TALENT • HEALTH • RETIREMENT • INVESTMENTS

CONVERTING A DC PENSION POT INTO A RETIREMENT INCOME STREAM

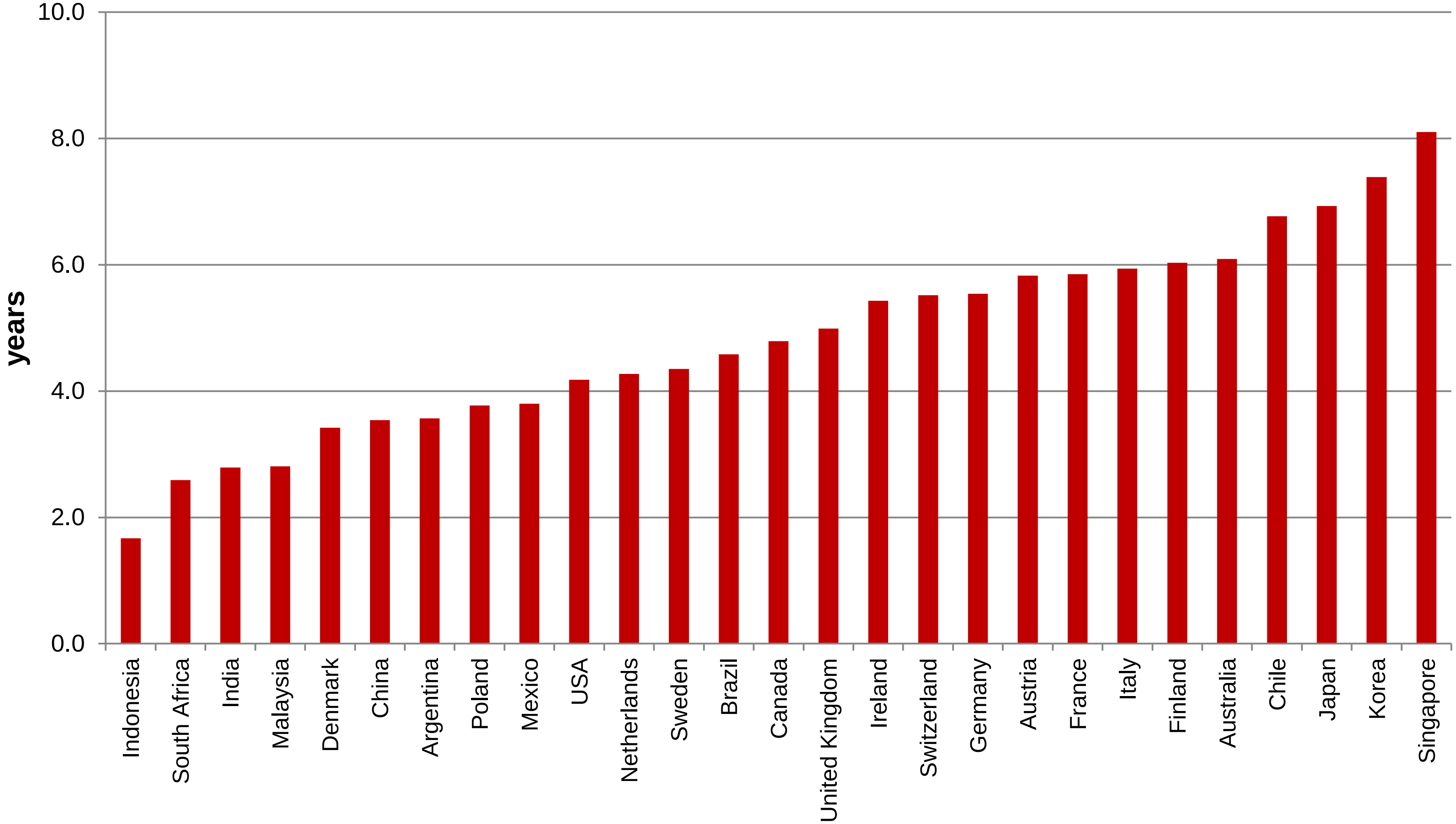
20 JULY 2016

Dr David Knox

Agenda

- Some global trends
- The Australian experience
- The Retirement Trilemma
- The options
- Responding to longevity risk

We are living longer!
Improvements in life expectancy at age 65 over the last 40 years



Some global trends affecting our retirement systems

- We are living longer
- Old age dependency ratios are increasing
- Social security costs are rising
- Pension ages are increasing gradually
- We are moving from DB to DC systems
- Employers and governments are promising less
- Individuals are being given more responsibility
- The gender differences are being highlighted

Some comments on the Australian system

- A compulsory system for virtually all employees (not the self employed)
- Commenced in 1992 with an employer contribution rate of 3%
- This has now risen to 9.5%, on its way to 12%
- No compulsory employee contribution, though tax incentives exist to encourage voluntary contributions
- Most employees can choose their fund (retail, industry, some corporates)
- Most employers have opted out
- Benefits cannot be accessed until age 56, increasing to age 60
- No requirement in terms of retirement products

Australia's Future Tax System – Henry Review
May 2010

Market failure

- "Products are not available in the market to cover the broad range of preferences in achieving security of income"
- "Given the diverse preferences of retirees, a single product is unlikely to satisfy all people who wish to manage their longevity risk. This suggests a need for product innovation within the Australian market."

