Natural Selection

Financial Services Forum

21-22 May 2018 • Hilton Sydney

Actuaries Institute

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A Product To Meet Changing Needs in Retirement

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Agenda

- Brief introduction
- CIPRs
- Revised Regulations
- Principles, not Rules
- Proposed Means Test Rules
- Forfeiture
- Proposed Product
- Advantages
- Financials
- Conclusion

Introduction

- Needs change
- Products need to be flexible to meet changing needs
- Longevity protection typically provided by guaranteeing a (predetermined) income for life – naturally inflexible
- But:
  - Long term consists of many short terms – longevity is just survival for each short term period
  - The vehicles for providing the income and protection can be separate – protection can be provided by a different product than that which provides the income (e.g. an ABP)
- CIPRs, revised regulations and proposed new means test rules provide context for that product

CIPRs

- Package or framework:
  - Deliver a minimum level of income that exceeds that provided by an ABP alone
  - Expected to provide a stream of broadly constant real income for life
  - Includes a component to provide flexibility
- Doesn't of itself encourage new products
- Underlying products must still comply with regulations

Revised Regulations

- Products must meet regulations to get tax concessions
- Wider regulations should supposedly encourage innovation
- But they won't –**if don't meet the rules then no tax concessions, even if protect against longevity – new rules encourage compliance, not innovation**
- Only allows some existing products (perhaps with complex features) to now be included
- Regulations still complex and prescriptive

Principles, not Rules

- Apply to package (e.g. CIPRs), not individual products
- Regulations could be greatly simplified
- A principle about protection against longevity could be explicitly added
- Require a minimum draw-down so that superannuation is used for its intended purpose
- Impose a maximum draw down to limit exhaustion of savings
- Tax consequences if breach these limits, rather than limiting design
- Provide framework for true innovation – providers could develop a new product to meet retirees' needs without having to first wait for changes to allow it

Proposed Means Test Rules

- Not 'one-size-fits-all' – rules need to vary with longevity protection provided
- Capital draw-down is not the distinguishing feature (even ABPs do that)
- Difference is how long a product lasts – benefits should be linked to that
- Difference from longevity protection is in the future, so benefits should be provided then, not now
- Balance incentive with cost
- New rules need to be simple

Forfeiture

- **There is no such thing as a free lunch** – the more that is forfeited (i.e. the lower the death benefit) the higher the potential income and/or the lower the cost for longevity protection
- Forfeiture in early years needs to be minimised to avoid potential regret
- Forfeiture in later years is (arguably) less of an issue
- A bigger death benefit means more for a bequest
- A bigger death benefit increases the risk of anti-selection – people ceasing cover if they think they are more likely to die
- There is an issue of how to distribute the proceeds of forfeiture – estimated or actual

Proposed Product

- **Pure Endowment**
- Like a deferred annuity but providing a lump sum on surviving a period - the lump sum benefit could then be used to purchase an immediate annuity at then prevailing rates to provide a guaranteed income for the remainder of the retiree's life
- **With-profits** – so that the insurer can afford to invest more aggressively, and the policyholder can share in expected higher returns – participation also provides a mechanism for providing survivorship benefits, without the need for predicting the chances of survivorship well in advance
- **Regular premium** – this limits the risk to the retiree of forfeiture on early death, as only premiums paid to date are forfeited – avoids complex death benefits

