Coping with the burden of longevity – do superannuation fund members really need or want new financial products?

Ross Clare
ASFA Research Centre
Financial burden of longevity

• A recent general community concern
• A much better concern to have than the alternative
• Currently 13% of population aged 65 and over
• Figure projected to rise to 25% by 2045 with large increases in the old, old
Some more numbers

• Life expectancy at age 60 currently 23 years for men, 26 years for women
• Around 40% of retirees will spend more than 25 years in retirement, with around 10% spending more than 35 years
• Those aged 85 plus to grow in numbers from 300,000 to 1.4 million by 2045 due to the babyboom busting rather than from increase in life expectancy
Theory and practice of annuities

• A rich and relatively long history in economic literature of life-cycle savings models
• A very long history of annuities in practice, as they were important when no welfare state
• Modern annuities started as far back as the 18\textsuperscript{th} century
The rates set for annuities

- The initial (and later) annual payments depend on whether there is a reversionary beneficiary, escalation of payments, guaranteed minimum payout
- People with poor life expectancy quite unreasonably are too poor and/or unwilling to buy annuities
- UK the only really decent annuity market
Regulatory provisions relating to income streams

• Account based income streams relatively lightly and flexibly regulated with not many obligations on providers

• Annuities and the like are strictly regulated with burdensome obligations on providers and no real scope for varying payments
## Market data

<table>
<thead>
<tr>
<th>Type of income stream</th>
<th>Funds under management $m</th>
<th>Sales in last 12 mths $m</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allocated pensions</td>
<td>66,176</td>
<td>13,926</td>
</tr>
<tr>
<td>TAPs</td>
<td>1,441</td>
<td>530</td>
</tr>
<tr>
<td>Lifetime annuities</td>
<td>na</td>
<td>9</td>
</tr>
<tr>
<td>Total annuities</td>
<td>4,447</td>
<td>547</td>
</tr>
</tbody>
</table>
More data or retirement income streams

- Around 2.9 million currently aged over 65
- Around 2.2 million get Age or Veterans Pension, total $22b
- 600,000 or more have private income stream with average around $20,000 a year, $12b
- Around 190,000 Comsuper pensioners on average $21,500 pa
The real challenges for retirement income streams

• Getting enough retirement savings to be able to stream them
• Achieving a reasonable investment return in retirement phase
• Paying little or no income tax
• Not spending too much each year
• Have sufficient pooling of longevity financial risks
Accumulating enough retirement savings

- A lot of hype in the media (some of which I contributed to) about people with $1 million or more in super
- Current average retirement payments more like $130,000 for men and $45,000 for women
- Public servants, university staff and even superannuation researchers tend to do better than that
Achieving a good investment return

- Annuities tend to have the double whammy of capital guarantee type earnings rates and high fees.
- Account based income streams can have genuine balanced or growth type investment returns, and often can do a good deal on fees as well.
Keeping tax paid to a minimum

- The tax regime applying from 1 July 2007 means those aged 60 and over pay little or no tax on income streams
- Biggest percentage improvement is for income streams for untaxed schemes, as nobody much ever paid tax on benefits from the taxed schemes
Not spending too much in retirement

• Drawdown factors have nothing much to do with expenditure patterns, as you can spend more or less than a required payment out of super

• New factors give a lot of flexibility, and also ability to keep money in accumulation mode

• Individuals can have growing super balance well into their 90s
Dealing with the consequences of longevity

• The Age Pension provides a certain amount of insurance, albeit for a relatively low level of retirement income
• Conventional allocated pension/account based income stream provides little protection
• Life annuities provide excellent protection, but at the cost of low income over retirement
Fiddling with the rules

• Compulsory annuitisation would impose costs on more people rather than fixing the problem

• Improving the implicit investment returns on annuities would require more year to year variation in payments to be allowed

• Even a redesigned life annuity is a challenging sales proposition
Fiddling with the rules (continued)

• Current rules basically rule out reserving/pooling of longevity risks in account based income streams
• Reserving does not really work because no pooling of risks and estate planning considerations
• Pool of 50 or more lives in some sort of tontine could help
Sharing longevity risks across account based income streams

• A yearly payment of, say, 3% or 4% of capital into a special risk sharing fund
• This fund also to have investment earnings tax free as will ultimately support an income stream
• Would pay out benefits to survivors, particularly those who reach old, old age
Conclusions

• The greatest financial challenge in dealing with longevity is to get some decent retirement savings
• Once a modest sum is achieved, then an income stream makes sense
• A range of income streams is better than one size fits all and/or compulsory annuitisation
Conclusions (continued)

• New income stream rules provide considerable flexibility and are sufficient for most people

• Good to see Age Pension asset test fixed rather than another work around

• Case exists for further enhancements to rules for both account based and annuity income streams