Actuaries Institute Podcast
Title: Developing the retirement income framework

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Speakers: Jim Hennington, Anthony Asher
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Introduction

Jim:

Hello and welcome to the Actuaries Institute Podcast and this introduction to an important piece of thought leadership that crosses over a few areas of actuarial practice, specifically superannuation, life insurance and investments. My name is Jim Hennington, and I'm a fellow of the Institute of Actuaries. Anthony Asher has launched a Dialogue paper called *Developing the retirement income framework*. Welcome, Anthony.

Anthony: Thanks very much, Jim, for the introduction and for all the work that you've done in the Retirement Incomes Working Group, and particularly on this Dialogue.

Jim: **So today we've got some discussion questions to go through. I'll kick off with the first one. So firstly, Anthony, what are the key focuses of the paper?**

Anthony: Okay. As you know, we address the support that retirees get from their super fund when they retire and the lack currently of lifetime retirement income products in Australia, and the support around that, which includes advice and recommendations from the superannuation fund. We all in the Working Group have done calculations to show that life annuities would allow retirees to spend much more, significantly more money from their super fund. And it also protects them from the risk of running out when they get older. Now you've recently done some calculations, Jim, on the score using the latest mortality tables.

Jim: **Yeah, I've done quite a bit of modeling, looking at a life expectancy and looking at life expectancy for different groups of people. So, one thing I've become really tuned into is just the uncertainty that each individual faces around their own lifespan. So, we have life expectancy, but there's a standard deviation around that, which is quite wide. And I think individuals instinctively know this and retirees, they hold back their spending just in case they are the ones who do live well past life expectancy. So yeah, I'm really**

encouraging the industry to quantify not just average life expectancy, but the range as well.

Anthony: Yeah. And once you take that into account, a lifetime annuity that allows you to spend up to 30% more, maybe, for a young person and very much more for an older person. I mean, when a “young” person here is 65, and the major issue is actually how long they will live. And life annuities are the obvious way to spend and have maybe been around for at least 2000 years, but not sold in Australia. And this is the question that we're concerned about. Now, the government is also concerned about it and has taken steps in the last few years to address obstacles to their introduction.

Anthony: So, the major obstacle that did exist until 2017 was that deferred annuities and with profits and smooth and variable annuities were not permitted in Australia, even though they were very popular and sometimes even compulsory overseas. So, they're now permitted and in 2019, the government has also changed the means test so that there's no longer too much of a disincentive to actually take an annuity rather than spend your money as quickly as possible.

Anthony: And also, in 2018, the treasury issued a retirement income covenant paper, which was intended to suggest that super funds developed a retirement income covenant. In other words, set of rules within the trustee, that address the question of what they give to retirees when they came to draw down their money. And that includes access to information and perhaps even advice, and we're really concerned that the cost of advice is very high. So, the cost of advice, the failure to offer appropriate annuities and the encouragement of trustees to make those offerings were the issues that we're looking at.

Jim: And Anthony, so what sparked your interest in conducting this research?

Anthony: Well, annuities have been a long-term interest of mine. I just loved the mathematics when I did it in the 70s. In the 80s, I was an actuary of the Prudential in South Africa, and we introduced the with-profit annuity, which was the first with-profit annuity that was permitted to be offered to retail customers in South Africa. And in the 90s, I actually was a director of Hollard Life in South Africa. I took on that role because they offered impaired life annuities, so giving a better deal to people that were sick with their shorter lifespans.

Anthony: And so, when I came here and discovered there were almost no annuities, it's been one of the things on my agenda since well, for

a long time. And that's why we set up the Retirement Incomes Working Group in 2012 to really get to grips with the issue. And we have about 20 members of which perhaps, only half are active at any one time, but we've made quite a lot of progress in the last eight years on the issues that need to be addressed before people have a really good set of options when they get to retirement.

