Institute of Actuaries of Australia

Innovation in Retirement Incomes

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1. Introduction

The objectives of this paper are to outline the key drivers impacting the growth in the retirement incomes market and to discuss and evaluate the expanding product and service innovations in this segment.

Key Drivers of Growth

Four key drivers are currently impacting the market:

1. The ageing population and the imminent retirement of the baby boomers
2. The growth in retiree assets from home equity and superannuation
3. Revised superannuation legislation and the impacts upon those retiring
4. The increasing need for advice for near and post retirees, and the growth of advice intermediaries

Products and Services

Currently, there are a range of annuity style products in favour within Australia and being used by retirees. We compare this current annuity product range to products available overseas. The relative merits of allocated and lifetime annuities are considered from the perspective of consumers and providers.

The growth of home equity release products has begun to gather momentum. We review this and consider the relative benefits and risks of these products in the context of retirement incomes.

The service challenge for financial planners in the provision of advice to retirees needs continued focus and development, now and in the future. Planners are evolving from a pre-retirement to a post-retirement focus. In doing so they will need more directly applicable tools to work with customers in exploring retirement needs and designing solutions when in retirement.

Future Innovations

The future of retirement income products will depend upon the degree and speed of innovation in the marketplace. In particular, product, service and advice developments that could improve retirement income offering to consumers while at the same time rewarding providers that develop such innovation.

2. The Environment for Change

While retirees have similar basic needs, they each have different wants and means available to them. In addition, they will have different levels of knowledge of investment markets and risk tolerance.

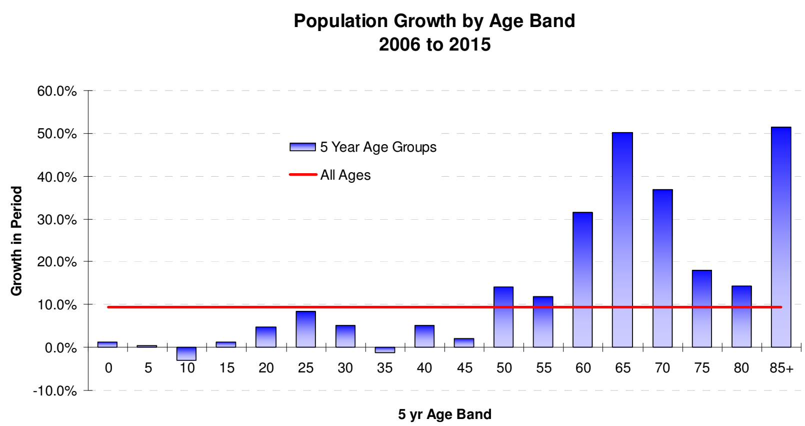
Two key challenges for financial service companies in this market are to:

1. Design and provide the tools that will help financial advisors to both educate their clients and improve the advice process; and
2. Build a suite of products that allow a financial advisor to tailor an optimal solution for their client

This will need to be done in a cost effective way, in order to ensure that new offerings can be made available to the mass market at an appropriate price.

Demographic Changes will be Pronounced

Australia, like most developed nations, has an ageing population. As a consequence, the savings and investment industry will see profound changes as more and more Australians move from the accumulation phase of wealth building, to the retirement phase of wealth draw down.



Source : Trowbridge Deloitte, ABS

The above shows that in some ages bands, the forecast population growth will be as much as 50% + over the decade to 2015. While well known to the financial services industry, it nonetheless demonstrates the significant underlying demographic growth that will occur in the retirement marketplace.

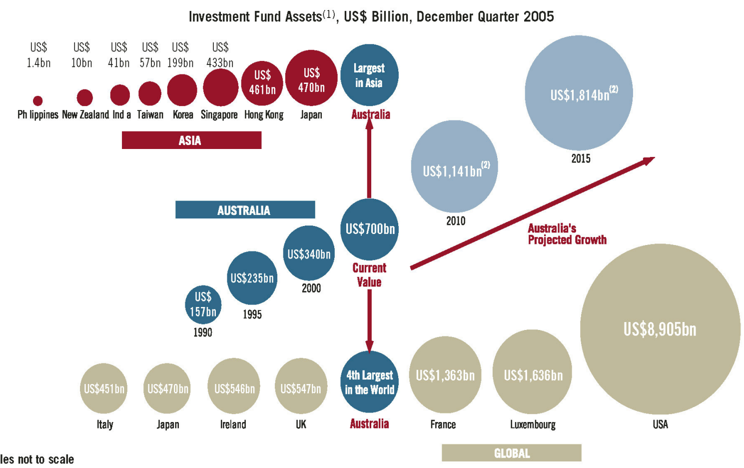
Continuing Growth In Superannuation Assets

Australia has recently seen the size of its superannuation assets surpass the $1 trillion level.

This growth has been underpinned by the compulsory superannuation charge legislation, requiring Australian employees to contribution at least 9% p.a. into superannuation savings. Additional tax and benefit concessions, as well as sustained public education campaigns, have resulted in many individuals contributing in excess of this mandated minimum level.

