Institute of Actuaries of Australia

Super Policy Forum

Building a Sustainable Retirement Income System

Catherine Nance

Topics

What do retirees need to cope with longevity?

What are the government objectives?

What is the role of government?

What is the role of Age Pension and means testing?

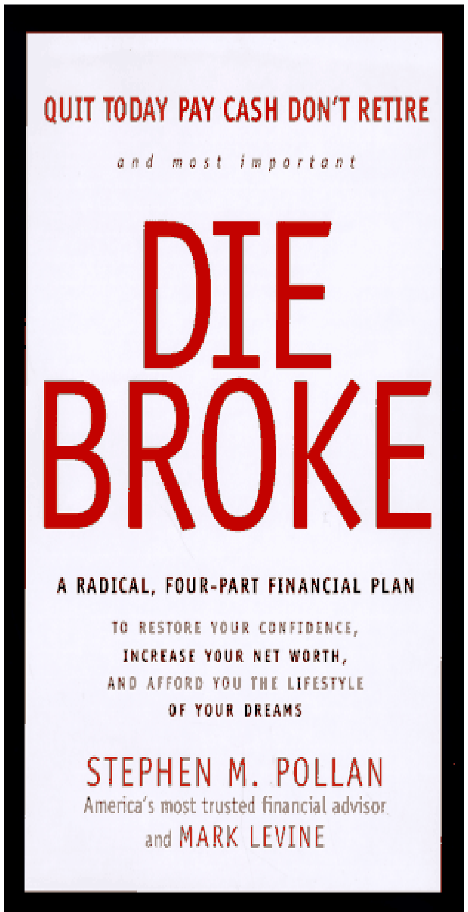
A deferred Age Pension

Needs of retirees

Retirees face the following risks:

- Save too little, retire too soon, spend to much or too little in retirement
- Investment & inflation risks when investing 20-30 yrs
- Lumpy cash flow needs for mortgages, health and aged care
- Fraud & mismanagement - can’t re-earn what is lost
- Variable work patterns
- Release of home equity
- **Live too long - Life expectancy is an “average” so 1 in 2 will out-live**

Needs of retirees



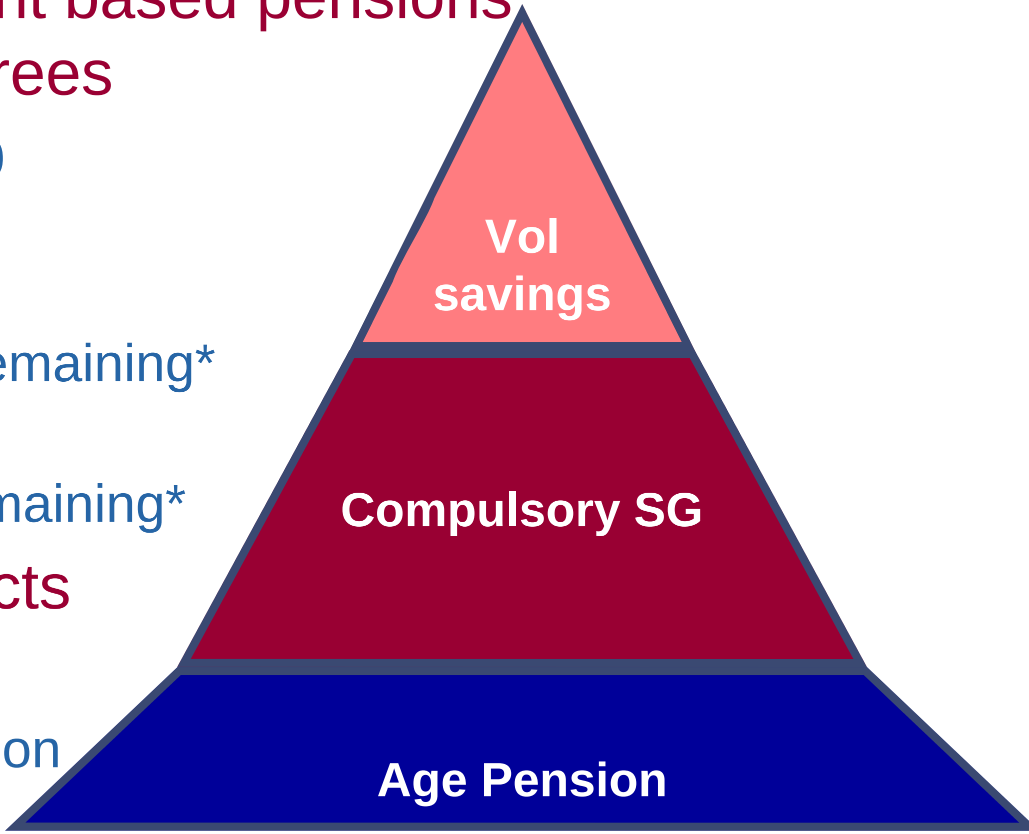
"The last cheque you write should be to your undertaker…
and it should bounce."

Stephen M. Pollan

Are retirees needs being met?

3 pillar system

- Super savings are in account based pensions
  Where risks reside with retirees
  - Example - 100 Males aged 60
    life expectancy is 86
  - 50 will live beyond 86,
    but only 25 will have assets remaining*
  - 20 will live beyond 92,
    but only 5 will have assets remaining*
- Home equity release products
  - ASIC concerns
  - Lump sums impact Age Pension



**Rawlinson and Cater 2008, ALT 00-02 with MI, 30% growth assets, pension draws based on life expectancy*

Wealth of retirees

Average Australian	**Now**	**Later**
Over 65s on Age Pension (Full)	80% (55%)	75% (35%)
Typical retirement savings	$70,000	$200,000
Age Pension as % of expenditure	79%	50%
Dependency on Age Pension	50% at age 65 up to 85% at 85	
Expected life at 65	86-90	+ 5 years
Home ownership over 65s	89% couples 77% singles	
Home ownership over 65s on AP	83% couples 53% singles	

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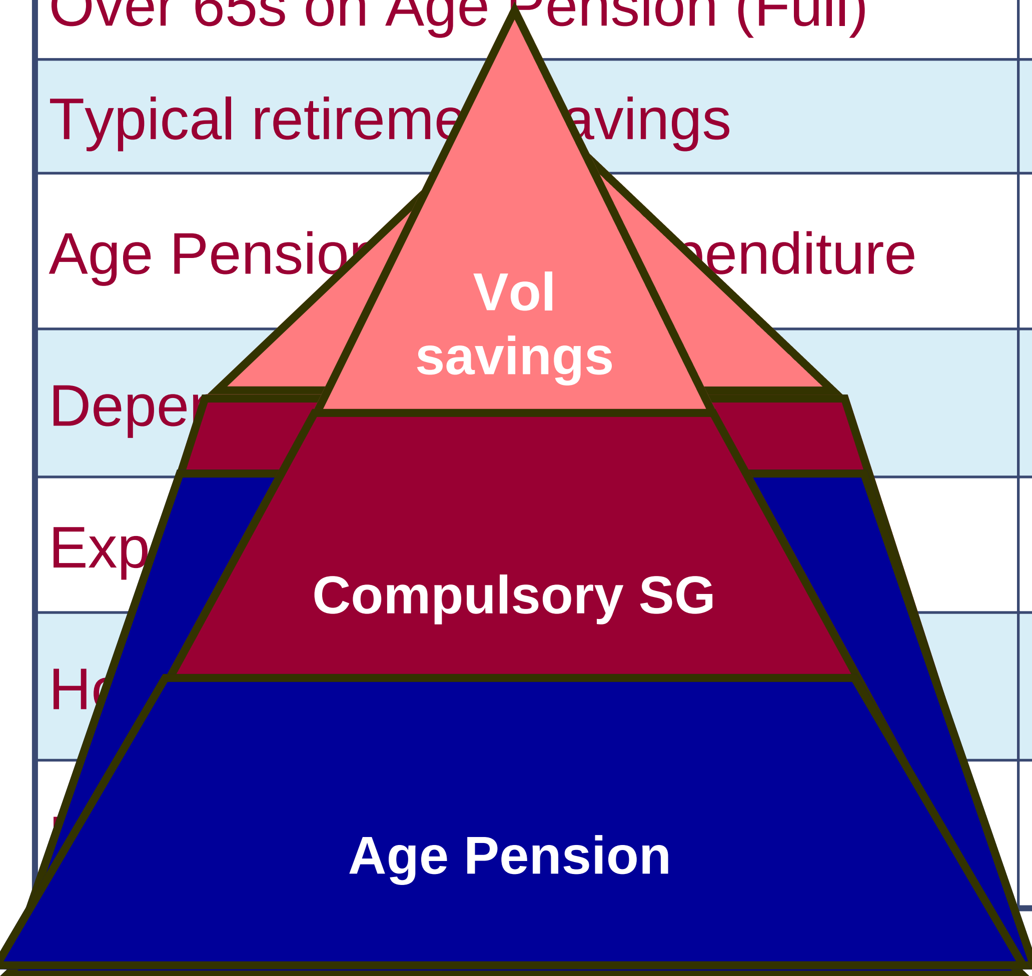
[illegible]	83[illegible] 53% [illegible]ngles	



Potential retirement products?