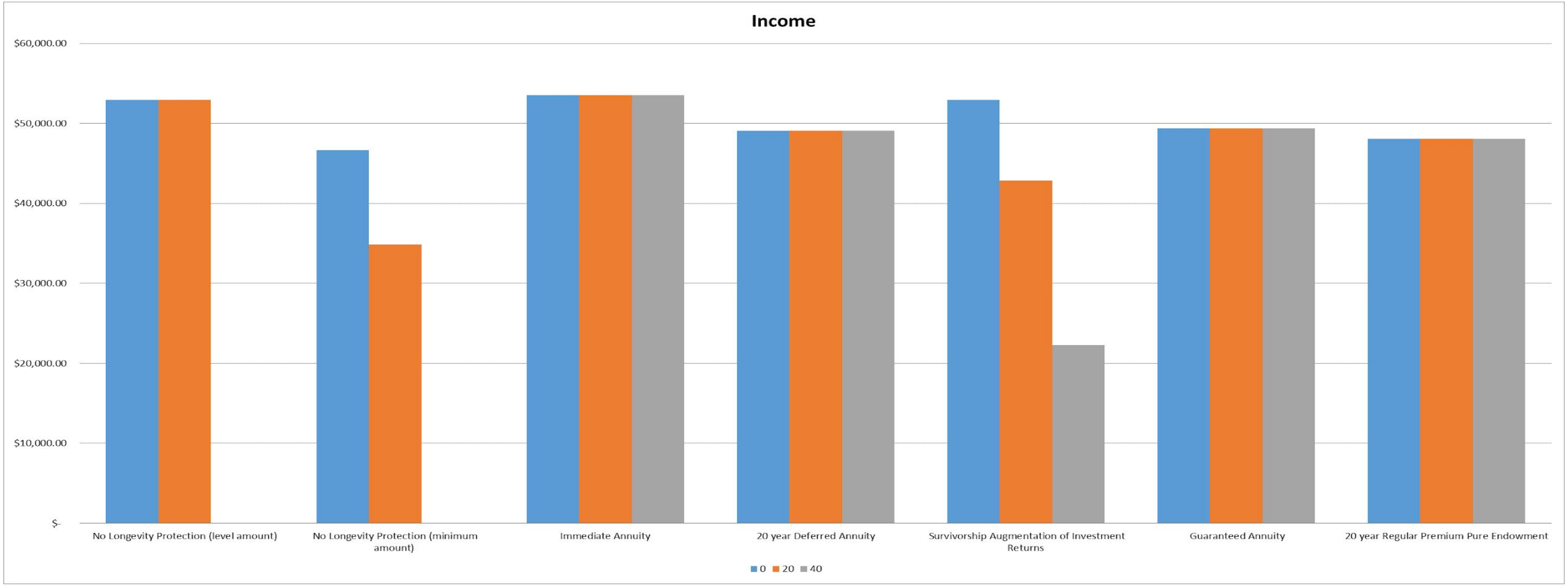
Advantages

- An adjunct to the ABP, which is otherwise a popular product
- **Simplicity** – like other traditional insurance products with which the policyholder is familiar
- **Familiarity** – similar to the insurance rider pre-retirement
- **Cost** – comparable to that of other longevity protection solutions – and by only protecting the 'tail' of life expectancy doesn't needlessly incur cost in the interim;
- **Flexibility** – the ABP provides flexibility - withdrawals can be adjusted up or down to meet changing needs – the investment mix of the ABP can also be changed as the retiree's attitude to future risk changes
- **An inheritance can be left** – when the retiree dies the balance of their account (less any premiums paid to date) remains to be passed to whomever the retiree specifies in their will
- **Retirees are not locked into conservative investment** – the retiree can choose the investment mix in the ABP – and under the Pure Endowment, while the investment strategy is chosen by the insurer, it need not be as conservative as that implicit with other products
- **Fosters self-reliance / self-confidence** - while allowing that protection against longevity relies on a third-party (something retirees can't do themselves)
- **Retirees value consumption now more than in the future** –this solution brings some benefits forward – benefits are even earlier than under a Deferred Annuity;
- **Tax treatment** – tax rules should be met for the ABP - the product would also need to meet the rules in respect of the Pure Endowment
- **Potential regret** – there is still some potential regret from early death – but less than under other products
- **Role of the advisor** – both the proportion of superannuation savings to be invested in the Pure Endowment, and the ongoing investment mix remaining in the ABP, will require advice

Financials

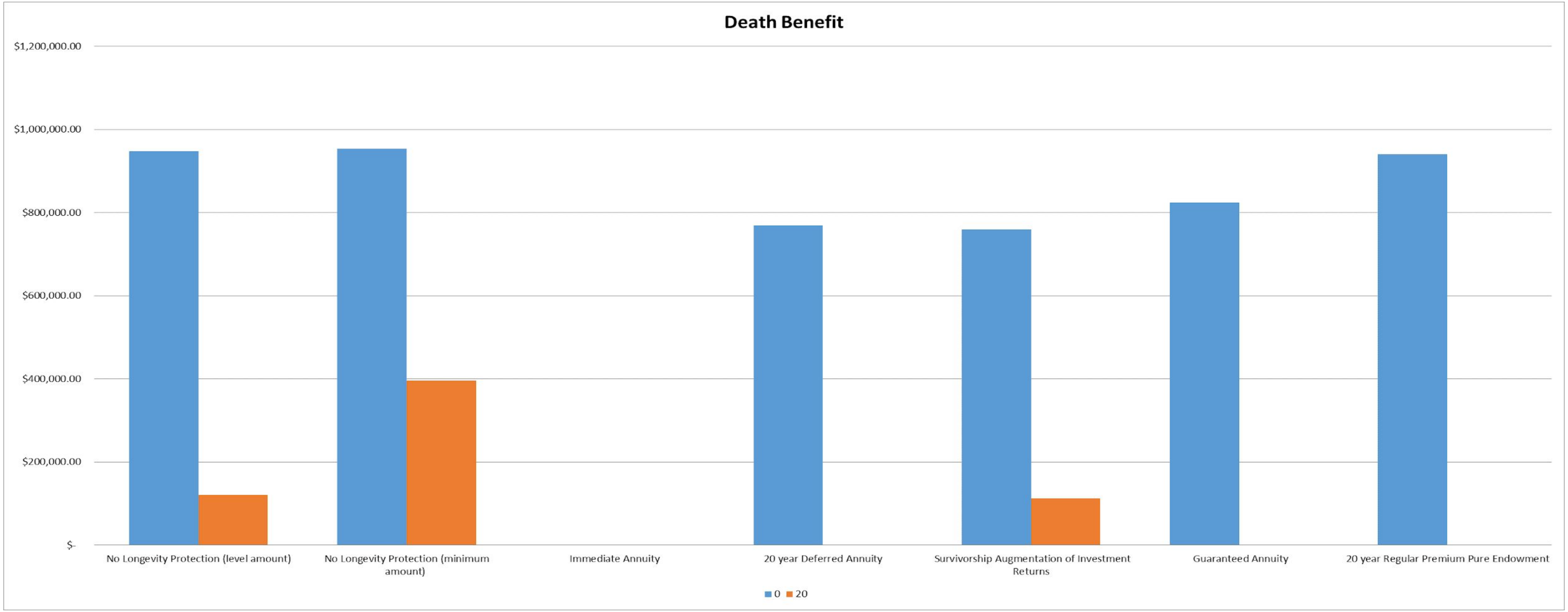
- Compare:
  - Amount of initial annual retirement income
  - Amount of annual retirement income in year 20
  - Amount of annual retirement income in year 40
  - Initial payment on death (or amount available for bequest)
  - Payment on death after 20 years
  - Present value (at 2.0%) of premiums for longevity protection