The growth of the Australian superannuation marketplace places it in the top 5 in the world in terms of total assets. It ranks higher than the United Kingdom, and is the leading country by superannuation assets across Asia.

The Global Significance of Australia's Investment Fund Assets Pool



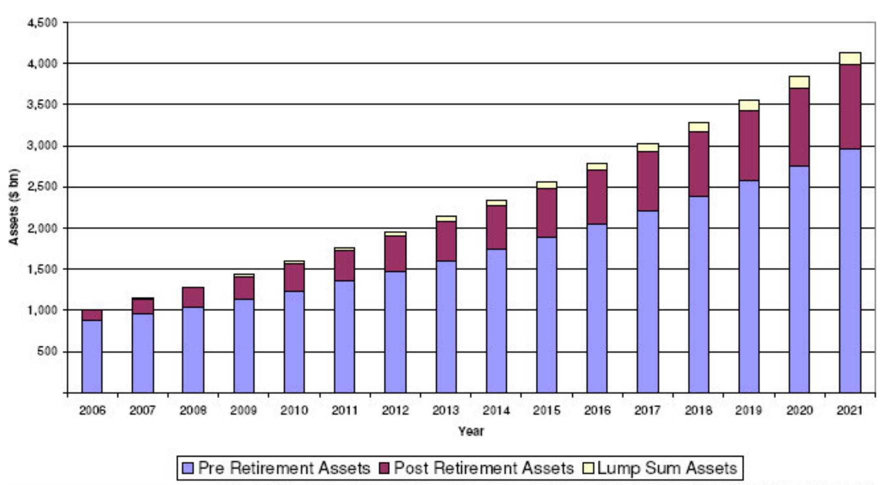
(1) Refers to home-domiciled funds, except Hong Kong, Korea and New Zealand, which include home- and foreign-domiciled funds. Fund-of-funds are not included.

(2) Based on long term average exchange rate of Australian dollar against US dollar (January 1984 to December 2005) of US$0.7080.

Sources: Investment Company Institute, Worldwide Mutual Fund Assets and Flows, Fourth Quarter 2005; Singapore's data as at 31 December 2005, sourced from Monetary Authority of Singapore; the estimated figures of Australia's investment fund assets were provided by ASSIRT Research (now part of Standard and Poor's); Axiss Australia

This growth is set to continue, especially in post retirement assets. Post retirement superannuation assets are forecast to grow by close to 23% p.a. until 2012, compared with 9% p.a. for pre retirement superannuation assets. This highlights the strong generational shift into retirement, and the considerable wealth in the over 55 age segment in the coming years.

Total Superannuation Assets by Year



	2006	2007	2008	2009	2010	2011	2012	2016	2021	CAGR (2012)	CAGR (2016)	CAGR (2021)
Pre Retirement Assets ($bn)	872	953	1,040	1,135	1,239	1,352	1,475	2,051	2,958	9.1%	8.9%	8.5%
Post Retirement Assets ($bn)	138	192	246	301	357	415	473	736	1,178	22.7%	18.2%	15.3%
- *Pension Assets ($bn)*	138	185	231	278	326	376	426	652	1,033			
- *Lump Sump Assets ($bn)*		7	15	22	30	38	47	84	145			
TOTAL	1,011	1,145	1,286	1,436	1,596	1,767	1,948	2,787	4,136	11.6%	10.7%	9.8%

1 Trowbridge Super Model - 2007

This increase in retirement assets will require different approaches in investment advice, allocation and product selection compared to that for pre-retirement assets. Where the investment of pre-retirement assets is primarily focussed on maximising the likely financial size of the assets by retirement age, asset strategies and individual needs in retirement are not so easily defined.

The management of such a growing base of retirement assets, both in advice and product choice, will be increasingly important and one which is already challenging financial advisers and product providers alike.

Retirement Assets Are Broader Than Superannuation

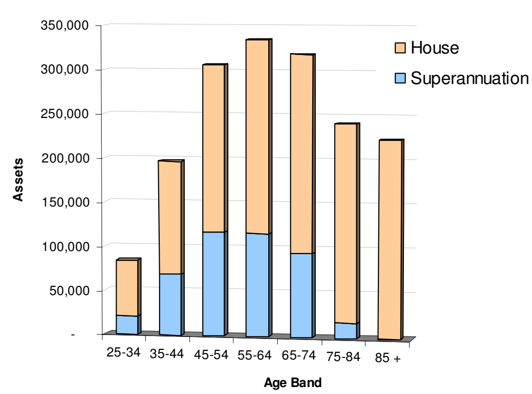
While Australians have made their minimum required superannuation guarantee charge contributions over a number of years, for many Australians this may still not be enough for their living needs in retirement. Indeed, it is often the wealthier individuals that perceive the value of financial planning and tax advice, and they have used such advice to contribute much more than the minimum requirements into superannuation (as well as having the financial means to afford to do so).

According to results published in 'Are Retirement Savings on Track' (*ASFA Research & Resource Centre, June 2007)*, superannuation savings for the "average" Australian household aged 60-64 are estimated to be around $125,000. However, the distribution of assets is quite skewed, with over 70% of households having balances less than $100,000.