Lifetime annuities - Guaranteed $ (indexed), paid for life

- No demand since Sept 2007 (asset test exemption removed):
- Unattractive product issues
  - Up front capital payment
  - Risk of institutional failure
  - Loss of capital on death
  - Expensive –capital hungry, lack of ability to diversify or hedge risks
- Lack of need
  - 80% retirees already receive a lifetime annuity (Age Pension)
  - Dependency on Age Pension starts at 50%, increases to around 85%
  - Retirement super savings are not large, which limits options
  - Can already increase part to full Age Pension using property
  - Remaining 20% retirees have less need or desire for longevity protection

Potential retirement products?

Pooled life products - Longevity risk shared with pool of retirees

- Australian market may be too small to adequately diversify risks
- Careful of promises made to members and credit risk of supplier

Variable, with profit, unit linked annuities

- Investment risks and returns potentially remain with retirees

Fixed term annuities - Longevity risk remains with retirees

Deferred annuities - which could commence from life expectancy

- Viable option for managing longevity risk but limited supply

Draw down pension accounts

- With good default investment options
- More flexible draw down rules (not limited to 1 July)

Capital protected investment strategies

Government objectives

Need to manage an ageing Australia

- Productivity declines with drop in workforce participation rates
- Costs increase in Health, Aged Care & Age Pensions

Need older Australians to support themselves for longer!

- We are retiring too early
- Current average retirement ages 61(m) and 58(f)

How

- Eliminate subsidised pathways to early retirement
- Provide strong financial incentives to carry on working
- Provide employers with stronger incentives to hire and retain
- Provide older workers with help and encouragement
- Change attitudes of employers and older workers

Eliminate pathways to early retirement

Need to limit lump sums before Age Pension age

Options

- Retain preservation age 60, limit annual withdrawals to min 10%, $20k
- Increase tax free age gradually to 65 (Age Pension age)
  - Can still access up to $145,000 tax free
- Include excess over annual limits in gifting provisions for Age Pension
- Increase both preservation age and tax free age to 65
  - Penalises those for whom early retirement is not an option

Financial incentives for continued work

Hugely complex system of

- Means tested Age Pension
- Marginal tax rates
- Four different potential tax offsets

High marginal tax rates for anyone on Age Pension

Marginal tax rates on earned income

Income p.a.		Person under Age Pension age	Self funded retiree	Age Pensioner
From	*To*			
0	3,432	0%	0%	0%
3,432	11,000	0%	0%	40%
11,000	27,685	15%	0%	40%
27,685	30,000	15%	27.5%	56.5%
30,000	39,351	34%	46.5%	67.9%
39,351	43,707	34%	46.5%	46.5%
43,707	48,750	34%	34%	34%
48,750	53,000	30%	30%	30%
53,000	63,000	30%	35%	35%
63,000	75,000	30%	30%	30%

Financial incentives for continued work

Hugely complex system of

- Means tested Age Pension
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- Four different potential tax offsets

High marginal tax rates for anyone on Age Pension

Option is to remove earned income from means test

- Added advantage of simplifying the means testing

What is the role for government?

Product facilitator?

- Act as longevity risk insurer
  - Issue longevity bonds
  - But already longevity insurer for 80% of population?
- Issue capital instruments to support capital markets ✓
  - Issue inflation linked bonds

Product provider?

- Allow individuals to purchase the Age Pension
  - Crowds out private sector market
  - Increases existing longevity risk

What is the role for government?

Ensure regulatory market is efficient ✓

- Remove legislative barriers for products such as annuities
  - SIS impediments for pensions
  - Commonwealth Health Seniors Cards and Age Care Bonds
- Ensure efficient process for approving new product
  - Product development currently hindered by having 4 regulators - ATO, APRA, ASIC, DFACS

Ensure policy settings encourage good behavious ✓

- Age Pension and means testing rules

Allow market to provide the product ✓

Age pension and means testing

Age Pension

- Need to ensure Age Pension is adequate (single age Pension is low)
- As Government is already longevity insurer for most Australians
  - focus Age Pension on later ages
  - product market is better suited to look after earlier ages
- Either voluntary or compulsory

Means testing

- Advantage
  - target financial resources
  - ensure age pension “adequate” level, whilst keeping costs affordable
- Disadvantage
  - potential for abuse and manipulation
  - high administration costs
  - undesirable level of intrusiveness
  - disincentives for self provision.

Deferred Age Pension

Single homeowner $150,000 assets, Age Pension of $14,000 pa

Retiree has a choice every year to take Age Pension or defer it

Take Age Pension:

- Can continue to work to supplement Age Pension
- No Earned Income test
- All income taxed at Marginal Tax Rates (no offsets)

Defer Age Pension:

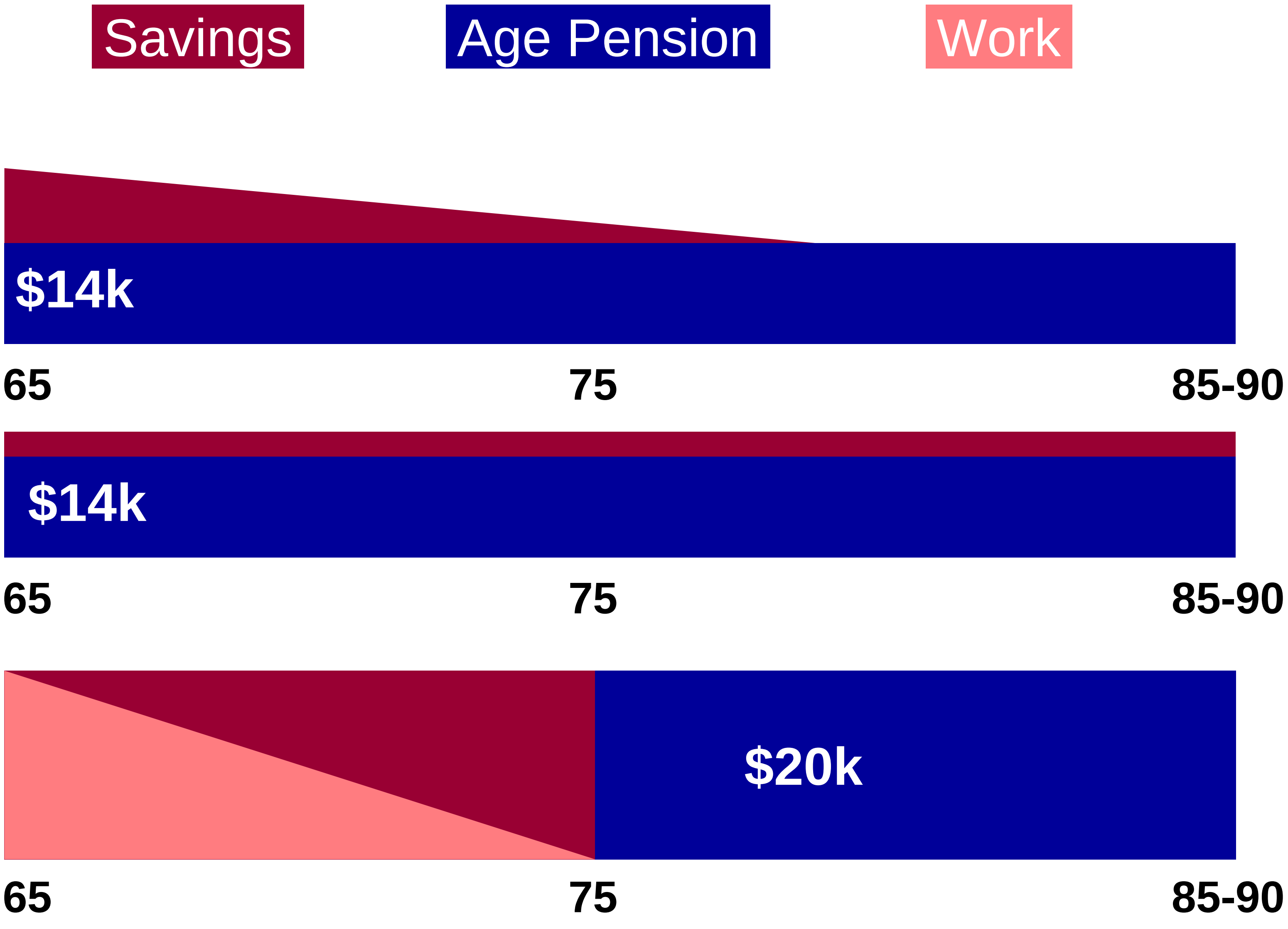
- Use savings and or work to live
- Income taxed at Marginal Tax Rates with a simpler mature age offset
- No limits on how long Ag Pension is deferred
- Age Pension increases each year in deferral (financial neutral basis)
  - $20,000 at 70, $28,000 at 75
- No impact on Pensioner concession card