Jim: **Yeah. So, for me, I joined the Group in about 2015, I think.I lived in the UK for about 15 years and when I got back to Australia in 2013, I was just intrigued by the fact that we only have individual accounts for retirement, where all the risks land on the retiree. I do a lot of stochastic modeling and was looking at, how is an individual to deal with this? I discovered some of the really interesting interrelationships between what the individual's assets are and what they get from the age pension, with means testing.**

Jim: **It struck me this is just a really complex, interesting piece of math. But yes, if every individual is trying to reserve for their own risk, they're either going to underspend, which I think a lot of them do, or they're going to overspend and run out - both of which aren't really great outcomes. You know a big part of this is what's their time horizon, how long do they need their money to last? And unless they're insuring that, then they're either going to overdo it or underdo it.**

Jim: **Hardly anyone knows exactly when they'll die. So, as actuaries, we have a deep understanding of the risks and the complex management required to convert a lump sum into retirement income. And with the RIWG, what we want to do is find ways to help others see these issues, but also to know they're solvable and to help formulate those solutions. So, it's a great Working Group.**

Anthony: Sorry, I should also add both my parents and my parents-in-law have had annuities and my dad is now in his 33rd year of retirement and is much better off as a consequence of having an annuity. And the research that has been done in the United States particularly, shows retirees with annuities are happier, as you would expect. They get the monthly amount or weekly amount of whatever it is into their bank account and they can spend it, no concern about investments, about “How much can I afford?”. It's just a question of getting on with retirement rather than having financial hassles. But you're actually involved directly in product development of this stage too, aren't you?

Jim: **Yes, I’m working with Optimum Pensions. It's a solution where we partner with superannuation funds and help them build their own lifetime income products. Yeah, so that's**

really exciting work. And another thing to add is that people who buy annuities live longer.

Anthony: Is that a selection effect or?

Jim: **It is, it is. It's a selection effect, but yes, it is true.**

Anthony: Well, it might well make a difference because you would have fewer concerns and you would also have money at a time when you're older in the nineties, when you might well find a situation where you face serious problems if you don't have access to cash. Yeah, I can say, I have no commercial interest in annuities except I do want to buy one to retire on and I can't afford to retire until they're available. But obviously most of our members have some interest in developing annuities. But we also know that most, well probably all retirement funds are thinking about it at this stage and what the Dialogue paper is intended to do is to give some impetus to that planning.

Jim: **So, what were some of the Dialogue's key points?**

Anthony: Right. Now, there's two sections to this. One is the misconceptions that really do need to be addressed. The first misconception is that people want flexibility for unexpected expenses and so don't buy annuities. Now, that's a mistake. One does need flexibility, and you certainly need a buffer, but the point about a buffer is that you draw down if expenses are higher or income is lower for some reason, and you build it up from your income when you can.

Anthony: When you ask people, how much of a buffer do you need, they will say perhaps six months of expenses, perhaps a year, maybe even two years of expenses. But if you don't buy an annuity, you don't have two years of expenses. You've got 25 years of expenses in your buffer, but nothing to build it up with. Although, in fact, with a little luck you would have the Age Pension. Most Australians have the Age Pension. Some do save from the Age Pension to build up buffers. So, we're not against a buffer, but just that the requirement for flexibility is misdirected if you think you shouldn't buy a regular income stream to top up your buffer when things go wrong. So, the buffer is one thing.

Anthony: The second is that people believe that annuities are unfair and give poor value to those in poorer health, which is true for the annuities that were sold before 1990. But since 1990 at least, I know the UK and South Africa and the technologies available here, it is possible to actually look at people's health and give a better deal to someone in poorer health. That's fantastic because actually, particularly around retirement, many people in poorer health have not been able to save enough and they're going on to early retirement. If you just give them credit for the fact, that's the

only good news you have for having poorer health. You get a better annuity because the shorter your lifespan, the more money you get. So that's another common misconception, which I've heard from trustees and directors who I think should know better. So, it's really a message that needs to get out.

Anthony: The third misconception is the idea that life annuities lock you into low-yielding fixed interest investments. That is true for what's available currently on the market, and they're low yielding because they are risk-free. As has been illustrated in the last few months, other investments can lose value rapidly. So, to get a guarantee, you've got to pay for it in the sense of having a lower expectation in the future, but there's no reason why life annuities cannot be linked to investments: equities, property, whatever, and this has been true since the '50s, when the American TIAA CREF Superfund, which is the equivalent of our Uni Super, offered this to their university employees. They have had an equity-linked annuity that's worked very successfully for now 70 years. So, it's, again, not new, and it's been proved to work.