It will be important therefore for many Australians to consider the broader wealth accumulated over their working life. This could include property, business wealth, personal savings and investments and other assets (together with the potential to continue in part time employment). These should all be considered in terms of potential for retirement income support and innovative advice and product solutions.

Property assets, especially the family home, are often of considerable value and well in excess of superannuation savings for the average Australian household. Indeed, over 85% of retired Australians own their home outright, and this asset is worth some 2-3 times on average the value of their superannuation savings.

Average Net Assets per Household



It is therefore important, when considering innovation in retirement income needs, and assets available to support these, to not focus solely upon superannuation assets. A broader perspective will be necessary for the greater mass of Australian households, as well as for more affluent households (as they are likely to consider a holistic perspective upon their retirement assets in any case).

Budget changes

A considerable short term impetus and focus on retirement assets came in the form of recent Australian government legislative changes. From 1 July 2007, amended taxation and superannuation rulings came into effect that dramatically simplified the way in which superannuation and retirement income options are treated.

The major changes implemented were:

- Lump sum benefits will be tax-free for superannuation members aged 60+.
- Reasonable Benefit Limits will be abolished.
- Investors will be able to take multiple lump sums if they choose, with remaining funds taxed at the fund rate.
- There will also be simplified rules for market linked pensions.

These changes mean that retirees (in particular) have considerably more freedom to access superannuation monies in various ways and to invest and move monies. The previous pension related eligibility rules will no longer apply for most, and the limits for drawdown of funds will also be largely removed.

With this freedom of choice and use comes the strong need for robust advice and appropriately suited products and services. Rather than retirees previously needing to see planners and accountants in order to "work around the system and minimise tax", they now need to receive strategic financial planning advice.

This significant simplification of the superannuation system creates an opportunity for life insurers and wealth management organisations to design new retirement income stream products and support advice and education.

3. The Varied Needs of Retirees

In retirement, clients can be in any number of life stages. Importantly, their view on time horizons, objectives and personal use of assets can be considerably different. Unlike pre-retirement where most people share a common goal of maximising their assets by age 65 (and they are largely captive to keeping assets within the superannuation environment), retirees are past this point and can use their superannuation assets whenever and for whatever they please – for most, their life has begun again !

Features by which to consider retirees and their different situations could include :

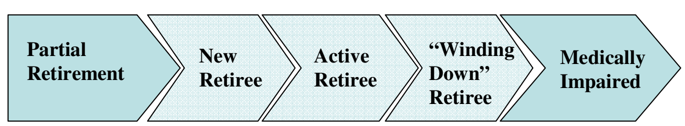
i. Life stage
ii. Funding position (assets versus income needs)
iii. Objectives (across time horizons) and risk preferences
iv. Home ownership status

Each of the above will influence what type of real life decisions and choices the particular retiree, and his/her family, are having to make. The advice on use of assets in retirement takes on a very real impact - most are drawing upon their assets to use in living the remaining years of their life, and have limited chance to make amends should poor or ill-informed decisions be made which have later ramifications.

Life Stage

We have taken this to mean the age, family, work and health status of the individual. This could range across the following (and in varying forms in between):

Retirement Life Stages



The trend towards phasing down to retirement has grown in recent years, partly due to the overall strength of the economy. Financially, partial retirement could assist the retiree in improving their funding position and broadening their options for an active and financially independent retirement. Financial planning strategies such as salary sacrificing are also available to them. Spending may well be less than "earned" income in this phase.

Recent and active retirees have as much energy as when they were working and can now put this energy into their leisure time! Expenses at this stage of retirement will generally be more weighted to entertain options such as travel, golf fees, etc. Spending potentially peaks at this stage of the life cycle as retirees seek to enjoy the fruits of their labour earlier in life.

As retirees move to a less active phase, but are not restricted by serious medical problems, they can be seen as "winding down" their active expenditure. However, at this stage of retirement, people may be considering alternative accommodation such as a retirement village, and the children and family become increasing an important aspect.

Medically impaired retirees could mean living in an old age home or requiring significant attention in the form of home care that severely restricts their movement. Spending in this phase will be dominated by "care" needs e.g. medication, treatment or nursing home fees. While general expenditure is likely be relatively contained (for Australian retirees), there could be a spike in spending needs to cover an accommodation bond in a nursing home or to make home modifications.

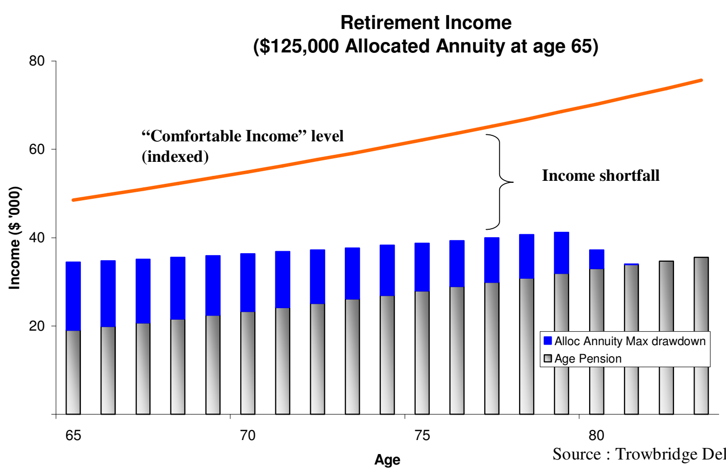
Each of the above have particular implications for financial advice, both when in that particular life stage, but also before. Assisting retirees to understand the various potential life stage financial needs, and planning in advance to ensure financial options, is important.