Example of Deferred Age Pension

Benefits

- At worst cost neutral to government
- At best increased tax revenues from any work over 65
- Simplified means testing
  - No earned income, so only need Assets based test
- Encourages continued involvement with workforce
- Enables retiree to manage savings & work for a finite period
  - Encourages fixed term style products
- Integrates savings and AP with variable work patterns
- Voluntary option to increase Age Pension & retirement age

Deferred Age Pension



Other options

Compulsory annuities are not optimal

- Retirees need flexibility
- Given relatively low level of savings for next 20 years, forced purchase of annuities will result in:
  - Many small annuities
  - Purchase cost for $10,000 pa annuity is around $200,000
  - Over-annnuitises wealth for many
- Forced purchase assumes people retire once only
  - Does not work well with increasing trend to move in and out of work
- People need clear incentive to voluntarily save for retirement

Universal age pensions

Cap home in assets test


Need clear and strong financial incentives to save more and work longer
Self Interest

Institute of Actuaries of Australia

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Andrew Boal

Adequacy

- *Age pension – means tested, assume it is a safety net <u>and</u> a supplement*
- *Employer super – SG level is a balance*
- *Voluntary savings – to meet personal retirement goals*

- The SG system is not yet mature – what "encouragement" should be provided?

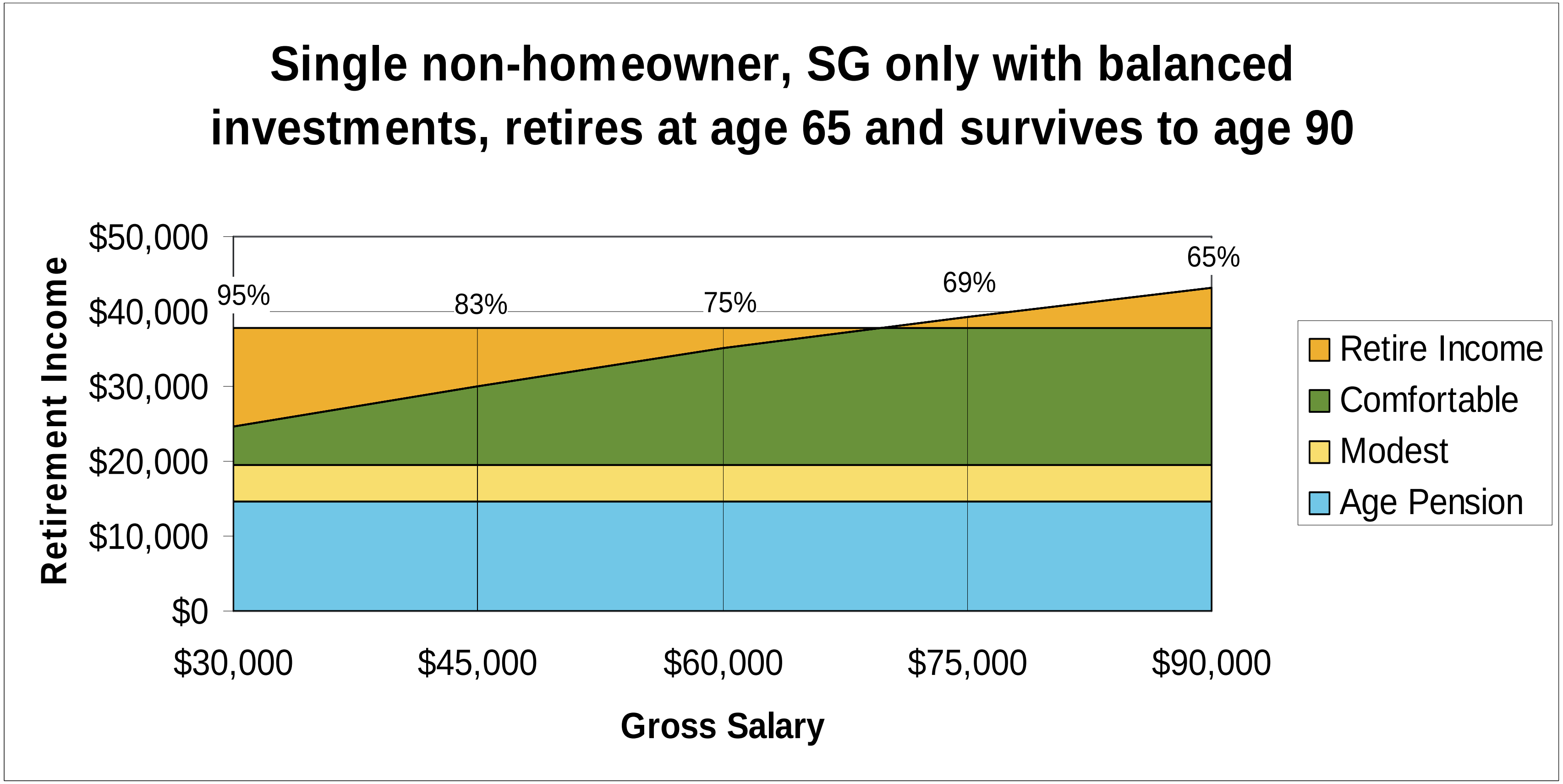
Adequacy

ASIC's fido retirement planner

Assumptions

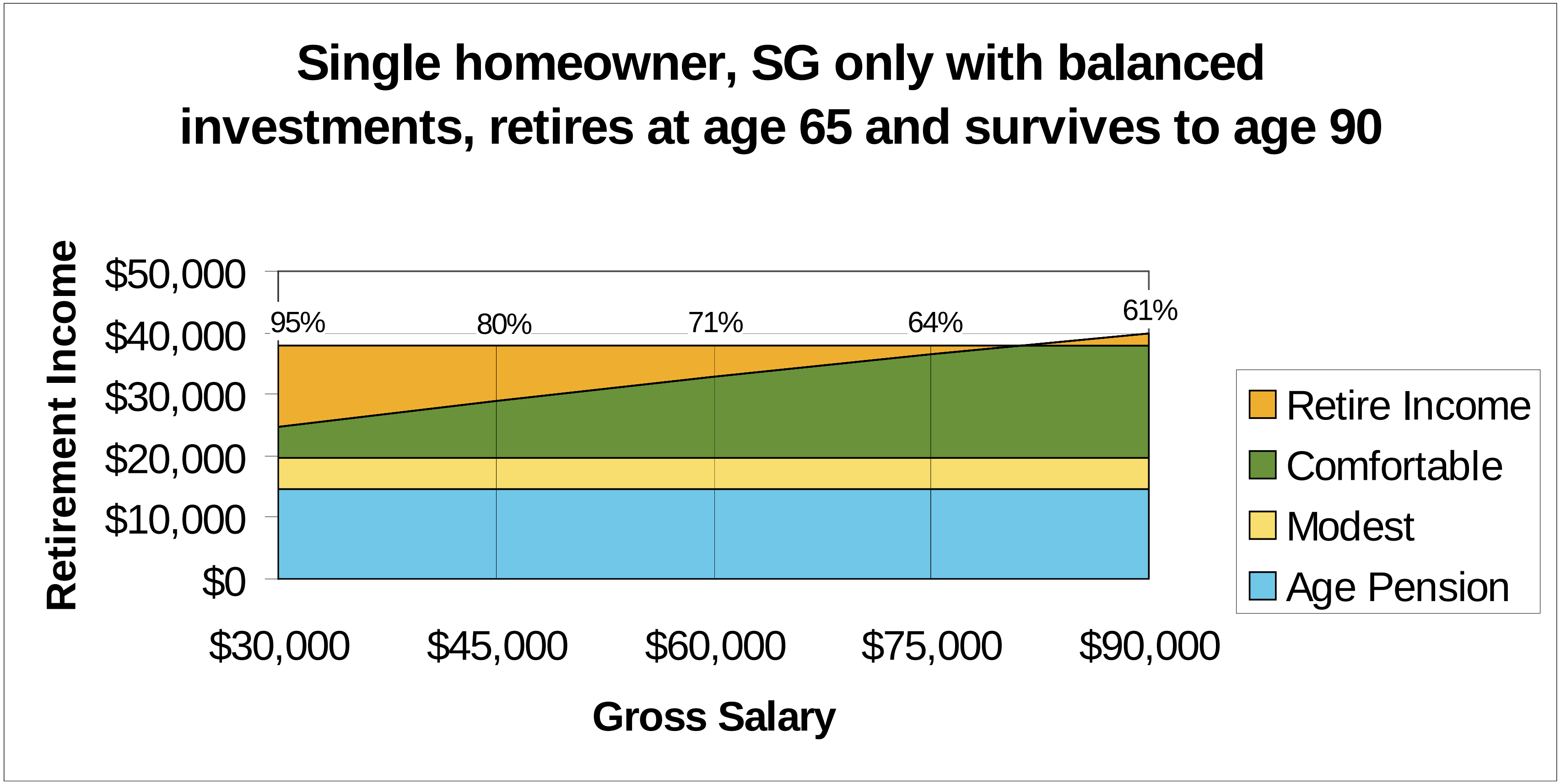
- Join the workforce at age 25
- 5 year career break at age 45
- 10 year career break at age 30 for spouse
- Balanced investments earn 8%pa
- Retire at age 65 and survive to age 90