Anthony: Finally, the idea is that people don't want annuities, and that's just wrong. If you ask people, it is true there's a bit of a framing question. If you ask people, would you like to invest in an annuity? What it does is it pays you up until you die. But seen as an investment, that's a bit of a funny investment, and the research that has been done (some interesting stuff in the United States) shows that if you offer them an annuity as an investment, 30% of them say, yes, that's a good investment.

Anthony: If, however, you say, look, this is a consumption plan. This is a harvesting plan. This is how you translate your current superannuation balance into an income for the rest of your life. Then it makes 100% sense, and then over 70% of the people want an annuity. The research that's been done here recently by my colleagues, Hazel Bateman and Susan Thorpe, from the University of Sydney have shown that that's the case widely, that people will take an annuity if explained appropriately to them. So four major misconceptions. Perhaps you might like to talk a little bit about the difficulties faced by trustees, Jim.

Jim: **Well, yeah, what I was going to add is that there was some research done recently by Melbourne Business School into these same topics about whether people want annuities. One of their key findings was that people don’t so much dislike annuities - there seemed to be a good appetite for them - but what people really didn't want is to have to make a choice!**

Jim: **So, people are terrified of the decision. What that tells me is people want their trustees to decide for them and to make good decisions and put them in front of them and to have that**

complexity taken care of for them, which yeah, that does push a lot of the complexity and thought process onto the trustees, which I think is your next point, Anthony.

Anthony: There are obstacles to the trustees adding annuities to the menu. The responses to the treasury's covenant papers show that the trustees are nervous. So, first is that they face criticism from the beneficiaries, the spouse perhaps, but certainly from the children, that if people die early, the money goes to make a 'profit' for the life insurance company.

Anthony: This is a misconception, and it's an unfair criticism from family, unfair in many respects because the annuity actually insures the children. Without an annuity, they get a bequest *maybe*. Maybe in a sense they are 'lucky', and their parents die early. More likely, their parents will die in their late 80s and 90s when the children are about to retire and don't need the money or shouldn't need the money. But possibly the parents live longer, and the children have to work longer because they need to support their parents.

Anthony: So actually, an annuity insures the children. But the important thing is that, well, there's very little evidence that parents need or want to give bequests to their children from the annuity. Australians can leave their house to their children, which is more than enough, in many cases. Most children, when they're asked, don't want money from their parents. They'd far prefer their parents to have a comfortable retirement than for their parents to be giving money. The other point is if people really wanted to leave bequests, they should be a little more intentional about it, set up a trust. Buy an annuity and give the rest of the money to their children now if you want to do so.

Anthony: The second major problem, the major problem perhaps for the trustees, is actually the obstacles to giving advice. So, trustees are petrified of making it appear that they gave financial advice that turns out in retrospect to be inappropriate. Now, of course, not giving advice is also giving advice because the default is, in a sense, implicit advice.

Anthony: So, the current situation actually is that the trustee is effectively saying, "Look, take a lump sum or take an account-based pension and draw it down because that's what everyone else does, and we don't make any comment." But you are making a comment because they are experts and they are effectively saying, "Take the account-based pension, that's appropriate". So, we need to shift the onus, and that requires, in a sense, activity from ASIC and from Treasury to say, "In fact, if you don't give balanced advice, you are actually at risk."

Anthony: Then there are issues about legacy products. So, what has happened in the past is that companies and funds have offered the new products, and they have not been taken up. Then they're left with 20 or 30 policies that they've got to administer for 20 or 30 years, which is very inefficient. So, there needs to be ways of making sure those legacy products can be managed very inexpensively and don't create such huge administrative costs.

Anthony: Then finally, one of the things that treasury was hoping was that funds could develop a comprehensive product for retirement that would be mass customized. But mass customization has turned out to be, really when looked at, not possible. People need advice, help. Even if they are given a default, they need comfort to say, yes, this is appropriate.