Funding Position

The funding levels of retirees, or the size of their available retirement assets, can vary considerably. It can range from those that are highly funded, to those that are likely to be nearly wholly reliant upon the government aged pension. However, in the middle is the "mass" of Australians that can be regarded as "somewhat, but not completely" funded. It is this mass market of current and near term retirees that present significant advice challenges for the financial planning industry.

The average superannuation assets per household are around $125,000 in 2007. Using AFSA/Westpac recommendations of what is required for 'comfortable living' (estimated at around $48,500 for a couple as at June 2007), it is likely that such superannuation savings will fall well short of meeting these levels throughout the retirees future lifetime.

In the following example, the retiree is relying on their superannuation to supplement their income from the aged pension. It can be seen that their income is lower than the ASFA 'comfortable' level and their fund is exhausted by around age 80.



Source : Trowbridge Deloitte

The need to consider both the asset (as it is drawn down) and the income provided, is a key aspect of post retirement advice. It is not simply a focus on asset growth – it is what income is available as well as the remaining asset value.

It will be required for proper advice to be able to extend across all forms of potential retiree financial assets, including superannuation, residential property, ordinary investments (eg unit trusts, shares) and other assets such as small businesses or shares thereof.

Objectives

The objectives for retirees can depend upon life stage, funding, family and other influencing factors. There are also likely to be multiple objectives, for instance :

- Overseas travel (on a semi-regular basis while still active);
- New purchases (of certain consumable items) every x years
- Income of $x p.a. for living expenditure for next y years
- Enough assets to provide income post age 80 of $y pa
- Inheritance assets for children of at least $z
- Remain in current home until a certain age, and then downsize

Understanding and prioritising the range of potential objectives, and over the various time horizons, is important. The clearer the objectives the better, and linking them to definable financial targets at certain milestone dates will enable monitoring of the success or otherwise of retirement planning strategies.

How a retiree structures their assets in retirement, and the combination of investments and products, will be critical to them reaching these objectives.

Explaining the likely needs at varying stages, and how these may influence objectives and decisions, is a key role of the adviser in this process. Retirees need to consider the time horizon of their various objectives, and this will interact with their risk tolerance.

Indeed, understanding the risk of the objectives not being met over the time horizon, and being able to track and actively update this, will be a necessity of planners advising retirees.

The range of risks that need to be assessed when advising retirees include investment risk, longevity risk (or a longer ”active period” than expected) and medical expense risk.

Home Ownership Status

Owning a home is both a financial and an emotional asset. For many retirees, their home is where family memories exist. It is in a location where they are comfortable and have access to friends, family and known amenities.

Home ownership status will have a significant impact on a retirees income needs. As stated in section 2, some 85% of Australians over 65 own their home outright. Given the strong property appreciation over the past decade, it is likely that many retirees have considerable equity in their property which they may or may not fully appreciate.

From a retiree’s perspective, whether to consider their home as a source of potential retirement income support is often not a financial one. It is an emotional one.

Many retirees will build their plans around their home and remaining in the residence for the medium term future and bequeathing it to children. The planner therefore needs to be cognisant of the strong emotional attachment that many have to their home. Others will seek to downsize and release equity, or consider one of the equity release products available.

Understanding the way in which this significant asset is considered by the retiree, as well as assisting them to know how it could be considered, is important.

4. Equipping Advisers

There is estimated to be around 15,000 financial planners in Australia. This is the major industry group that has the professional, educational and regulatory standards to be advising retiring Australians in both general and specialised advice. There are also many other intermediaries that retiring Australians turn to for domain expertise – such as accountants, tax advisers, mortgage brokers and solicitors.

To date, the vast majority of financial planning focus and advice has been on pre-retirement superannuation assets. In particular, in advising clients on maximising superannuation to create the largest possible "nest egg" for retirement This is largely explained by the fact that most Australians are still in pre-retirement.

There will come a time in the next 5 years, however, when many planners will need to consider how they approach the issue of their retiring client base, or risk losing some of their most lucrative clients. In particular, will they have the necessary skills, understanding and advice tools to appropriately advise on post retirement, rather than pre-retirement.

Complexity of the task

Most people approaching retirement face an inherently complex problem of how to best arrange their financial affairs post retirement.

There are a considerable range of issues to consider, such as:

- Investment allocation and the trade-off between risk and return
- Inheritance and asset preservation versus income levels desired
- Social security and taxation concerns
- Longevity risk
- Preparing for "impaired stage"
- Choosing products and providers

Each of these issues involves uncertainty and complexity that will vary for each customer.

