Retired Market Financial Products

Notes for prior reading

Institute of Actuaries of Australia

Biennial Convention – Coolum 2003

Concurrent session

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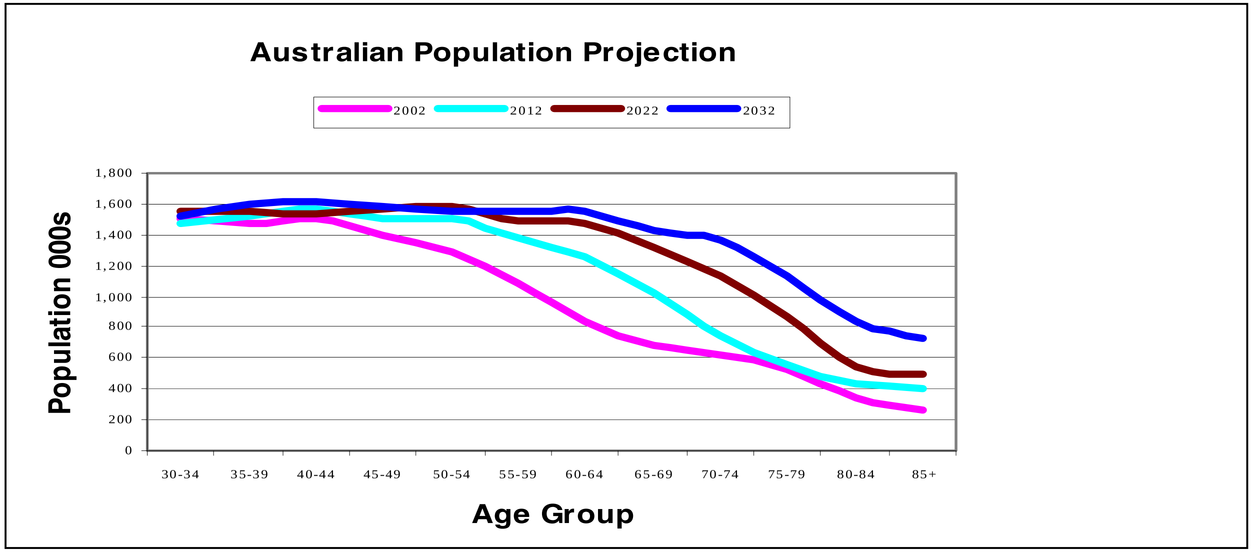
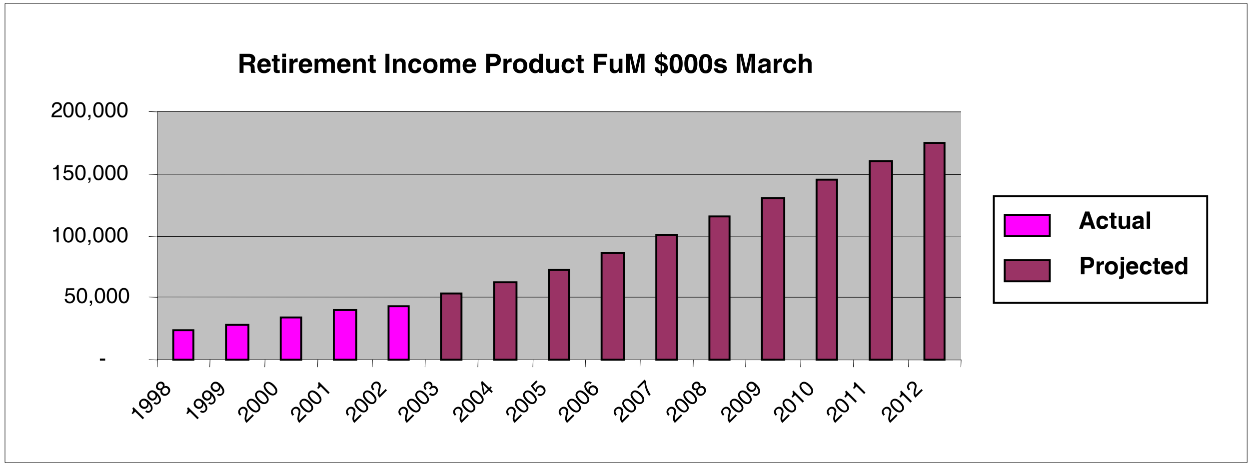
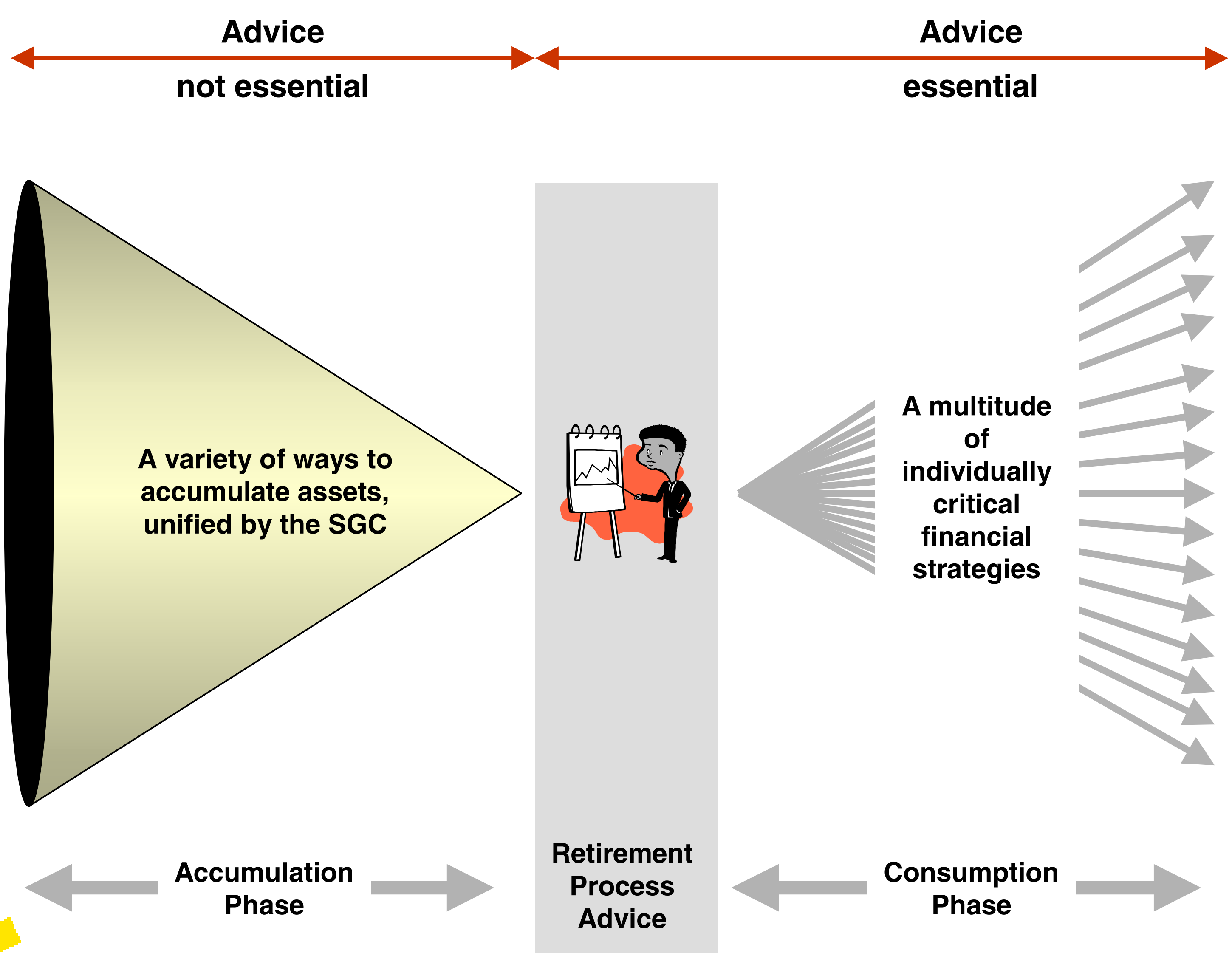
Australia’s ageing population …