Adequacy



- Modest and Comfortable standards of living are based on Westpac-ASFA Retirement Standard
- Percentage shown is the proportion of pre-retirement salary, after tax
- Retirement Income does not include any rental assistance

Adequacy



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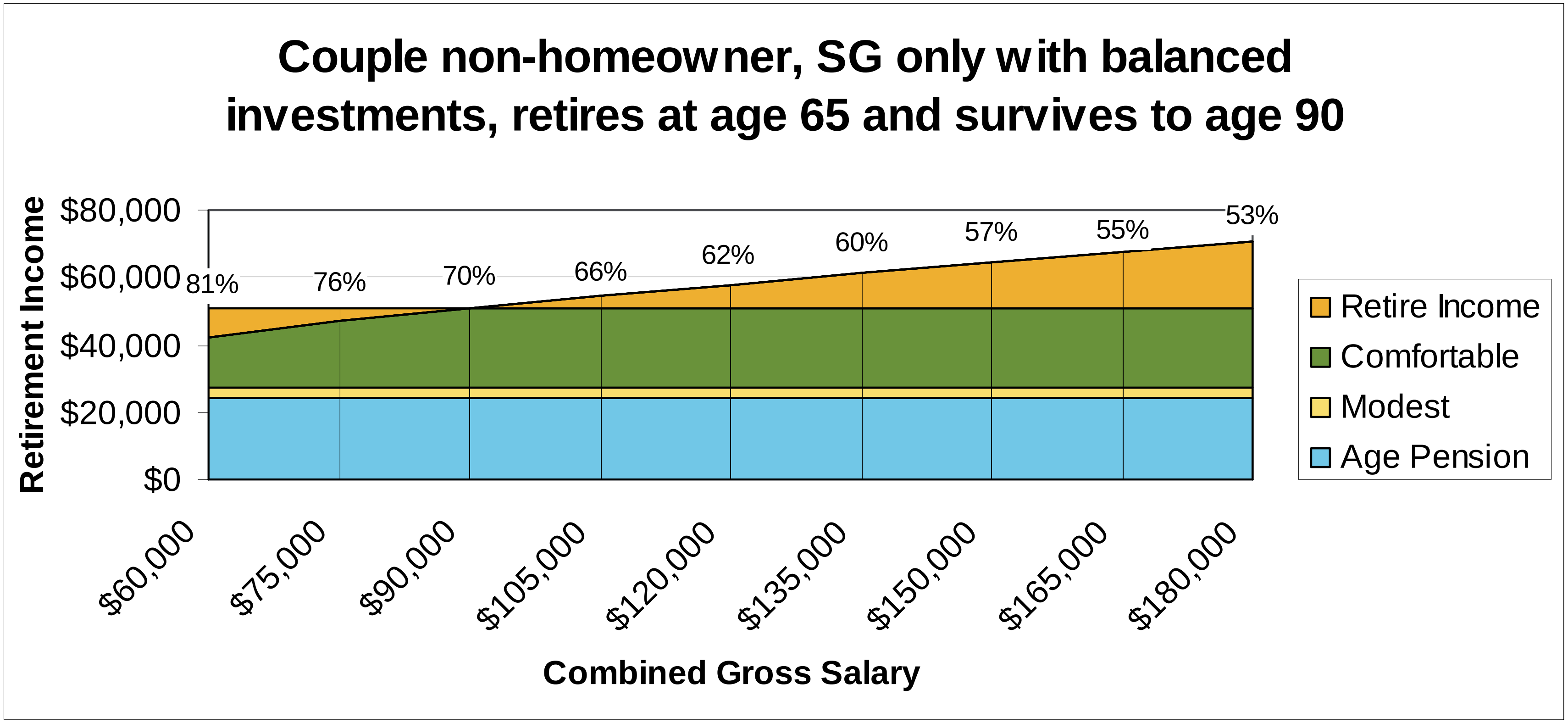

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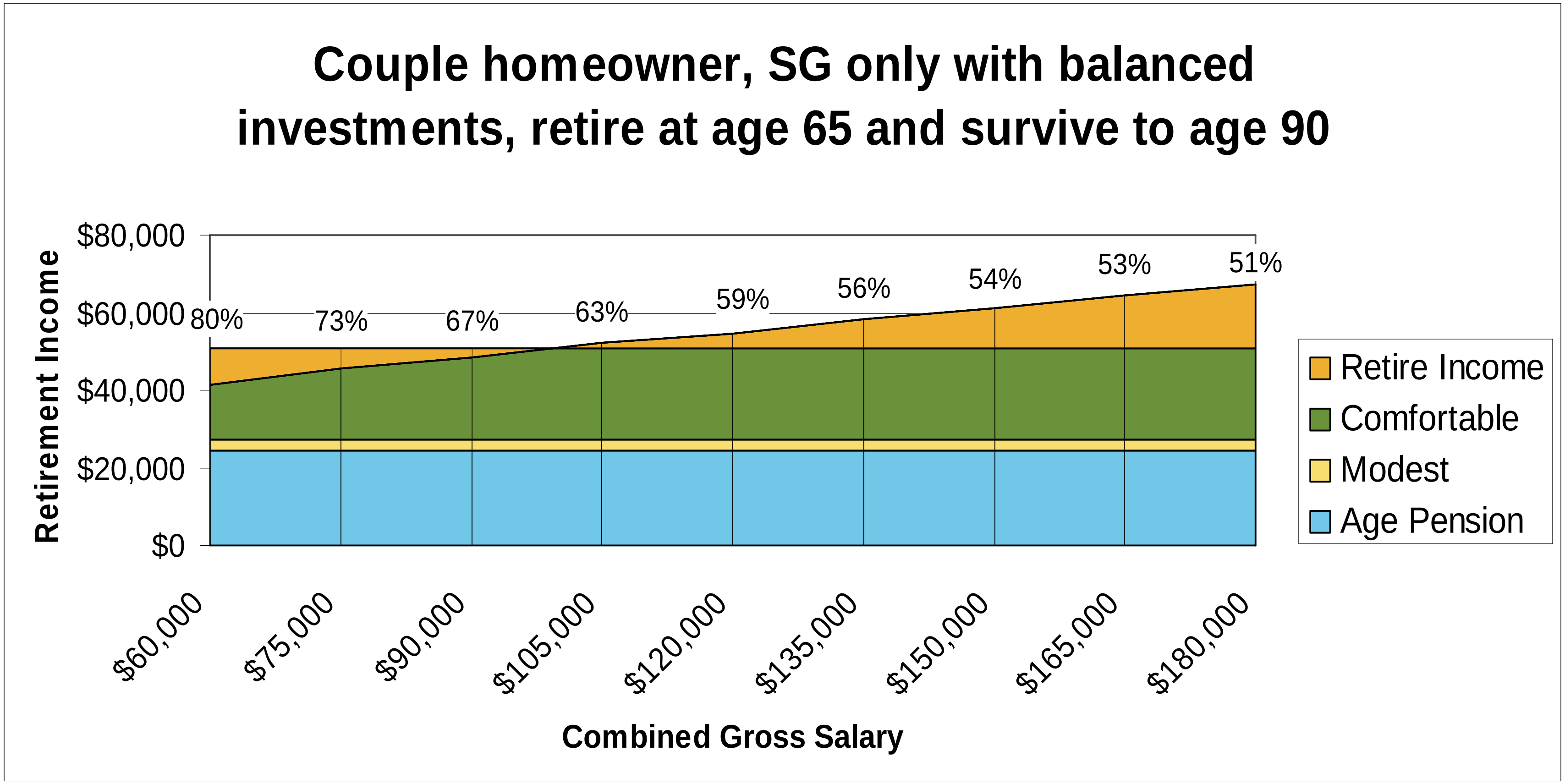