The general approach it seems at present is for retirees to place their funds with allocated annuity, or unitised, products. This is likely driven by a combination of factors, such as retiree desire to "actively" monitor their portfolios and have "open access" to their funds, combined with strong recent performance of equity markets (at least prior to July 2007!) leading many to consider this the optimal asset class for their funds. In addition, the recent budget changes have also removed the benefit for alternative exempt annuity products.

One could also perversely take the view that much of the reason for such allocation of funds to unitised products is that it is the "easier" and "safer" path for the financial planner. The strategy is quite a simple one, it is relatively quick to adopt and the ultimate "risk" is viewed by the client as due to investment markets, rather than the "advice" given.

In our view, there needs to be both a greater level of client education and recognition of the risk/return objectives, and better planner strategy tools and more in-depth advice. Importantly, the optimal outcome considering longevity and income preservation is an area we consider greater emphasis must be placed.

Retirement Adviser Tools

The quality of advice is often dictated by the degree of adviser support tools available.

Advisers, like other professionals, need to efficiently allocate their time to maximise their own productivity and give quality service to their clients. Understanding client circumstances, considering and developing optimal strategies, liaising with the client and formalising the statement of advice and financial plan are key components of the adviser's role with the client. In order to facilitate this, advisers need tools that allow them to perform the above in the most efficient and appropriate way.

Many client based tools exist on the marketplace. These include proprietary commercial software packages (such as Coin, Xplan and VisiPlan), as well as internally developed software within dealer groups for their own planners (eg. Count Financial's Interact software).

The capability of such planning software for advisers has evolved considerably over the past few years, and will no doubt continue. It is common for them to include various analyser and optimiser applications, some of which are based on Monte Carlo simulations of investment outcomes.

However, in our opinion, there is still a gap to be filled in terms of post retirement planning software functionality. Those tools that currently exist are primarily focussed on pre-retirement, and generally any Monte Carlo applications are limited to selected investment assets.

We consider the market can evolve further in relation to:

- Including a broader range of retirement specific products and investment assets – such as property assets, equity release products, life or health insurance and income certainty/protection products

- Incorporating longevity risk and morbidity probabilities into the stochastic modelling. This would allow more sophisticated risk profiling for clients, especially around the probability of meeting income needs and asset preservation for inheritance

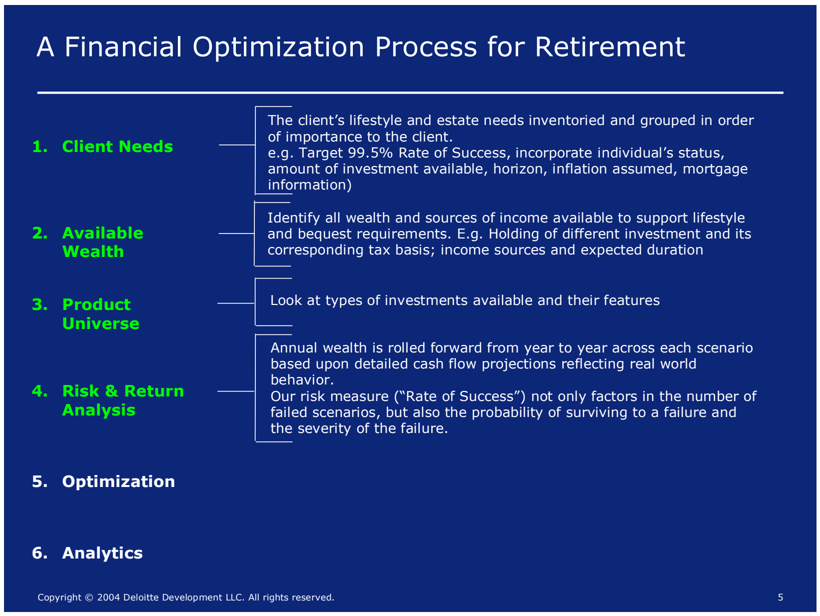
- Developing analysis and reporting that can be performed by advisors and presented to clients to more effectively communicate the full risk picture of retirement and for ongoing client contact

These would require the ability of the software for retirement purposes to:

- **Integrate Protection & Investments**
- **Measure Rates of Success**
- **Optimize Strategies to Achieve the Client's Objectives**
- **Demonstrate the Value of Protection**

A "Best Guide" Software Tool for Post-Retirement Advice

The enhancements above require a tool which can deliver the following process for an adviser with a post retirement client :



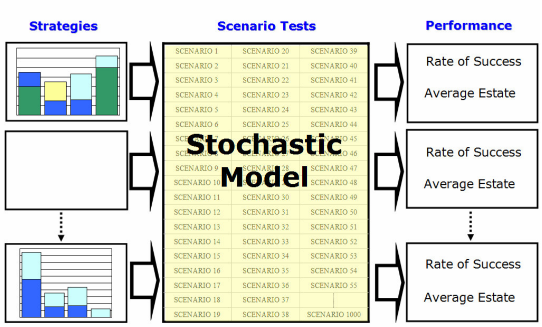
The risk and return analysis in the above diagram is where the role of actuaries and their deep understanding of stochastic modelling can be used in financial planning advice tools.