Jim: **I guess the other issue for trustees is their other priorities. Superfunds are often under pressure to merge and also deal with other regulatory issues like the protect-my-super issues. Right now, it's all about the COVID industry-wide changes. So yeah, I think to get on the front foot and really prioritise things that are high value but not urgent, it doesn't always happen. So just from a project management point of view, these things don't always get the priority they ought to.**

Anthony: COVID has really created another major series of activities that need to be done. But can I add just one thing that in developing this dialogue and I think is possibly one of the most interesting things. So, in the UK, three or four years ago, the government changed the rules. Prior to that, annuities have been compulsory for everyone who retired from UK pension funds, their superannuation equivalent. But now they basically have pension freedom. So, they've said, "Listen, you can take your money out if you like, you don't have to buy an annuity with the money."

Anthony: And as a consequence, a lot of people are now no longer taking annuities, but taking the lump sum. But recent work by the Financial Conduct Authority in the UK has indicated that one of the reasons why people are not taking annuities is they are being advised not to do so by their advisors. So, the figure is 11% of people who retire are now taking annuities in the UK. 55% of people withdraw their money as a lump sum, and those 55% are taking less than 30,000 pounds normally. And 30,000 pounds is possibly about two years of income for those on the state pension in the UK, which is perhaps a reasonable buffer.

Anthony: So, of the other 45%, a quarter are taking annuity, so that's the 11% of 45%, but they've divided the people into those that are getting advice from advisors and those who are going to the government's website for information. Those that are going to the

government's website for information are four times more likely to take annuities than those who are going to financial advisors.

Anthony: So, it appears very strongly as though financial advisors are advising against life annuities. So, the question would be why they do that. And I'm afraid the answer appears to be that they are wanting to keep their clients. The point about an annuity is that you get advice from your advisor, put this money into a life annuity, and it will pay you for the re st of your life. Have a good life. Don't come see me again. And if you have an account based pension, that question is well, “Take 4% of the fund this year, invest it in X, in these shares, in this particular portfolio and come and talk to me again next year, about how much you fell down and where to invest”.

Anthony: So, there's an ongoing stream of fees, and it's certainly tempting to think that they are tempted and that the advisors are moving people away from life annuities. And the possibility is that in fact the funds themselves are supporting that because they want the funds under management, rather than have the money transferred to some other company.

Jim: **Another issue I see there, Anthony, is financial planners tend to use projection models that are deterministic. So, they tend to use models that just assume a fixed rate of return, and they assume a fixed age of death, for want of a better word. Like a runout age or something similar. But if you're using models that don't test the full range of lifespan that each individual face, and you just ignore that, then an account-based type approach does look good.**

Jim: **But it's really, really important to consider risk, and when you do consider risk, then the annuity or the lifetime income stream starts to look like good value. So, as you mentioned before, it's a framing issue. But if the super funds and planners are just using deterministic models, then I think that perhaps influences their advice.**

Anthony: Yep. I think you're right. And so, the models that they are told to use by their employers, the licensees and by the funds themselves. So, the whole industry is geared towards giving too much certainty and too much ongoing advice rather than saying, "Take this, and this will last you and make you happy for the rest of your life." So, lots of things to address.

Jim: **So, a couple more from me, is it's fairly clear that the public overall, they just want to rely on experts to make good decisions on their behalf. They don't want to have to figure out how to self-annuitize and manage risk themselves. They kind of just hope and expect their Super fund has thought**

about it for them. And another one for me is that new retirees, they instinctively hold back their spending in case the markets don't do too well, or if they live longer than average.

Jim: **And because they're all holding back their spending, it leads to some major market inefficiencies. And another one is, as you mentioned, that retirees who do take lifetime income streams or annuities, they get significant peace of mind from that, they just don't need to worry. It's like having a salary, but not needing to work. It just pops into your bank account each month. And because of that, they're happy to sustain higher spending than if they're having to shoulder all the risk. But lastly for me is that it's a lot easier than many people in the industry think for super funds to create these lifetime income products themselves. It's not as hard as many seem to think.**

Jim: **So, Anthony, what steps need to be taken to act on the findings in the paper?**

Anthony: Well, the first thing is Treasury needs to move ahead quite quickly with a retirement income covenant, which would require trustees to have in place a balanced retirement income portfolio, which would include the option of a lifetime annuity, which currently, very few have. And not only a lifetime annuity, but with profits, smooth, investment linked or whatever annuity that allowed investment freedom and impaired lives so that all members would be given a fair deal, not just subsidizing those in good health, and with appropriate, balanced advice.