… and the growing wealth they will own

Australia’s retirement finances pivot around ‘Advice’



Financial products for the retired market include (1):

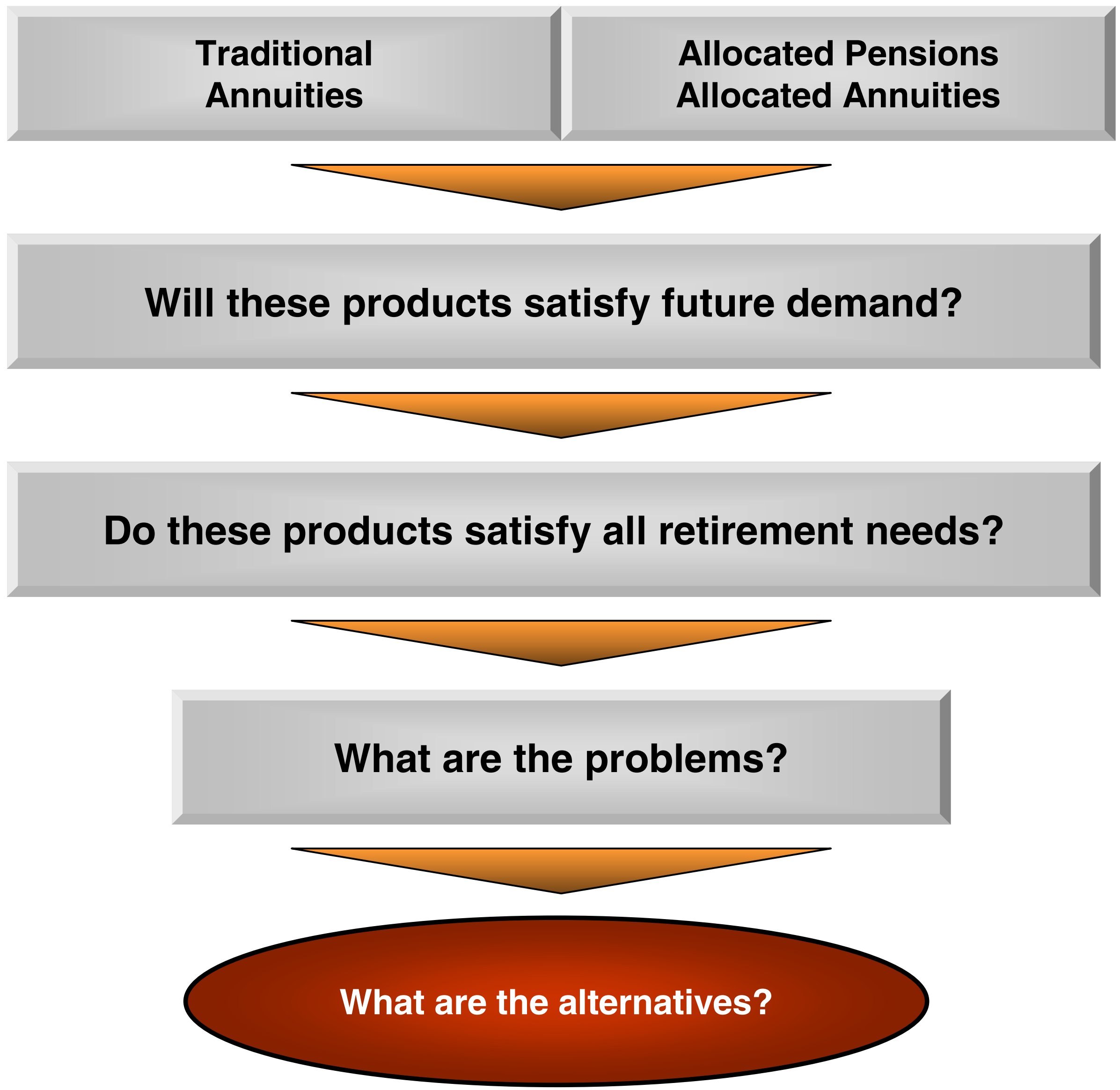
- Retirement income
  - Allocated pensions
  - Allocated annuities
  - Traditional annuities
- Managed investments
  - Master trusts
  - Unit trusts
- Specialised banking products
  - Deposits (eg deeming accounts)
  - Margin loans
  - Guaranteed equity

Financial products for the retired market include (2):

- Protection (generally little tailoring for the retired market)
  - General, health, life insurance and long term care insurance
- Services
  - Financial advice
  - Wrap accounts, IDPS, etc
- (Direct investments – equities, property, etc)
- (Family home)

This session focuses on retirement income, the family home, long term care, and financial advice

The major current financial products are aimed at retirement income :



Six issues with the current market and available products

1. Lack of a “complying” equity-backed income stream product
2. Lack of a longevity risk insurance product which is equity-backed
3. Customers’ perception of capital loss on early annuitant death
4. A major proportion of retiree’s wealth is locked up in housing
5. How to fund long term care at very old ages
6. Our system of individual risk bearing relies on the availability of consistently good financial advice

The challenge for the private sector is to deliver successful outcomes post-retirement for an ageing population

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Some quotations . . .

“By providing financial protection against the major 18th and 19th century risk of dying too soon, life insurance became the biggest financial industry of the century ….. Providing financial protection against the new risk of not dying soon enough may well become the next century’s major and most profitable financial industry”

- Peter Drucker, the Economist, 25 September 1999

“A strategy where the aim is to exhaust an investment fund over the future life expectancy, is somewhat unsatisfactory:

– the most likely outcome is that the final 2 years of life (mode minus expectation) will be spent in poverty, and

– Around 25% of those following this strategy will spend their last 6 or 7 years in such circumstances”

- Wadsworth, Findlater & Boardman, 2001

“ ….. Wastage …..” !