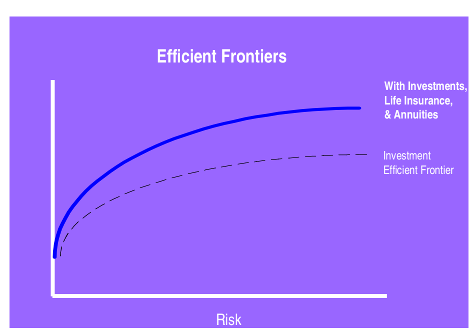
For instance, a stochastic modelling engine could be developed which can model assets (across various asset classes including property etc) and be combined with various products designs and, importantly, incorporate mortality survivorship.

It could also include various "failure" or "success" measures. Again, actuaries would be ideal to consider these, by applying the notions of:

- Timing – probability of survivorship to failure
- Frequency – proportion of scenarios that have a failure
- Severity – ratio of sustainable to desired lifestyle

The resulting simulations, and the "success rate" produced, would provide probability weighted risk/return outcomes. This then allows for optimisation strategies to be developed.





With any advanced tool which provides such insights, it is only as good as the ability of the adviser to understand and use it, as well as the ability of the client to make sense of it.

From our anecdotal experience and discussions with advisers and others in the industry, we consider that there would be two types of primary use:

1. High net worth clients and advisers – generally, these are the type of clients (and their advisers) who will be more financially literate and appreciate the sophistication that such post retirement strategy planning tools could provide. Such clients will likely not be “scared” or “put off” by the rate of success outcomes, and will have generally more available assets to enable income levels to be largely met with optimal strategies.

2. Dealer Group Optimisation Strategies for Client Category – this is for the larger mass of clients who are not high net worth. In this case, the dealer group could run through various assumed client profiles (eg age, asset mix and size, objectives, risk tolerance) and use the tool to determine the optimal asset allocation. It can then be referenced by advisers in the group to use when selecting potential strategies.

   So rather than the client and adviser being deterred by the complexity (and the “success rates”) coming from the model, the benefits can still be achieved in terms of optimal strategy.

Experience from the United States shows that the development of such tools is well advanced in terms of supporting advisers with clients in retirement. We consider that as Australian advisers embrace the challenge and opportunity of advising a greater volume of retired clients, that such developments will be inevitable.

5. Product Innovation – Now and In The Future

To complement the innovation required in advice-based tools and the manner in which advice is provided, there will also be the need for continuing innovation in the product mix available for retiring Australians.

After spending their working lives accumulating retirement savings, Australians will be faced with a wide variety of products to aide in managing wealth and hopefully enjoying spending their nest egg over time.

In this section, we consider the following range of current and potential products :

- Current Annuity Products
- Innovative Longevity Products
- Potential Alternative Annuity style products (ie variable annuities)
- Property Equity Release Products
- Insurance – risk and long term care

Current Annuity Products

The most common current products available and generally utilised by retirees are annuities. These are generally available in both “allocated” and “lifetime” variety in the Australian marketplace :

Types Of Annuity	Description of Key Features
Allocated Annuity	The current product offering of retiree specific investment management products in Australia is dominated by allocated pensions (and similar drawdown style products such as TAPs). Allocated pensions provide unit linked investment vehicle with flexible drawdown (minimum set by government). Allocated pensions have a number of positive features including flexible investment options allowing the retiree to tailor their asset allocation, simplicity and transparency. A weakness of allocated pensions is the inability to manage longevity risk, without taking on high levels of investment risk or continually reducing spending.
Lifetime Annuity	Lifetime annuities provide a fixed income stream (potentially indexed) for the life of the retiree. They are generally guaranteed which offers risk protection, however this comes at a cost in terms of pricing (value for money) and lack of access to funds. Providers also require considerable capital charges to maintain such portfolios.

Allocated annuities can be expected to be the benchmark for all potential products over the medium term at least. They provide many benefits for retirees, and receive supportive taxation treatment for individuals. Their flexibility and the potential for “hands on” involvement by retirees and advisers are likely to see them remain popular. Their popularity has no doubt been buttressed further by the recent strong investment returns.

The future of lifetime annuities however is less certain. They have lost their social security advantages in terms of asset test exemption status and pricing remains sensitive (in terms of value for money for purchasers). Retirees it seems prefer flexibility as the major requirement as opposed to income certainty.

Innovative Longevity Products

As discussed in the advice section, there is a need to focus retirees and their planners on the risks of longevity in terms of income sustainability and older age protection. From a product perspective, there have recently been innovative Australian developments in the design of longevity income products.

The Asteron Longevity Income Stream (ALIS) product is a relatively new product that we classify as part of the 'longevity pooling' products. It is sold in tandem with an allocated annuity and is designed to provide a top-up to surviving policy owners via 'mortality boost' (a transfer of funds from deceased policy owners in the same pool). It provides the flexibility of maintaining an allocated annuity, while giving a degree of longevity cover.

With the ALIS product, the policyholder elects to pay between 10-20% of their retirement assets into the particular "asset class" pool established by the product. Should they survive to age 80-85, then they can begin to receive income relating to the growth of their own assets, as well as those assets in the pool "boosted" by other policyholders that have not survived.