Anthony: So that really needs to move quite quickly. And I might say that actually, while you were talking, it struck me that the COVID issue actually makes this very much more important. Because one of the problems with the current economic settings is that asset prices are high, but people are not spending. And one way of converting high asset prices into spending is to convert it into an annuity, get the retirees to spend the money and get the economy going again. So that's one.

Anthony: Then the second thing is that ASIC really needs to look very carefully at the type of advice that is given. We've identified the fact that advice needs to be made cheaper, and automated advice that basically presents people with their options, and it gets them to understand what the issues are. That's really important, and to free up super funds to offer information that's really useful rather than be so fearful of giving information that they keep people in the dark. Because that's the current situation. “I'm so afraid of misleading you that I'm not going to tell you anything.”

Anthony: And the third issue, which is relatively novel but that has been suggested in the financial systems inquiry... and I do know that there are people in the financial planning association that have asked for it... We want the ATO to provide assets and salary data that it has on us in an appropriate format to authorized people, like their financial advisors, so that it's much quicker for the financial advisor to give advice. So, the point is, in order to give financial advice now, a financial advisor needs to know all your assets and what your past history has been in terms of income. Also, what your spending has been, to tell you how you're going to continue that spending into the future. It's really difficult to collect that information, most people haven't a clue.

Anthony: Anyway, I mean, that's just a nice story. The ATO knows more about your finances than you do, I almost guarantee. They've got your superannuation balances, they know how much interest you're earning, they know which shares you own. The ATO knows what your spouse has been earning. If you get the MyGov information from Medicare, they know who your dependents are for Medicare purposes. They've got lots of information. That could easily be put into a standardized format and made available for financial advisors.

Anthony: As I say, the Financial Planning Association has suggested this, they would like it. So financial advisors would like it because it would enable them to reduce the cost. It reduces the fees they'd need to charge to give advice, which would make it much more widely available. That is a major obstacle. $3,000 for financial advice is just ridiculously expensive. When in fact, if all the information was available, appropriately automated and turned into advice, financial advisors could spend an hour with people and tell them and give them all they needed to know which would be $500 instead of $3,000. So those are the three things that would be done.

Jim: **Yeah, I agree, and I think such tools would also assist retirement income projections. For example, if superannuation funds know more about your about your spouse and other savings. Because ultimately superannuation is just one account of one individual. Whereas the age pension means tests look at all the assessable assets and incomes of the household. If that data was available, it means that the retirement income projection, including the age pension can be much, much more meaningful.**

Jim: **So, any parting messages to the listeners?**

Anthony: Well, assuming that most of our listeners are actuaries or people that are working in this area, design a product that the actuaries

would want to buy to fund their parents' pensions. What would you like your parents to be on? I think maybe that's the way to envisage it. Let's develop products that are really good.

Jim: **When you do that, make sure you allow for risk, not just life expectancy, but the standard deviation around that.**

Anthony: That'll be absolutely right. We will almost certainly need some type of life income product. So, the message to actuaries and trustees, let's push forward with this, particularly in the light of COVID, when people are being more cautious and need assistance to be less cautious because their risks are covered effectively.

Jim: **Yep. I agree. I think we just need to get on with it. I mean the financial system inquiry was recommending these initiatives back in 2014, 2015.**

Jim: **The government has been supporting that and working on it in the meantime. Treasury has done an enormous amount of work. As you mentioned earlier, things like the retirement income covenant and the new means test incentives. The Australian government actuary has designed a retirement income risk metric. The government's behavioral economics team have done a lot of behavioral research about how to present retirement income products. There's been an enormous amount of progress already, an enormous amount of thought. I think it's time to get on with it. Anyway. That's all we have time for today. So, thank you for your time, Anthony. It's great to put these ideas into the public domain and hopefully encourage more development in this area.**

Anthony: Yeah. Thanks, Jim. Thanks for your support. It is an area that I've really been interested in for a long time and I think we're very close now to getting something that really works so perfectly in Australia.

Jim: **So, listeners, we hope you've enjoyed this discussion. Find out more about the dialogue paper by visiting the Thought Leadership section of the Actuaries Institute website. As always, write in with your questions and comments on the show. We'd love to hear from you. I'm Jim Hennington. Bye for now.**