A Different Approach To Meeting Changing Needs in Retirement

David Rush
Martin Paino

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Overview

- Needs in retirement
- Cost of longevity
- Existing problems
- A different approach
- Some issues – funding, anti-selection
- Possible designs

Needs in retirement

- Needs (despite the basics) relating to:
  - Health
  - Marital status
  - Lifestyle
  - Wealth
  - Travel
  - Dependents
  - Transport
  - Sport & entertainment
  - Bequests

Needs in retirement

If there is one thing that is certain, it is that an individual's needs will not remain constant for long, if at all

Cost of longevity

There are actually two longevity problems:

- **Individual** longevity
- **Portfolio** longevity

The two are often conflated in one solution.

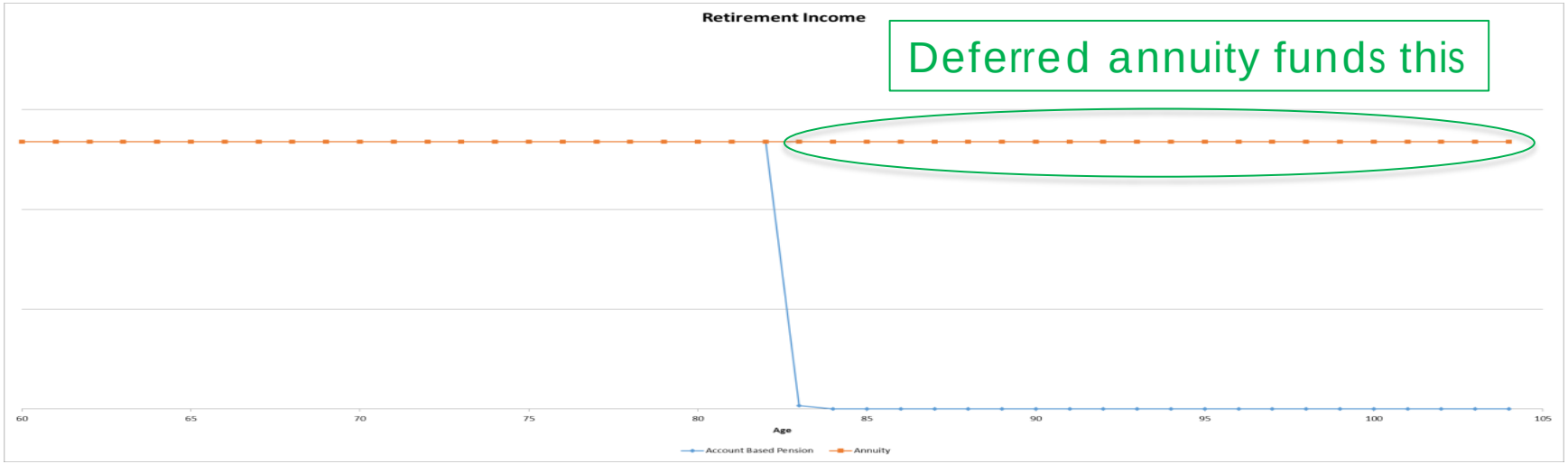
Cost of longevity

A possible measure:

the proportion that must be set aside for a deferred annuity to be purchased which provides a continuation of the same income stream once the person reaches their life expectancy

Cost of longevity

An example:



Indicative cost of longevity

Age	Males		Females	
	e_x	Longevity Cost	e_x	Longevity Cost
65	19.2	13.7%	22.1	11.2%
70	15.3	16.1%	17.9	13.2%
75	11.8	18.9%	13.9	15.9%
80	8.6	22.2%	10.2	19.4%
85	6.1	25.7%	7.1	23.3%
90	4.2	29.0%	4.8	26.4%
95	2.9	32.0%	3.3	26.3%
(Australian Bureau of Statistics, 2011-2013)				
Australian Life Tables, Interest 2.00% p.a.				