Note : Another provider, Ingevity, has a similarly innovative 'Income for Life' product. It is actively working with potential alliance partners to support its product drive into the marketplace.

These developments are at the vanguard of a new generation of products that will offer Australian retirees options to better manage both their investment and longevity risks.

The challenge however is one of product design coupled with how they are advised and integrated with adviser tools and platforms. Consumer education and adviser willingness to embrace the concept and its benefits will be a critical sales success factor.

Alternative Future Annuity Style Products

The first place to look for new retirement income products is in overseas products. There are two key developments that we consider potentially viable in the Australian market :

1. <u>Variable Annuities</u>

   These are a type of hybrid between allocated annuities and lifetime annuities. Variable annuities provide a stream of units set at outset rather than an income stream that are paid while the policy owner survives. Over time the value of units vary with underlying investment markets and policy owners are be able to change their investment allocation.

   As such, it gives the benefits of the income stream, at an unit price that is determined by asset market growth (and selected investment strategy of the policyholder).

   Providers in the US typically offer guarantees that consumers value highly but involve complex hedging programs. For example, if a guaranteed minimum income benefit is added to a variable annuity that also allows some equity upside, then the provider will have a series of options to cover.

   We certainly see a place for variable annuities in Australia, given that they allow investment flexibility and provide full longevity insurance.

Potential drawbacks can be that upon death no funds are returned to the estate (unless there is a guaranteed death benefit) and this also restricts the ability to offer a surrender value. Also at least initially, consumers may find the concepts underlying variable annuities to be complex, as the stream of units is generally set to reduce over time, with the expectation of unit price growth compensating for the reduction in units.

2. With-profit annuities

With-profit annuities are also a type of hybrid annuity product. They begin with a guaranteed income stream that is set at a level below what would be provided by life-time annuities. In exchange however, over time policy owners would expect to receive bonuses. Having an initial buffer allows for the underlying funds to have some equity investments and a lower capital requirement than lifetime annuities.

If the pool performance is as expected (with equities returning a risk premium) then bonuses will be payable and in such expected outcomes overall policyholders are likely to receive more income than under lifetime annuities. However, they are in part sharing the risk via the bonus mechanism.

Drawbacks for with-profit annuities working in Australia could be the lack of support that they may receive with consumers, adviser and even providers. This is because Australia has moved noticeably away from bonus style contracts towards more unitised funds with greater transparency and flexibility.

Summary of Annuity Products Features

Feature	Allocated Pensions	Lifetime Annuities	ALIS [1]	Variable Annuities	With-Profit Annuities
Access to funds	Flexible withdrawals	Locked in income stream at purchase	Restricted	Locked in at purchase	Locked in income stream at purchase
Investment Options	Choice of asset class and manager, ability to change over time	Not required as company guarantees earning rate	Three options	Choice of asset class and manager, ability to change over time	Company determines the appropriate investment allocation
Investment Return Profile	Depends on investor choice and fee levels	Individual return based on longevity, fund assets often in fixed interest	Depends on option chosen	Depends on investor choice, fee levels and individual longevity	Individual return based on longevity and fund performance
Longevity Insurance	None offered	Completely insured	Covers individual but not systemic risk	Completely insured	Completely insured
Investment guarantees	Based on investments chosen, generally not guaranteed	Backed by life company, requires capital	Not guaranteed	Based on investments chosen, but elaborate guarantees are often offered	Existing income level plus reversionary bonuses are guaranteed.
Easy to understand?	Transparent and well understood	Simple promise	Simple concept, although benefits may not yet be fully understood	Contracts are often complex, underlying concept is not too complex	May be complex for Australian market given loss of familiarity with 'with-profit' contracts

[1] Note focus is on the ALIS product, which is written in tandem with an allocated annuity

Property Equity Release Products

Releasing equity from property is nothing new for Australians. However, rather than using a financial product to achieve this, most Australian retirees do it via the common method of "downsizing" ie. selling the family home and moving to a less expensive property and investing the money released for retirement purposes.

Recognising both the considerable asset that most Australians have in their property, as well as the opportunity for a product to facilitate releasing such equity for, there has been a proliferation of equity release products and providers enter the market in recent years.

Three types of property equity release products generally exist :

- Reverse mortgage
- Home Reversion
- Shared Appreciation Mortgage

The advent and growth of equity release products provides an alternative to downsizing for many retiring households which may prove a more suitable alternative.

i. A reverse mortgage is essentially an interest compounding mortgage provided specifically to people aged 60 and over, subject to loan to value limits based on age. It is not required to be repaid until death, or earlier sale of the property (or move to aged care in certain products). This "open ended" feature is extremely important, as is the "no negative equity guarantee" (ensuring the borrower can never owe more than the value of their property).

   A key retirement income feature of many Australian reverse mortgages is the ability to take an instalment income version of a reverse mortgage. This allows the borrower to receive a regular stream of payments into the future, to the extent that their LVR limits permits. Also, for most households this will be classed as a return of capital, and not treated as income for aged pension entitlement purposes, nor taxation purposes.

ii. A home reversion product is essentially a deferred contract of sale agreement between the lender and the borrower. The borrower receives a lump sum of cash in return for a portion of their property being owned by the lender. The borrower is allowed to remain in the property for the remainder of their life and not have to pay any rent or other payments to the lender. At point of sale the lender has a right to its proportion of the property's sale price.