Retirement Income



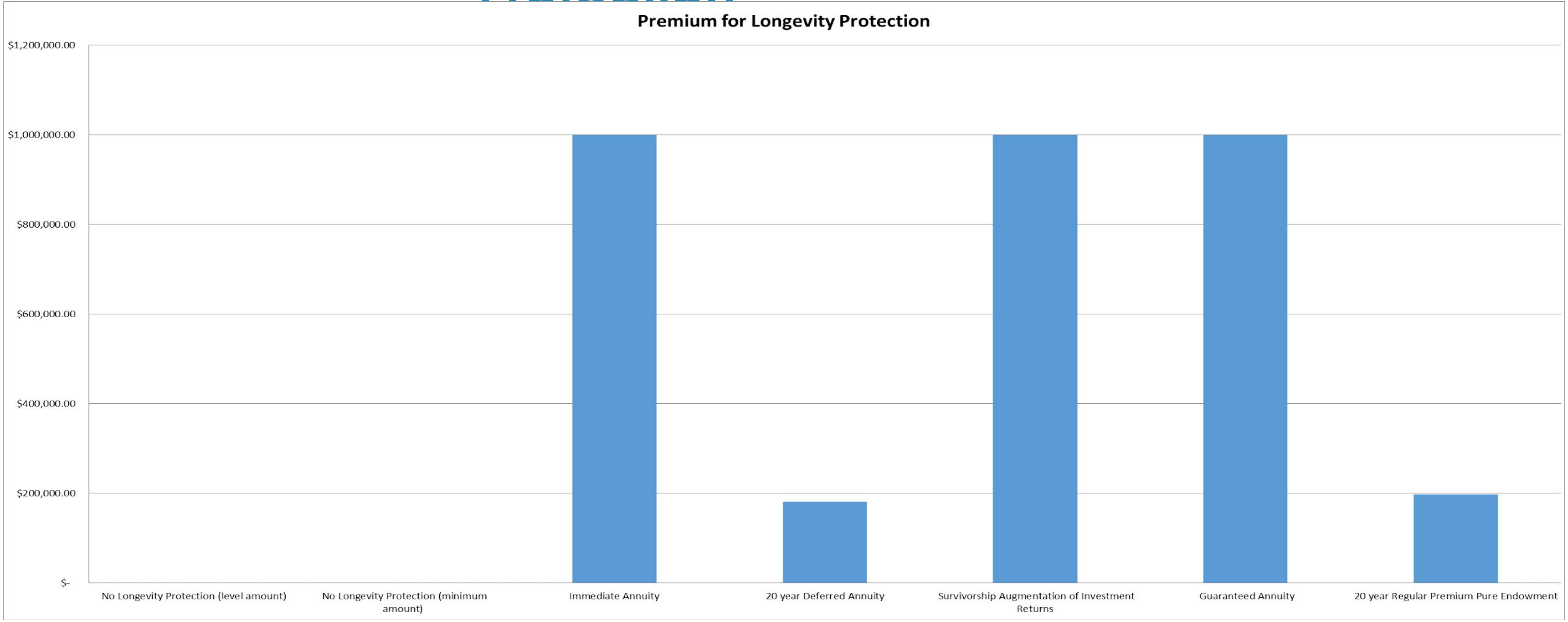
- Longevity protection prevents income running out
- Higher income from packages where there is more forfeiture
- Immediate annuity can sustain maximum income as full amount forfeited on death
- Income reduces under Survivorship Augmentation of Investment Income as forfeiture is not sufficient to sustain income

Death Benefit



- Higher death benefit leads to lower income throughout, or inability to sustain initial income
- Pure Endowment produces close to the full initial death benefit

Premium for Longevity Protection



- An Immediate Annuity or Guaranteed Annuity requires the whole investment to be paid as a premium
- Survivorship Augmentation of Investment Returns assumes the whole investment is in that investment option
- A Pure Endowment costs slightly more than a Deferred Annuity because it is Regular Premium, rather than Single Premium

Conclusion

- A Regular Premium With Profits Pure Endowment will better meet changing needs in retirement
- Optimises protection against longevity while providing ample flexibility
- Comparable to, if not better than, typical existing solutions
- Fewer constraints around forfeiture, investment or estimation in advance