- Wakeling & Yang, 2001

Retirement incomes

To the extent retirement income was purchased, it was traditionally provided by a Conventional Annuity

A Conventional Lifetime Annuity is characterised by:

- Fixed interest asset backing
- Inflexibility of income
- Some loss of funds on death
- Complying – receives favourable treatment under tax and social security regimes
- Provides longevity cover

The problems have outweighed the advantages, and conventional annuities have not achieved the market penetration seen in other countries

The market response has been to develop Allocated Pension and Allocated Annuity products

- ✓ Allows equity - backed investments and hence likely to increase overall income through better yields (despite current performance!!)
- ✓ Flexibility in income stream
- ✓ Funds not lost on death

But…

- Products are not “complying”, hence not excluded from the social security means test
- Longevity cover is not available

So ….

IFSA continues to lobby government on ways to recognise these products as “complying”

> ***“Complying Growth Annuities” would be a solution to only half the problem - is the danger of living too long understood well enough in the advisory market?***

The importance of Longevity Risk – (1)

Source: "Managing Longevity Risk" – Wakeling & Yang, IAAust, 2001

- Longevity risk is clearly a factor in retirement planning – but is it as important as investment risk?
- How can you plan for a retirement period of unknown length?
- Take a 58 year old male retiree requiring $35K p.a. for life
- Average Expected retirement period – 22 years
- A typical illustration of the impact of investment risk has been:

Capital Sum Required for Male, 58, wanting $35,000 p.a.

Low risk 5.00%	Medium Risk 6.25%	High Risk 7.75%
$615K	$544K	$473K

Source: Managing Longevity Risk – Wakeling & Yang, IAAust, 2001

The degree of tolerance for investment risk might affect a retiree's capital planning by up to (615 – 473) = $142k

Such illustrations and advice at least discuss the impact of investment risk, but they ignore the risk of "living too long"

The importance of Longevity Risk – (2)

Factoring in the longevity risk gives a very different picture

Longevity Risk (Risk of Outliving Capital)	Low risk 5.00%	Medium Risk 6.25%	High Risk 7.75%
52%	$615K	$544K	$473K
20%	$790K	$673K	$563K
5%	$910K	$753K	$613K

Source: Managing Longevity Risk – County Investment Management Limited Discussion Paper

A 58 year old male with a risk tolerance which makes him choose the medium risk investment option is unlikely to be happy with a longevity risk which equates to a 52% chance of outliving his money

The impact of longevity risk is at least as important as the impact of investment risk

Without longevity cover, individuals must either restrict living standards or die excessively asset rich - leading to retirement provision "wastage"

With $615K the retiree can choose:

Low investment risk/ high longevity risk

OR

High investment risk/ low longevity risk

No product provides this trade off

Longevity Insurance - Alternative

An Annuitised Fund

The Concept

- Retirees consume an annuitised fund in the form of an income during their expected lifetime. The fund receives ongoing credits to reflect a transfer of assets from those annuitants who die
- Annuitant owns a “lifetime tenancy” of the fund. On death any remaining assets are forfeited. This is effectively the ‘premium’ for the insurance
- Described in “Reinventing Annuities” – Staple Inn Actuarial Society paper by Wadsworth Findlater & Boardman
- In actuarial terms, this unbundles the investment and mortality(survivorship) risks – similar but in reverse to the processes with unbundled savings & death cover policies