Existing products

Existing products examined were:

- Lifetime annuities
- Fixed annuities
- Deferred annuities
- With-profit annuities
- Investment Linked annuities
- Account Based Pensions
- Guaranteed Minimum Withdrawal Benefits
- Longevity Pooling Investment Option

Features of existing products

Some features of existing products are:

- Longevity protection
- Flexible payment
- Investment choice
- Market risk
- Forfeiture
- Capital requirements
- SIS regulations

Problems with existing longevity solutions

Particular problems with products providing longevity protection:

- complexity
- cost
- inflexibility
- investments, not income
- retirees want to leave an inheritance
- retirees want to control the investment strategy
- self-reliance / self-confidence / distrust of insurers
- retirees value consumption now more than in the future
- tax treatment
- potential regret
- not the default
- retirees see the Age Pension or family home as adequate for their needs
- role of the advisor

The Account Based Pension (ABP)

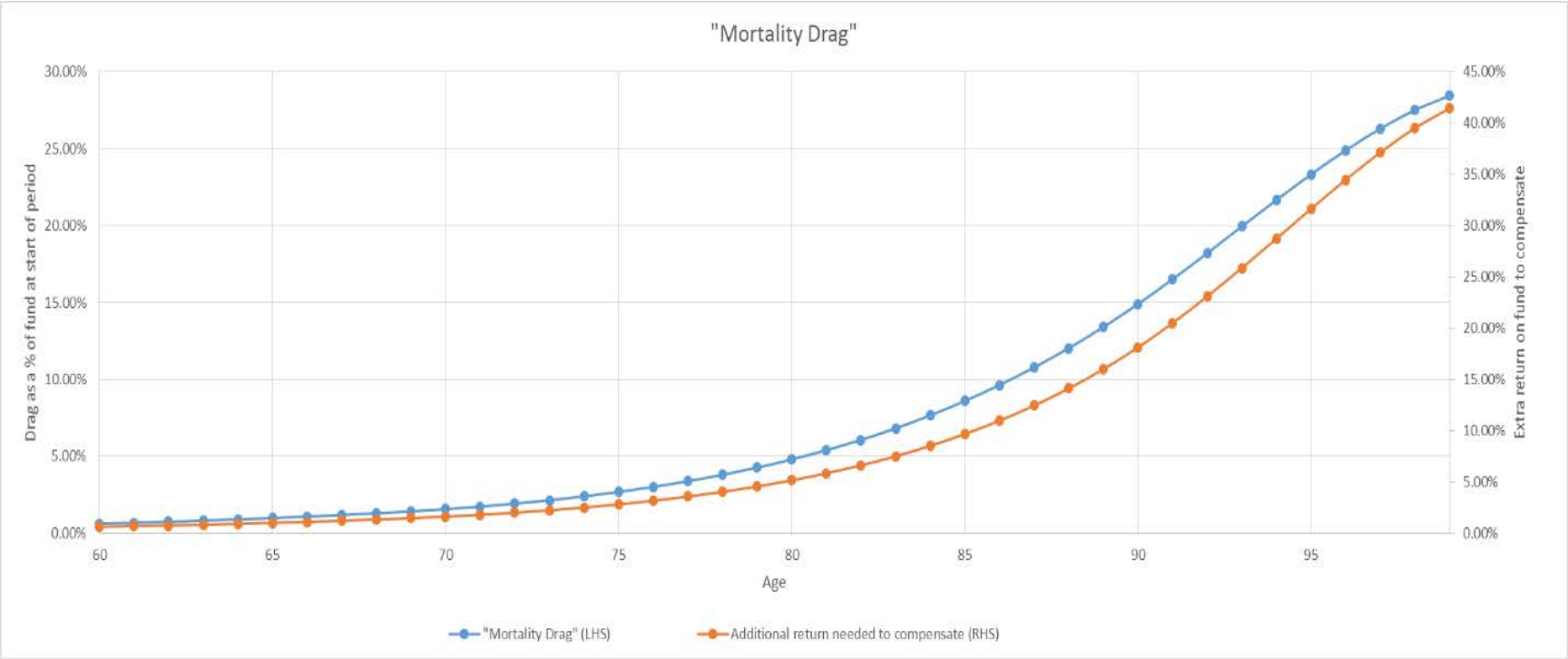
By contrast with the above, the ABP is popular. It sells because of:

- simplicity
- familiarity
- cheap
- flexibility
- an inheritance can be left
- retirees can do their own investment
- fostering of self-reliance / self-confidence
- value for money
- tax treatment
- potential regret
- role of the advisor

A different approach

- Many people assume that the only way to protect against longevity risk is to provide some form of long-term guarantee on the provision of income
- Longevity risk is made up of a lot of smaller risks in each period – the risk of surviving each period
- Similarly, the benefit that is needed to offset the risk in the long term is essentially the accumulation of smaller benefits in each period
- Individual longevity risk can therefore be met by providing a benefit on the risk materialising (i.e. not dying) in each period
- 'Living bonus'
- But insurance rider, not alternative investment option

Amount each period



Benefit and Funding

- Benefit = $\frac{q_x}{(1-q_x)} AB_{x+1}$
- Fund benefit
  - Premium = $q_x(AB_x - 1)$
  - Forfeiture
- Issues to consider
  - Premium v Benefit
  - Premium v Forfeiture
  - Frequency of Benefit
  - Advice

