Longevity risk pooling
A practical alternative in an account-based pension environment?

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Asking the tough questions

So, when will you die?

Australian Projected Life Expectancy (in years)

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<th>At birth</th>
<th>At age 60</th>
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<td>2007</td>
<td>2047</td>
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<td>Men</td>
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Source: KGR, April 2007

The holy grail, or just part of the puzzle?

The financial services industry loves posing the question ‘How much is enough?’

- But the answer is typically confined to:
  - assumed investment returns and costs
  - unchanging legislation, and
  - asset allocation and contributions as ‘levers’ to influence the outcome.
- We have largely side-stepped the risks associated with outliving your savings.

How long will you (and your super) last?

Source: a presentation to Institute of Actuaries, 4th Financial Services Forum
The Best Laid Plans, by Darren Witheram and Richard Storey
Why the sudden interest in longevity risk?

- Medical science continues to lift our life expectancy
- Inexorable shift from defined benefits to defined contribution
- Incentives for the annuitisation of super removed (e.g. RBLs and complying income streams)
- Australia now has an unprecedented *laissez-faire* account-based retirement model.

The traditional response – lifetime annuities

- Unpopular and under utilised in Australia
- Relatively expensive, conservatively structured and weighted in favour of the offering institution
- No longer supported by tax and social security incentives
- Little policy appetite to reinstate incentives or mandatory annuitisation.

Case study – Geoff plans for retirement

Geoff’s vital signs:
- Single, 65
- Healthy
- 40 years of super
- $450,000 lump sum.

Let’s assume (generously) that Geoff has 22 years to live (87yo).

Geoff and his financial planner decide in retirement he needs $37,000 p.a.
- Approximates ASFA/Westpac “comfortable lifestyle” expenditure budget for a single person @ Dec 07.

They discuss investment risks and devise two scenarios:
1. Conservative drawdown – slow decumulation to age 100
2. ‘Plan to life expectancy’ drawdown.
Scenario 1 – conservative drawdown
- allocated pension to age 100
- income = $27,000 p.a. (includes Government age pension).

Problem: Scenario 1 produces income significantly below Geoff’s expectations.

Scenario 2 – plan to life expectancy
- target income to age 79, reducing from 80 to 88
- Government pension (~$14,000 p.a.) from then onwards.

Problem: Scenario 2 runs out and leaves Geoff exposed to age pension only beyond his assumed life expectancy.

The missing link – longevity risk
- planning dialogue has been all about investment risk and addressing the situation as a unit of one
- but Geoff faces a significant risk – what if he outlives his savings?

Geoff needs a holistic solution that addresses all of his future financial risks.

Longevity risk pooling – a means to an end
An end:
- income needs of those who live longer is funded by the unspent assets those who don’t
- everyone has greater certainty around draw downs in early retirement
- survivors have prolonged access to higher income
Scenario 3 – Geoff swims in the longevity pool

- Geoff invests 20% of super into longevity pool:
  - income = $37,000 p.a. until age 80
  - longevity pool supplements income after age 80.

Assessing the ‘longevity alpha’

- ‘Longevity alpha’ projections suggest:
  - 1 to 2% p.a. for those retiring at age 60 who survive into their mid to late 80s.
  - Up to 4% p.a. and above for > 100.
  - Even higher if favourable assumptions are used regarding the social security treatment of pensioner’s account.

Will anyone buy it?

- UniSuper conducted a series of in-depth qualitative discussion forums on this topic.
- The research consisted of:
  - 8 focus groups = 60 allocated pension members
  - interviews and group sessions
  - men and women aged 55 and over.

UniSuper member research

- Income needs in retirement:
  - enjoyment – overseas travel an expectation for many
  - risk of investment performance
  - inheritance for their family
  - worried about running out of money.
- Most had adjusted expectations of retirement lifestyle to meet expected income.
In their own words

"I want an income from pension no less than what I was earning. I'm going to enjoy life! I worked hard!"

(Melb, woman 55+)

"It's all a matter of choice. I want something to give me at least five years amount of time then go back to basic living."

(Melb, woman 55+)

"I find I'm spending a lot more money now in retirement than when I was working. My income requirements are higher now!"

(Bris, man 65+)

"Not much I can do about the situation. I am trying to make sure something is vaguely there however long I live."

(Melb, woman 55+)

Members want answers to longevity risk

- Most participants had thought about their life expectancy
- The 'D-word' was openly discussed
- Personal estimates of life expectancy varied, based on:
  - the longevity of their parents and grandparents,
  - their own health and
  - the understanding that life expectancy is increasing generally.

Members want answers to longevity risk

- more than 50% interested in "looking at the numbers" to find out more about a longevity pooling Scenario
- 1 in 6 said longevity pooling would be advantageous for them

Issues to consider

- administration and scale
- selection risks
- communication & modelling tools
- contestability and liquidity of pensions
- role for Government?
Superannuation providers beware

- Australians will feel the burden of an ageing population
- Individuals are increasingly responsible for their own retirement incomes
- The public purse will struggle to keep retirees in the manner to which they are accustomed.
- ‘How much is enough?’ is important, but ‘How long this will last?’ also needs an answer.

Thank you

Any questions?