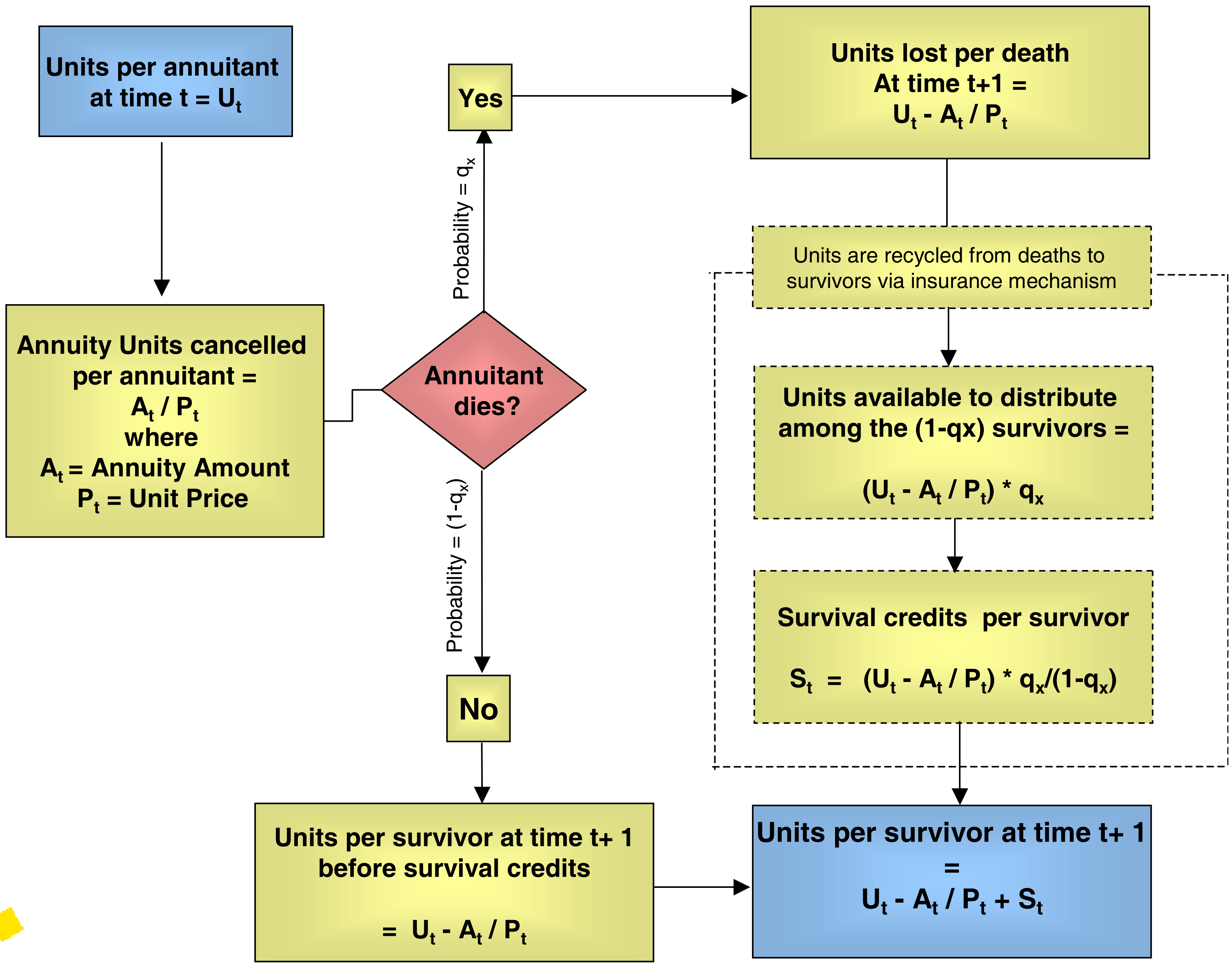
Longevity Insurance – Alternative (cont):

An Annuitised Fund (cont):

Benefits…

- Provides insurance against longevity
- Allows investment flexibility
- Flexibility in level of income
- Insurer reduces cost of providing guarantees
- No retirement provision wastage
- May help to resolve the “complying growth annuities” problem.

Operation of an annuitised fund



Source: “Reinventing Annuities”, SIAS paper, Wadsworth, Findlater and Boardman 2001

Annuitised fund – Product design

- “Lifetime tenancy fund”:
  - Survival bonuses each year
  - No claim on assets after death
  - Unitised
- Available as single life, joint life, last survivor, or guaranteed payment term
- Income levels chosen within upper and lower limits
- Income levels reviewed periodically to reflect investment / mortality experience
- Choice of funds, investment policy can vary with increasing age
- Mortality / survivorship risk rates guaranteed by life office for 2 – 5 years
- At very high ages switch into a conventional annuity

Annuitised fund – Product design issues (cont)

- Transparent presentation in customers' statements :
  - Rollup of fund
  - Shows investment return
  - Survival bonus
  - Annuity payment
  - "Premium" on death (i.e. transfer of fund to surviving annuitants will appear in year of death)
- Fund based charges and mortality loadings for the product issuer
- Trade-off between marketability (longer survivorship guarantees) and capital requirements (no survivorship guarantee)
- Requires ongoing advice – facilitates dynamic (vs. static) financial planning
- Advisor no longer has to predict customer's date of death!