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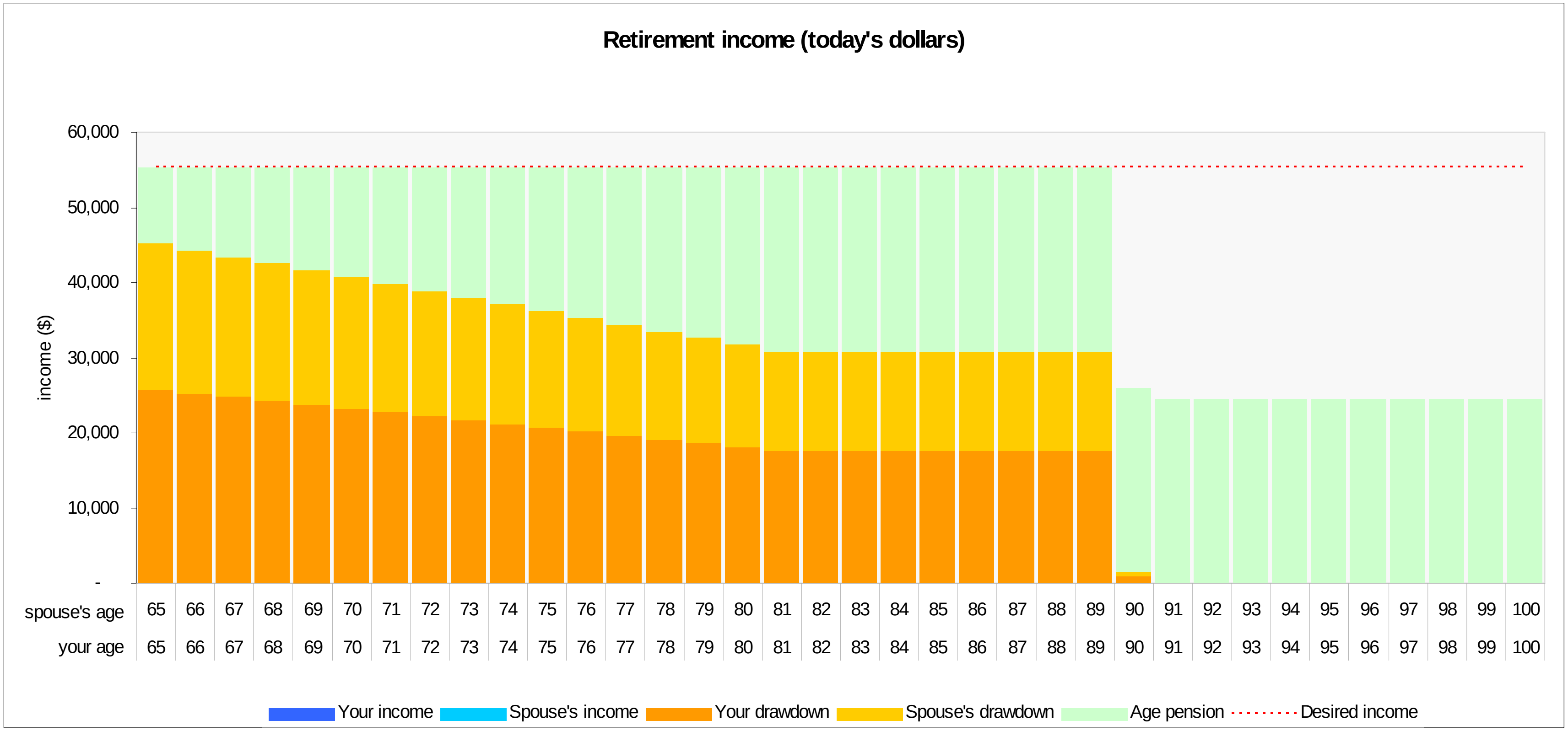
Volatility

Consider a couple on average earnings that has saved $607,000 combined

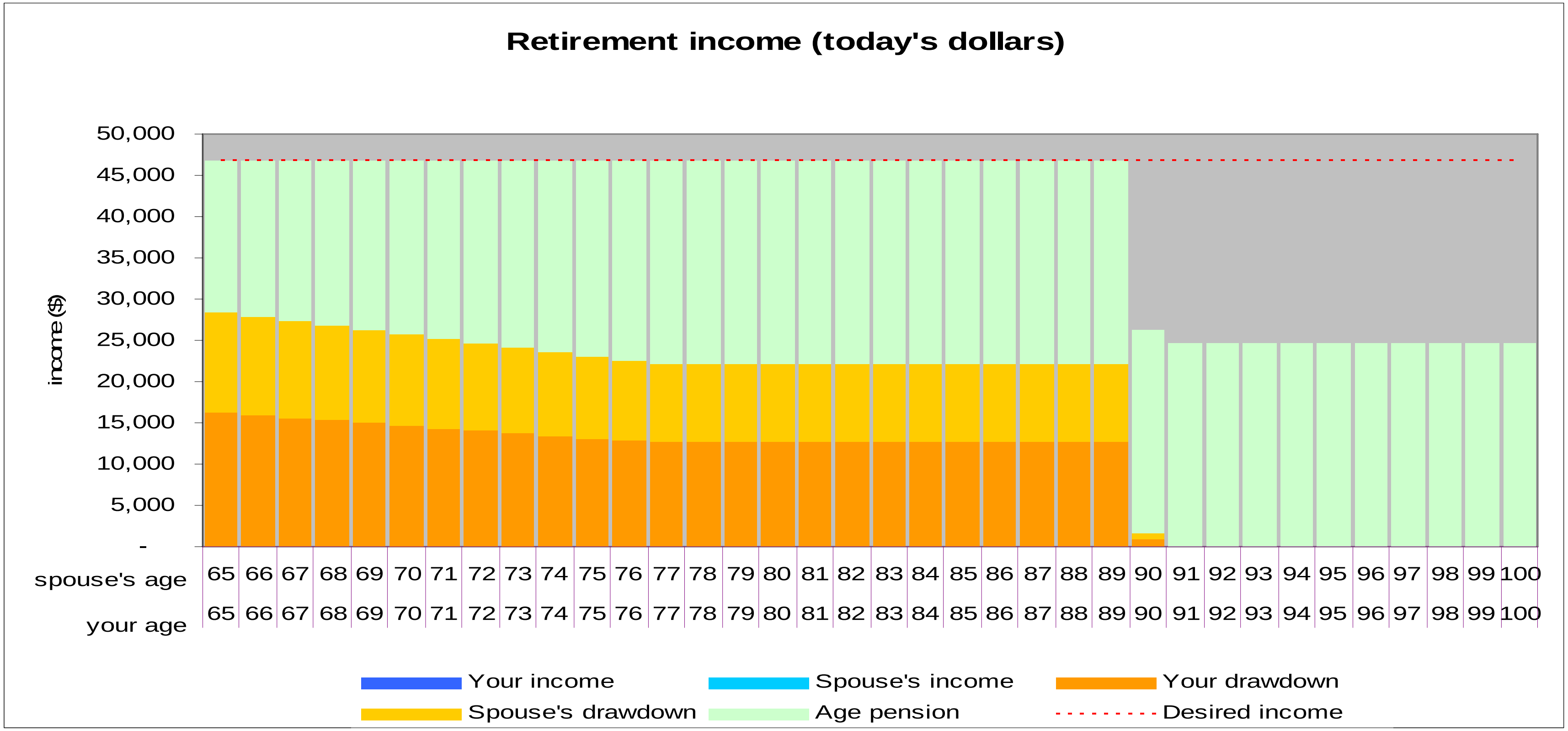
- Note, invested in a balanced option (8%pa)



