15 year voluntary withdrawal, reversionary nomination, lump sum on death to estate or reversionary within 15 years
- AMP North (GRIP)
- Macquarie Lifetime Income Guarantee (GRIP)
- MLC Masterkey Investment Protection (GRIP)
- Metlife Max (GRIP)
- Westpac – Immediate annuity (up to 15 years or 95 years old)
- CommInsure – Immediate annuity (up to 30 years or life expectancy)

Deferred Lifetime annuities (DLA's)

- Guaranteed lifetime income stream negating longevity and market risk
- Income commences once policy holder survives a pre determined age
- Significantly cheaper price than immediate annuities (depending on deferral period)
- Attractive returns compared to other asset classes due to "mortality credits"
- Opportunity to package product with other offerings

DLA's – A building block for a total retirement solution

A successful product will provide solutions for two risks so far poorly addressed by current offerings.

1. Longevity risk, that investors will outlive their funds. (The government must remain incentivised to assist commercial solutions given the demographic outlook and ultimate ownership of all risk through the aged pension.)
2. Investors/retirees generally need to take risk (away from fixed income investments) to generate additional returns given current cash and bond rates of return.

As a result DLA's can be seen as a building block for product /investors, providing longevity insurance in a structure that also facilitates and promotes other capabilities to enhance and protect investments.

- Investment in risk assets (equity and other risk premium assets)
- Dynamic rebalancing strategies
- Protection and income enhancement strategies

Regulatory and tax change needed for development

- Confirm tax treatment during deferral period.
- Address minimum drawdown requirements, annual benefit payments and application of standard minimum surrender values
- Clarity around asset test requirements during deferral period.

Other considerations inhibiting growth

Shortage of long dated assets for Life Co's to hedge their liability.
(A greater offering of long dated government bonds has been suggested as a solution.)

No default options or extended tax incentives for annuity products.

A solution to overcome investor perceptions of long-term viability of product suppliers – is APRA regulatory oversight sufficient?

Industry Concerns Impacting Product Development

Minimum deferral periods, maximum deferral periods and upper limits on amounts that can be invested into a DLA.

- All will have significant impact on the types of products that will be developed.
- Defined periods and limits will constrict the range of products.

Capital standards

- Consistent standards applied to domestic and international participants negating cross border capital arbitrage.
- Reduction of capital required to offer products will increase affordability and promote further product development.