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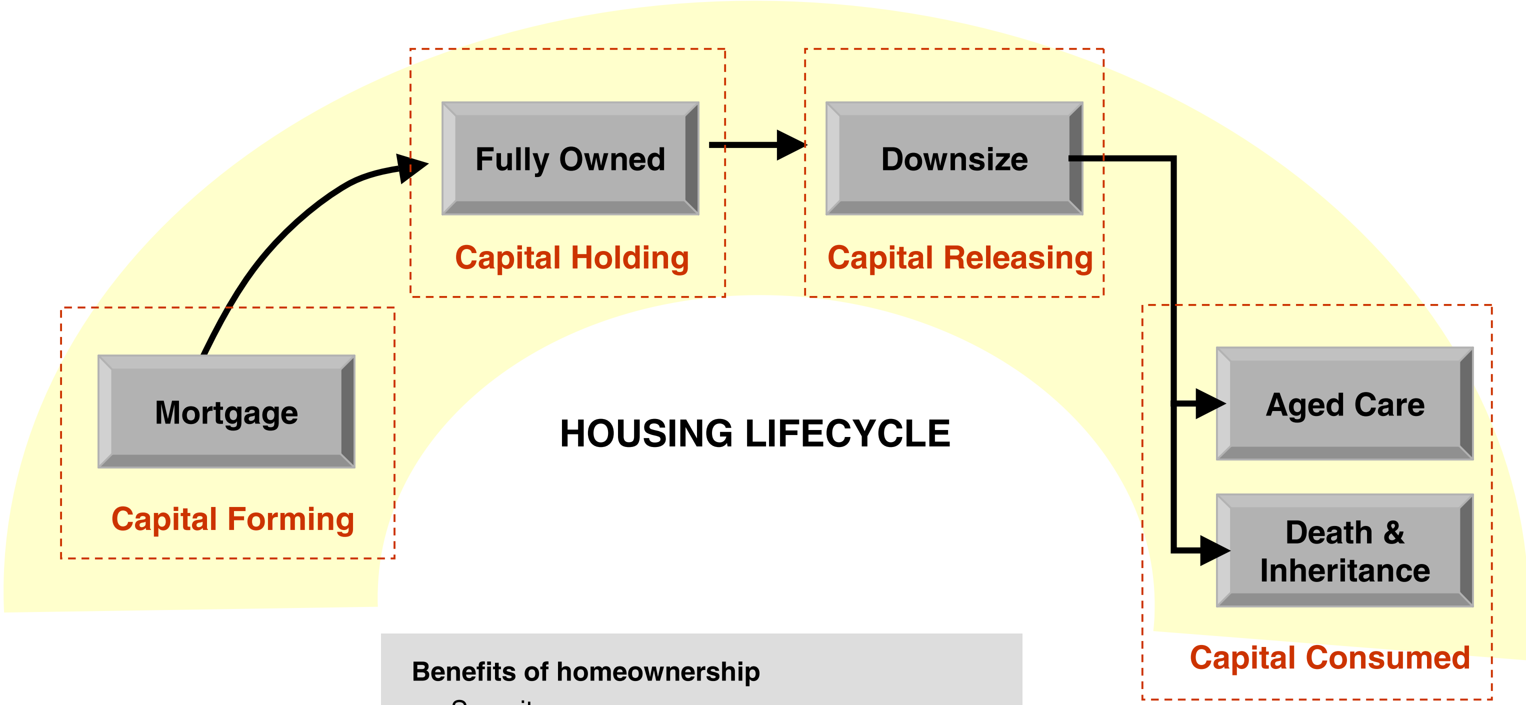
Wealth locked into housing



Benefits of homeownership
- Security
- Recreational / Activity
- Social
- Economic – appreciation / rent savings
- Pass on as estate

Social Security
- Owner-occupied home excluded from incomes test
- Assets test hurdles increased by approx. $100,000 for non home-owners

Taxation
- Gains are tax free
- No deduction for interest, repaid, depreciation
- No inheritance tax
- Once paid for, the family home sits entirely outside
- the income tax regime

Wealth locked into housing – the responses

Financing responses:

- Mortgage to fund living costs → puts the home at risk
- Downsizing & using the difference to fund living costs
  - Market forces (demand vs supply) may mean there is little or no difference
  - Downsizing is more effective if moving location
- Sell home to fund an aged care position → loss of independence

Policy responses:

- Lobbying to tax the imputed rental - cashflow problems for retirees
- Periodic proposals to cap exemptions around family home

No response satisfactorily unlocks this wealth

Wealth locked into housing – an alternative

Home Equity Release Mechanism

- Two basic approaches
  - Borrow against the security of the home, with a right of occupancy which supersedes the capital position
  - Contingent sale of the house, with right of occupancy until death
- Key feature of both is the right of occupancy
- This right means that the housing market price risk is taken on by the institutions.
- The home owner must still utilise wisely the capital received. This creates financial risk for the retiree and reputation risk for the institution.
- An approach to consumer protection is outlined in the next slide