Volatility

If, instead of earning 8%pa in the last 2 years, the return was -10% and -15%

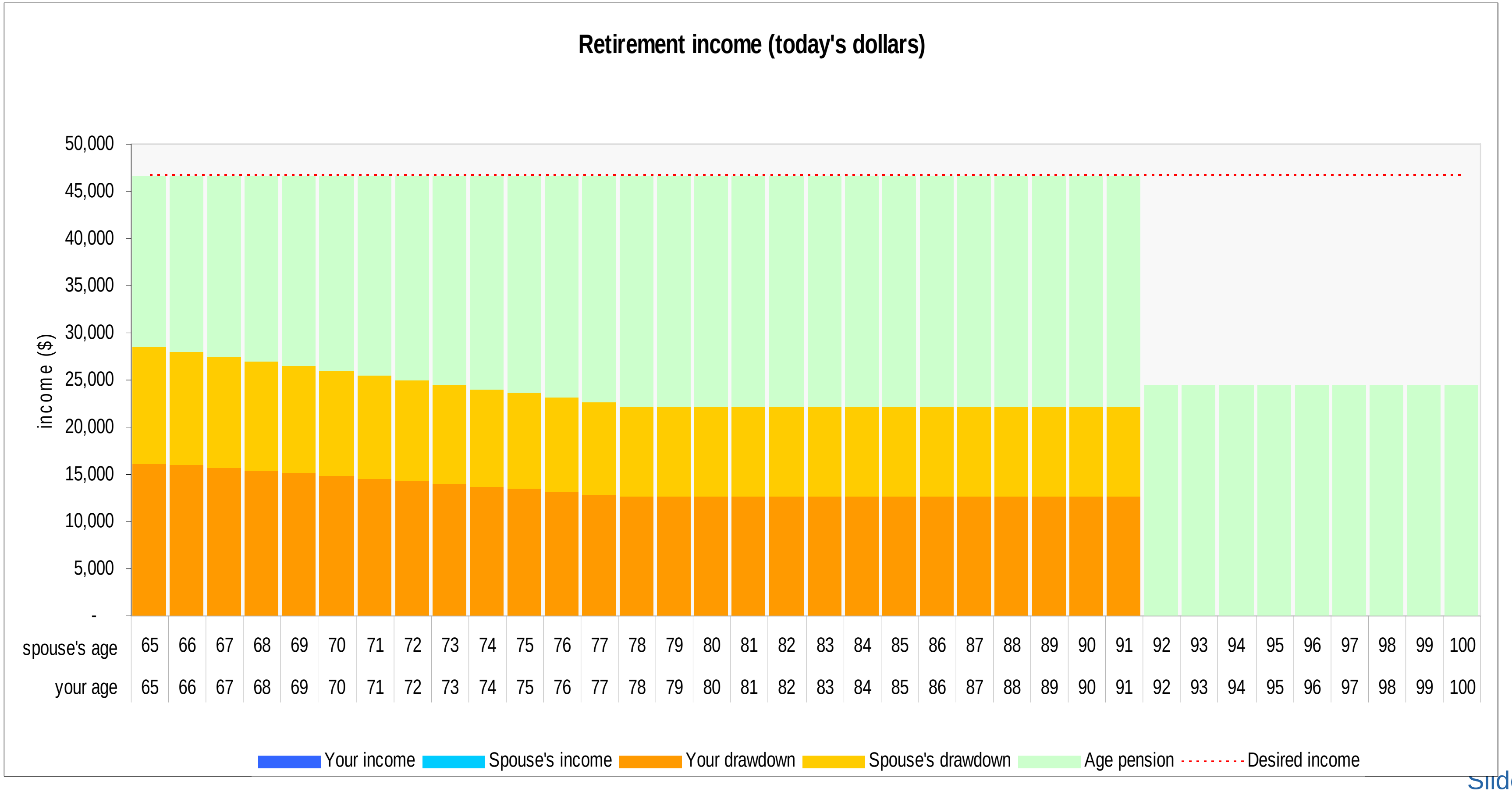
- Combined savings reduces to about $398,000



Volatility

Based on this reduced amount of $398,000 at age 65

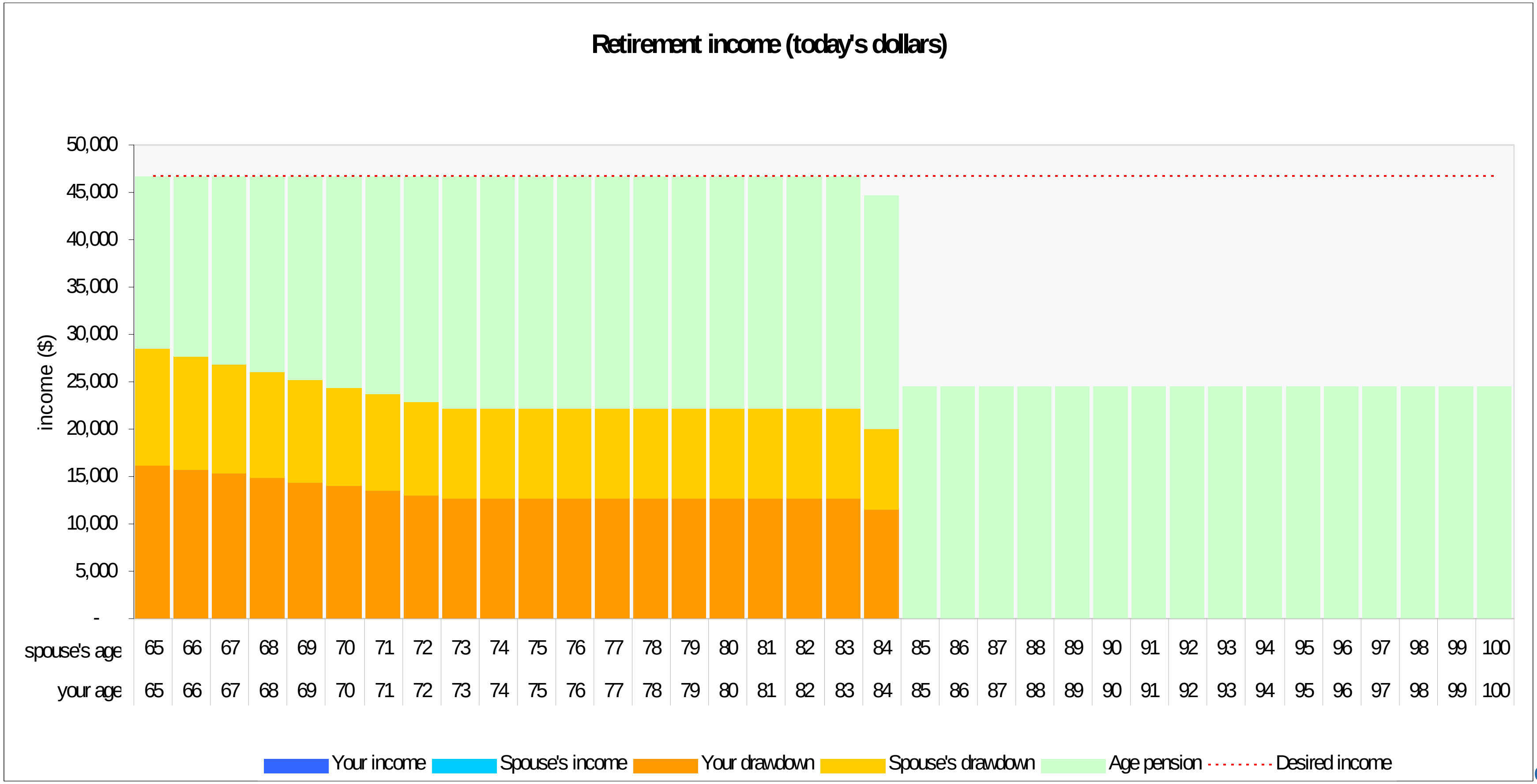
- If the member now invested in a growth option (8.5%pa)



Volatility

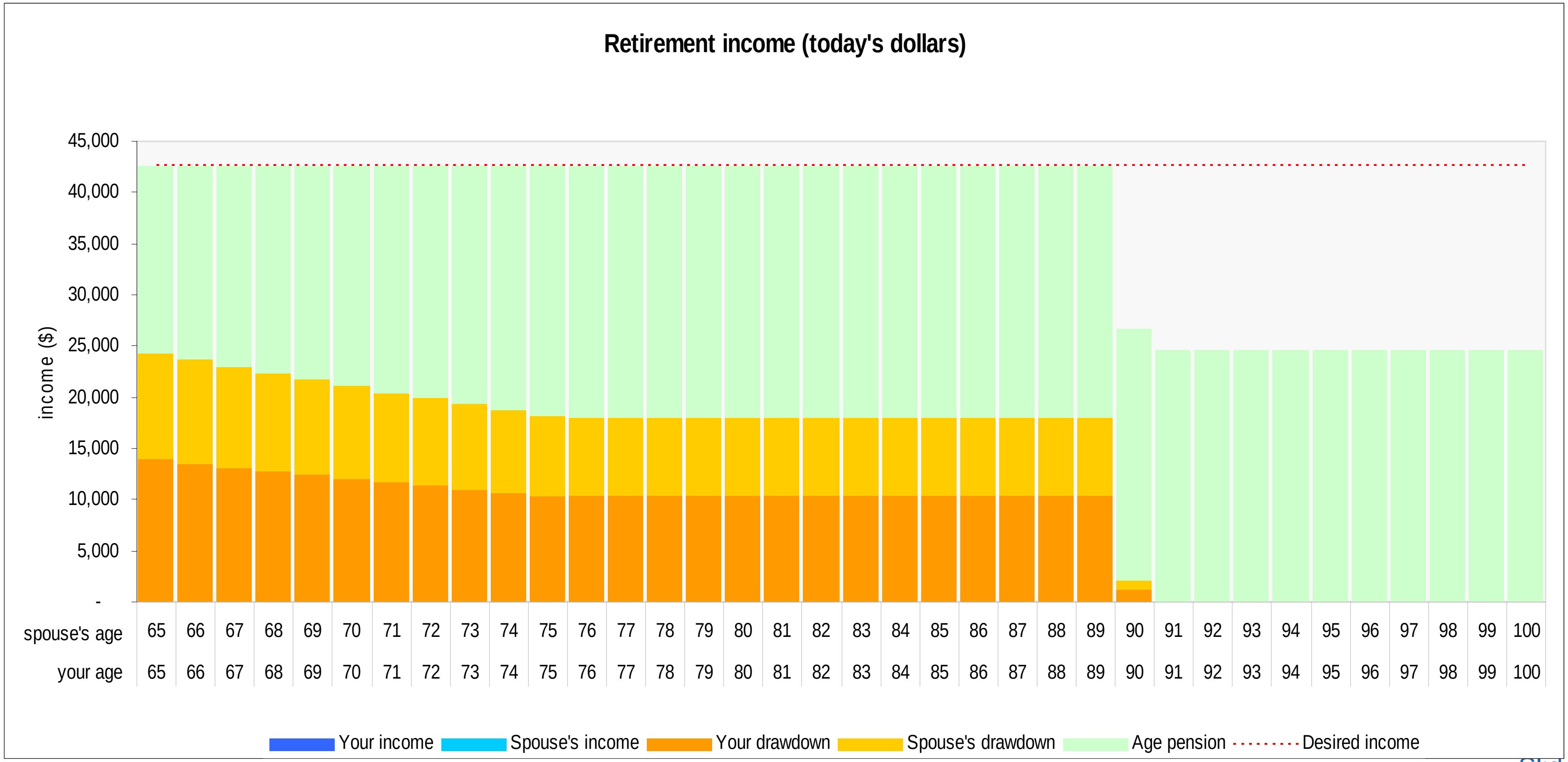
Based on this reduced amount of $398,000 at age 65