Australia’s Superannuation System – Cooper Review December 2010

- “The retirement income product market has been underdeveloped.”
- “The Panel proposes measures, including requiring MySuper trustees:
  - to offer a retirement product to MySuper members
  - to explicitly consider longevity and inflation risks when developing investment strategies for post-retirement members
  - to offer pro-actively advice periodically to members planning for, and already in, retirement”

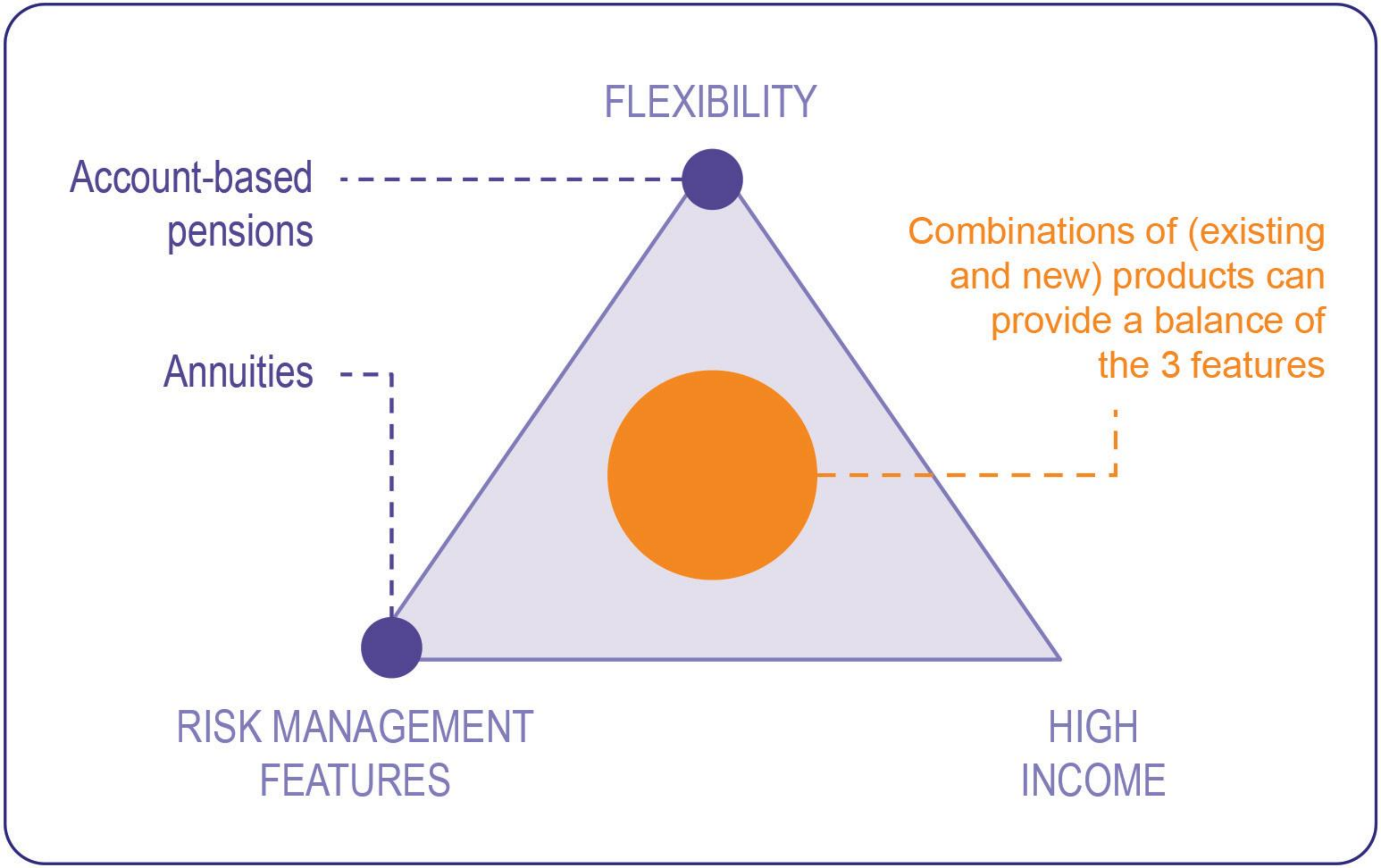
Financial System Inquiry – Murray Review
December 2014

- “Managing multiple financial objectives in retirement is complex.”
- “A well-functioning market would be expected to provide a wider range of products that meet different needs and preferences.”