Wealth locked into housing – an alternative (cont)

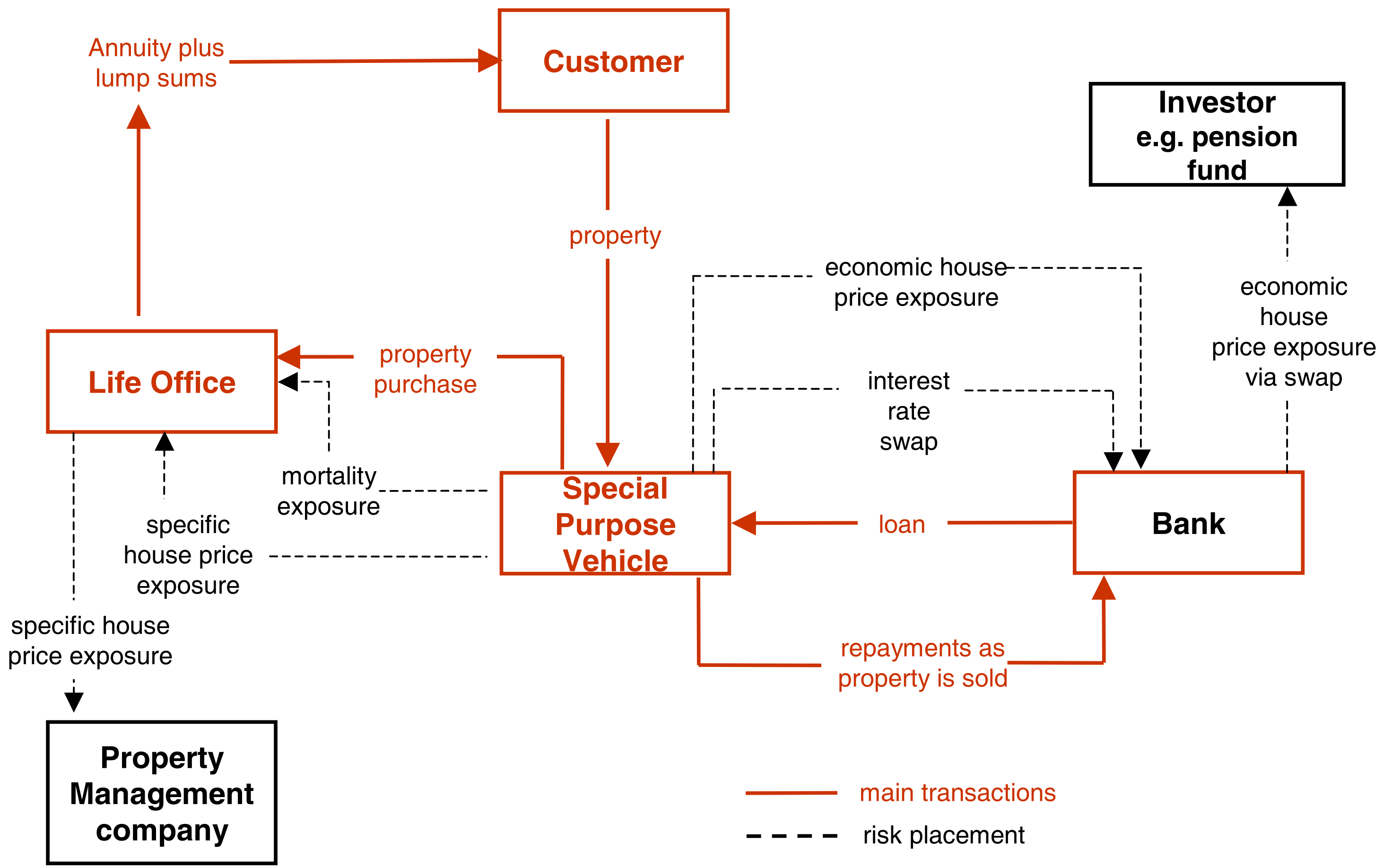
- An approach to financing and risk transfer is required – see later slide
- Obstacle:
  - Consumer and potential heirs' attitude
  - Institutions' attitude and risk
- Potential market size – limited to a (low?) percentage of capital city retirees' housing stock