   The amount lend and subsequent ownership stake is generally determined based on life expectancy as a key factor (as well as assumed property growth and opportunity cost of funds for the lender). For instance, a 65 year old borrower may be advanced 30% of the value of their property as cash in return for the lender having entitlement to 60% ownership.

iii. Shared Appreciation Mortgages are a hybrid. They advance funds as a lump sum of cash to the borrower, and in return the borrow must repay the original principal plus around 2x the LVR of the capital appreciation eg. if a borrower advanced 20%, then the provider would be entitled to that principal plus 40% of the capital growth.

According to the *SEQUAL/Trowbridge Deloitte Reverse Mortgage Study,* reverse mortgages have grown to be over $1.8b of outstanding lending as at 30 June 2007. This comprises almost 30,000 households. There are over 12 providers offering reverse mortgages that are members of SEQUAL, only one provider of home reversions and no current provider of SAMs to the retiree market.

Of particular curiosity is that no insurer has yet offered any of these products. In Australia, they have been developed and offered by the trading banks, specialist banks or non-bank lenders. This is in contrast to the UK, where some insurers have entered the market place.

Retiree Insurance

The most common product provided to retirees would be health insurance and general insurance products.

Health insurance is provided to many retirees and provides significant benefits to them. There exists a 'reinsurance pool' to ensure that such contracts remain profitable (or at least not loss making) to health insurers over the long term. Without a risk based premium offering however (ie under the current community rating approach), scope for retiree specific developments has been limited.

In general insurance, retirees have a need for personal insurance cover like other consumer segments and are served by the industry accordingly.

In life insurance, the market for risk insurance products for retirees in Australia is currently relatively restricted when compared to overseas markets. A particular product which has been previously attempted and not been successful has been Long Term Care :

Previous attempts at establishing a Long Term Care product in Australia failed to survive. A key impediment to the market was that places in nursing homes receive a large government subsidy, such that the aged pension covered the gap remaining. Since then accommodation bonds have been introduced, but this has not triggered the re-entry of insurers into providing Long Term Care insurance products.

Risk cover for death, TPD and trauma insurance is generally offered to retirees, particularly if they are continuing an existing policy. However rates typically rise with age and often become prohibitively expensive and retirees generally have less need of these products, than while they were working. Income protection has ceased offering lifetime benefits, which is consistent with the needs no longer existing and the significant moral hazard in retirement for such products.

Overall however, there could be potential to more broadly consider the wider role of insurance when potentially packaged with other retirement income products. However, given a lot of it revolves around health costs, there is limited application for this to exist.

Other potential product designs

A number of industry commentators and product designers have been grappling with the dilemma of innovation in retirement incomes. Some of the interesting views, as well as some thoughts of our own, are below.

<u>Pool Sharing Products</u>

We believe there are potentially more evolved versions of longevity pooling products that could be designed that may address market sales and adviser usage issues.

With the right mechanism, there could be no need to restrict the investment flexibility of an allocated annuity. The product could also be structured to allow for all retirees to receive benefits from the 'pool', regardless of their current age. The key to achieving both these features will be in finding the right mechanism.

The randomness of a pool return could be replaced with a short term guarantee of a term which could be provided either by a life insurer using their pricing skills (and taking some longevity risk) or by a provider purchasing a hedge product from an investment bank (these products already exist in overseas markets). This could be in the form of "longevity swaps" of the development of such instruments to allow investors access to the return/risk profile from longevity.

From a client time horizon perspective, it can be difficult for client and adviser alike to decide at age 65 to enter into a product with a minimum 15 year period before any benefit is received. Shorter term "optionality" of the longevity buy-in, at say five yearly intervals could be considered. For instance, the client could effectively commit more to provide them with an option to re-assess and re-commit to the pool depending upon life stage at specified time/age windows, penalties for early withdrawals. However, this may address some of the difficult sales perception at present for longevity products.

It should be noted that all 'pool' products involve a trade-off of more funds for surviving policy owners coming from the remaining funds of deceased policy owners.

Ready Access Products

Given superannuation funds now have very few restrictions on their withdrawal, all products could be altered so that income is paid into a cash account they have that is still within the superannuation fund. The retiree could then access their funds via ATMs, EFTPOS and the internet.

This would have many convenient features for retirees, such as keeping their funds in a tax advantaged environment and potentially accessing better rates that are often offered by competing products such as term deposits.

Ultimately, there is going to be considerably more choice and innovation in the years to come for Australian retirees. We consider the future for retirement incomes to be very positive. It is a challenging environment, and one which is going to grow at a rapid rate and offer opportunities for all who participate in it.

The converging aspects of demographic movements, compounding growth in retirement assets, increasing financial literacy of consumers and evolving retirement life stages will present new areas for providers and advisers alike to assist in innovating in Australia's future retirement income market.