- If the member now invested in a stable option (6%pa)



Volatility

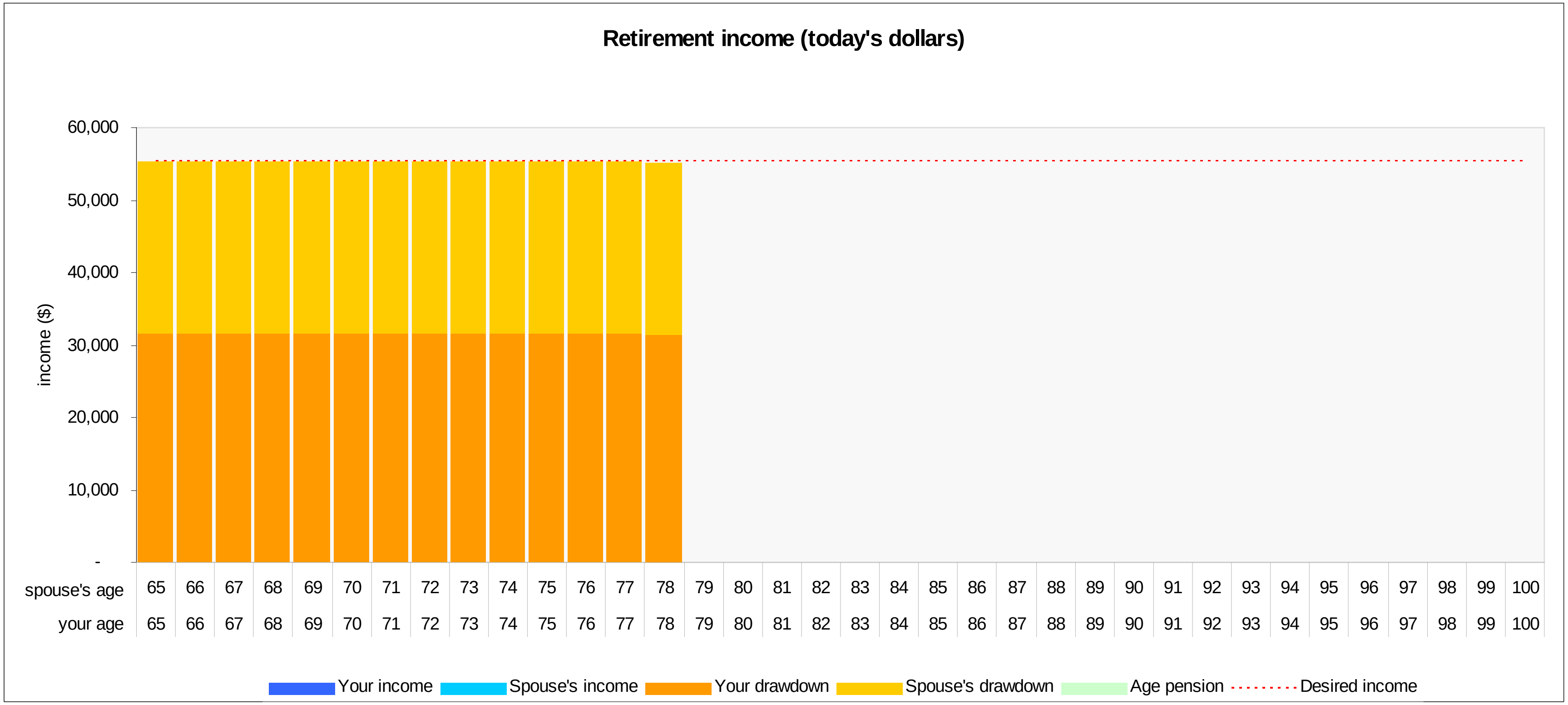
The member needs to take a reduced income to make it last to age 90 in a stable option



Longevity risk

Consider a couple on average earnings that has saved $607,000 combined

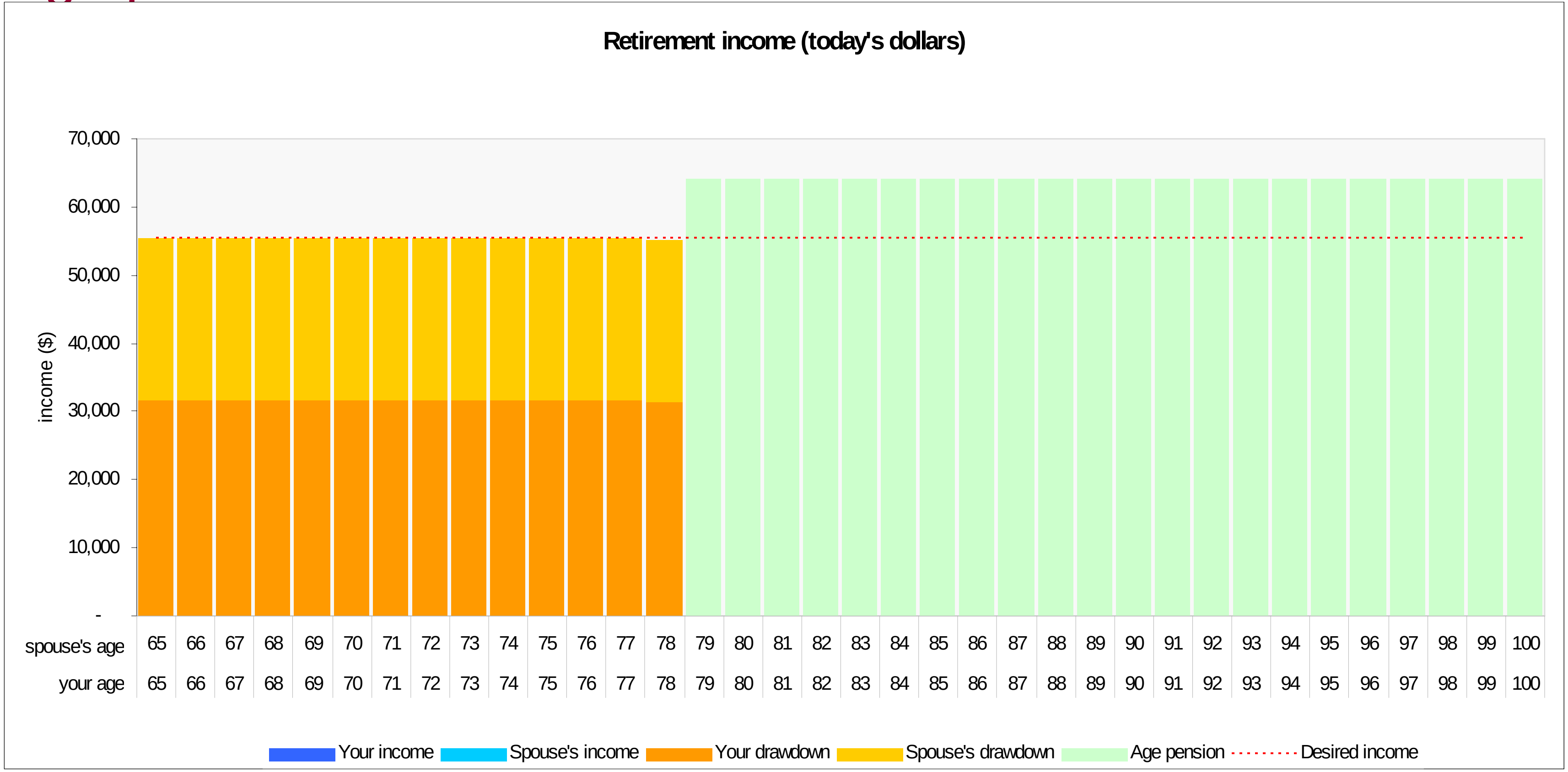
- Without the age pension, the savings only lasts to age 79