Home equity release – consumer protection

- UK industry body - Safe Home Income Plans ("SHIP") - offers:
  - Code of practice (endorsed by Age Concern)
  - Formal consumer complaints procedures
  - SHIP logo used by members as a badge of consumer protection
- SHIP code of practice:
  1. "Fair, simple, and complete presentation of plans" – includes benefits, obligations, variables, limitations, costs, moving house, tax, changes in house values
  2. Client's solicitor fully involved, and certifies that the plan has been explained to the client
  3. A SHIP certificate will clearly state the main cost to the householder's assets & estate
  4. "No Negative Equity" guaranteed by all SHIP plans
  5. SHIP plans also provide freedom to move to suitable alternative property without financial penalties

"No negative equity" and "Freedom to Move" are critical to the success of these arrangements

Home equity release: funding & risk placement



Source: "Report on Equity Release Mechanisms", LeGrys et al, Institute of Actuaries 2001

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Protecting your independence – Lifetime care products

Independence requires the ability to perform 'activities of daily living' (ADLs)

Washing	**getting into/out of a bath or shower and washing yourself while in there**
Dressing	**being able to dress yourself**
Feeding	**being able to eat food or drink that has been prepared for you**
Mobility	**being able to move from room to room in your own home**
Transferring	**being able to get on or off the toilet or commode, and from an upright chair into a bed of a similar height, & vice versa**
Continence	**being able to control your bladder and bowel function**

"For those over 85, nearly 4 out of a 10 found at least one ADL difficult or impossible" (UK experience)

Lifetime care products – insurance against what?

- Budget cover
  - e.g. “unable to perform 3 or more ADLs for at least 3 months
- Mid range cover
  - e.g. half the maximum benefits if unable to perform 2 ADLs for at least 3 months increasing to full benefit when unable to perform 3 or more ADLs
- Top Cover
  - e.g. “benefits paid in full when unable to perform 2 ADLs for at least 3 months
- All covers will pay out full benefit for organic “mental impairment” requiring supervision or care to protect self or others:
  - standardised tests assessed against clinically published data
  - short and long term memory
  - orientation as to person
  - deductive and abstract reasoning

Lifetime care products – customer choices

Level of cover	
Payment of benefits	- cash - invoiced payment to care provider
Amount of benefit	- cash amount as specified - payment limited to cost of care
Type of benefit	- income only - income plus lump sum
Funding	- regular premium - single premium
Investment choice	- for single premium policies
“Immediate needs”	- a cover designed for those already requiring care

Lifetime care products – Illustrative UK premiums

UK market – Premiums to buy $1,600 per month of benefit				
Age next	**Single Premium**		**Monthly Premium**	
	M	**F**	**M**	**F**
Budget Range				
50	14,410	23,890	60	80
70	14,800	26,640	130	180
Mid Range				
50	18,820	30,850	70	90
70	18,450	32,940	170	230
Top Range				
50	23,010	37,490	90	110
70	22,030	38,960	200	270

Source: Daily Telegraph supplement, 2000

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Retired Market financial products – Financial advice

- Financial advice is an increasingly professional field
- Primacy of 'advice' → assess "Financial Advice" as a product in delivering outcomes
- Repeatable, predictable quality required for every purchaser
- FSRA and FPA are raising standards
- ASIC survey of financing planning advice quality measures an industry undergoing major transition:
  - some improvements since 1998 (but changes in methodology)
  - 50% of plans "OK", "Good", "Very Good"
  - 27% of plans "Poor", "Very Poor"
  - 14% of plans failed the legal requirements
  - quality correlations around some sectors

Has a trend away from guarantees in financial products put too much weight onto 'Advice' to deliver the outcomes?

Questions for discussion

1. Australia’s system of asset building for retirement is internationally recognised. Is our system for delivering outcomes for individuals post-retirement effective enough?
2. Which of the overseas innovations might work in Australia?
   a) annuitised fund
   b) home equity mechanisms
   c) long term care cover
3. What other issues must be addressed in order to produce acceptable post-retirement outcomes?
4. Have we gone too far in eliminating product guarantees and replacing them with “advice”?

References

- "Managing Longevity Risk – A wake up call for Australia's retirement system" - Wakeling & Yang, IAAust 2001 Convention
- "Reinventing annuities" - Wadsworth, Findlater & Boardman, Staple Inn Actuarial Society, Jan 2001 (available from www.actuaries.org.uk)
- "Report on equity release mechanisms" - Le Grys et al, Institute of Actuaries, London, Jan 2001 (available from www.actuaries.org.uk)
- "Survey on the quality of financial planning advice" - ASIC Research Report , Feb 2003 (available from www.asic.gov.au)

In addition to the authors of these references, I wish to acknowledge the help of my colleague Peter White FIA, and the peer reviewer John Maroney FIAA, in the preparation of this presentation

End of paper