Anti-selection

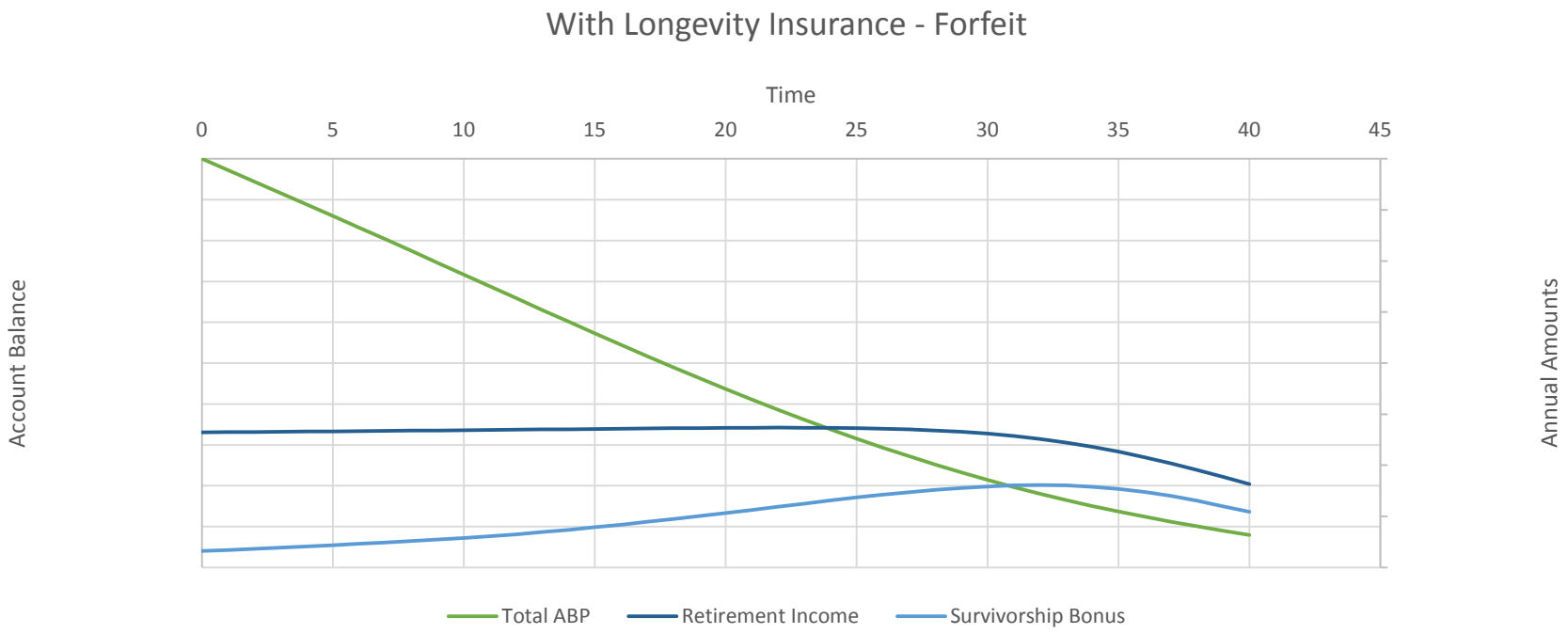
- The risk that the retiree ceases or reduces their cover in the event of their likely death
- Risk increases with the level of forfeiture involved
- If no forfeiture there is still anti-selection risk
- Some rules and restrictions needed – offsets some flexibility and simplicity
- Potential options include:
  - Extending the length of the period between benefits
  - Apply a penalty if the retiree cancels or reduces the cover under the rider

Possible designs

- A deferred annuity style product providing a single lump sum benefit on surviving a period aligned with remaining life expectancy

- A product providing an annual top-up payment to the ABP while the person remains alive, funded primarily via the forfeiture of the ABP balance on death.

A stylised example



Conclusion

- Existing products have (mostly) focused on the provision of income
- Longevity is addressed by guaranteeing that the income will continue
- However, there is an alternative approach

- **The provision of an income in retirement, and the investment of funds to provide that income, can be separated from protection against longevity risk**

- This doesn't lock people in based on an estimate of future static needs

- **One alternative involves using an insurance rider in conjunction with the already popular Account Based Pension**

- No single product solution is appropriate in all circumstances – we are all unique individuals with unique needs.

Questions / comments