Longevity risk

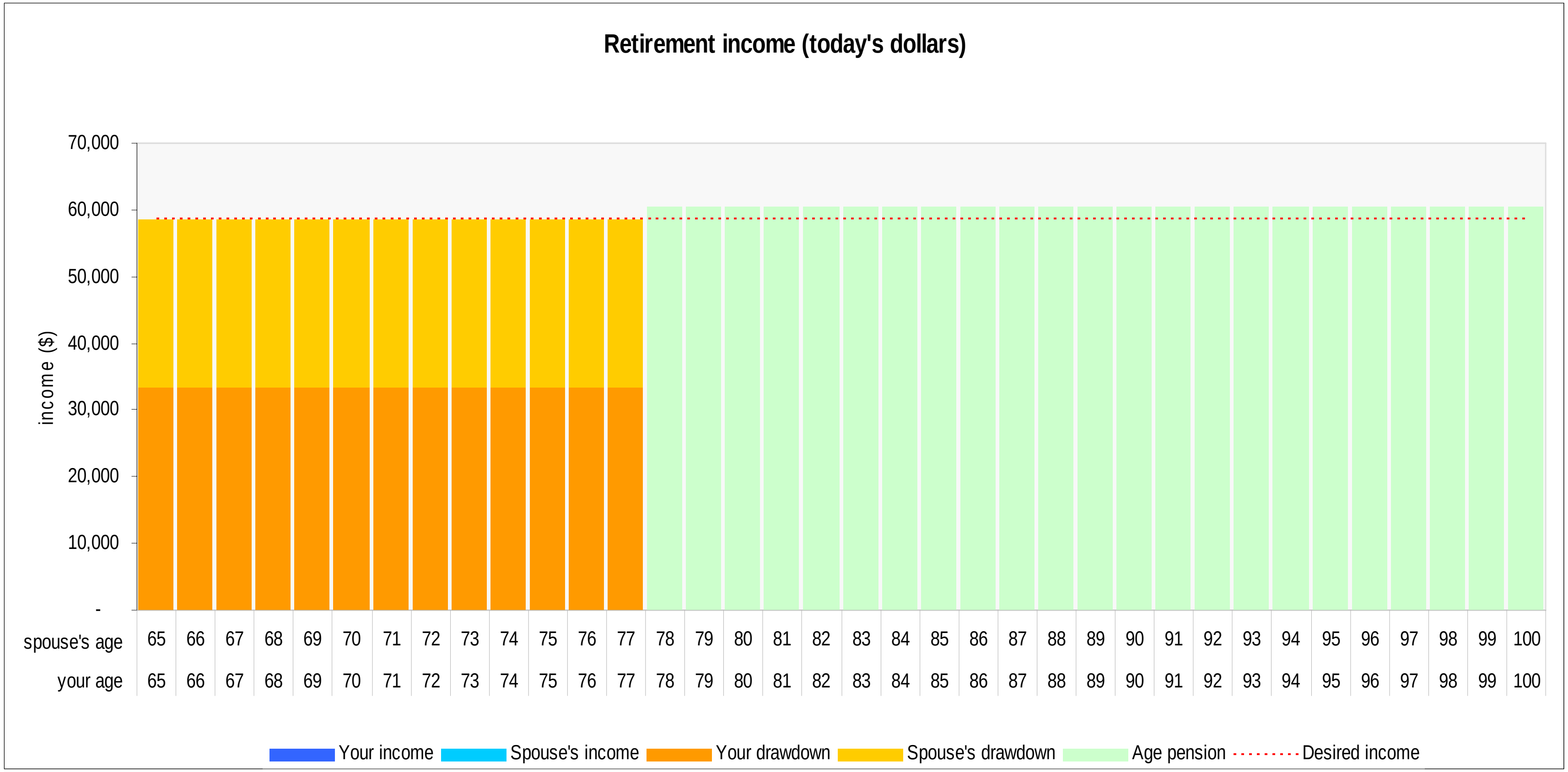
With a deferred age pension from age 79

- Age pension increases from 42% to 110% of AWOTE



Longevity risk

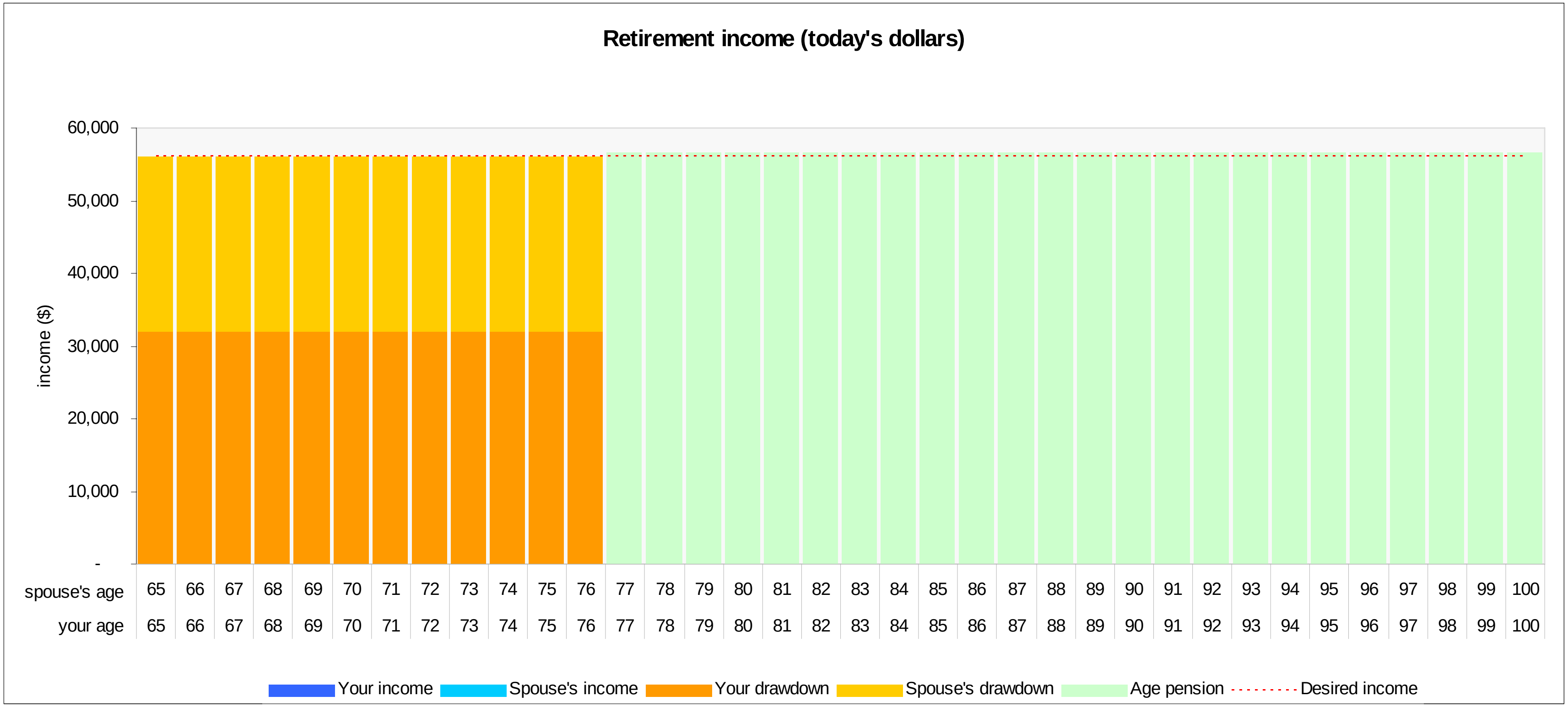
Or alternatively, 103% of AWOTE from age 78



Investment risk

If retirement savings are switched to stable (6%pa) at age 65

- Age pension of 97% of AWOTE from age 77



Summary

Age pension provides a buffer against investment volatility

Adjust draw down amounts to reflect different investment outcomes

A cost neutral deferred age pension can help manage longevity risk

To a lesser extent, can also assist with post-retirement investment risk