Recommendation 11

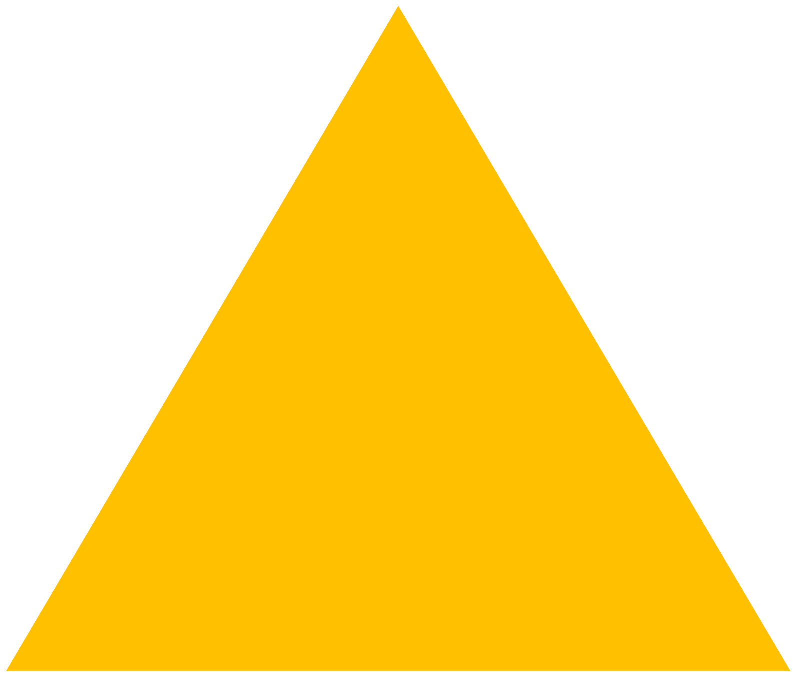
- Require superannuation trustees to pre-select a comprehensive income product for members’ retirement. (CIPR)
- The CIPR should have minimum features determined by Government. “These features should include a regular and stable income, longevity risk management and flexibility.”

FSI: Desired features of retirement income products



The Retirement Trilemma

Access to income from good net returns
(with investment choice)



Protection from risks
(eg market, longevity)

Access to capital
(before and after death)

What are the main products?

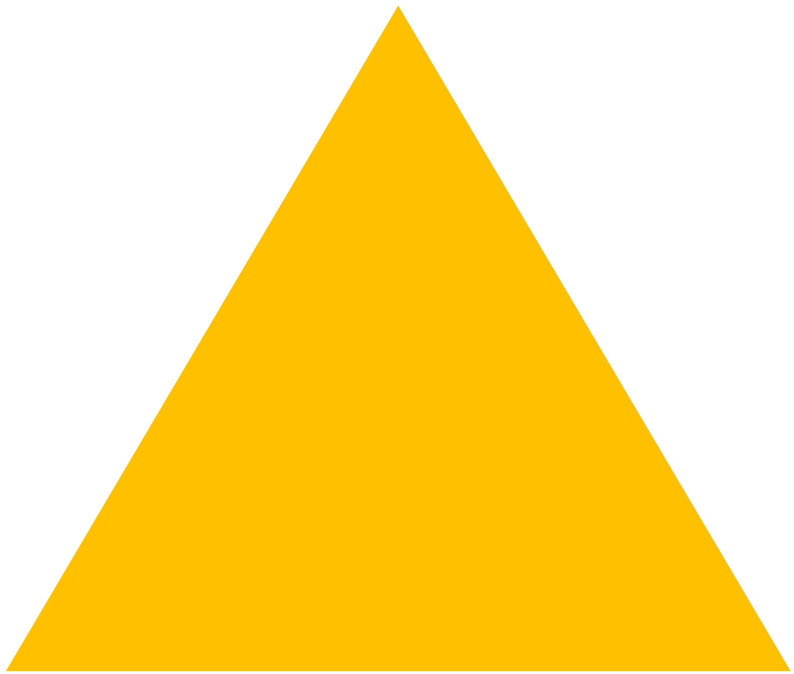
Access to income from good net returns
Account based pensions

Protection from risks
Annuities

Access to capital
Lump sums

But there are problems with each product

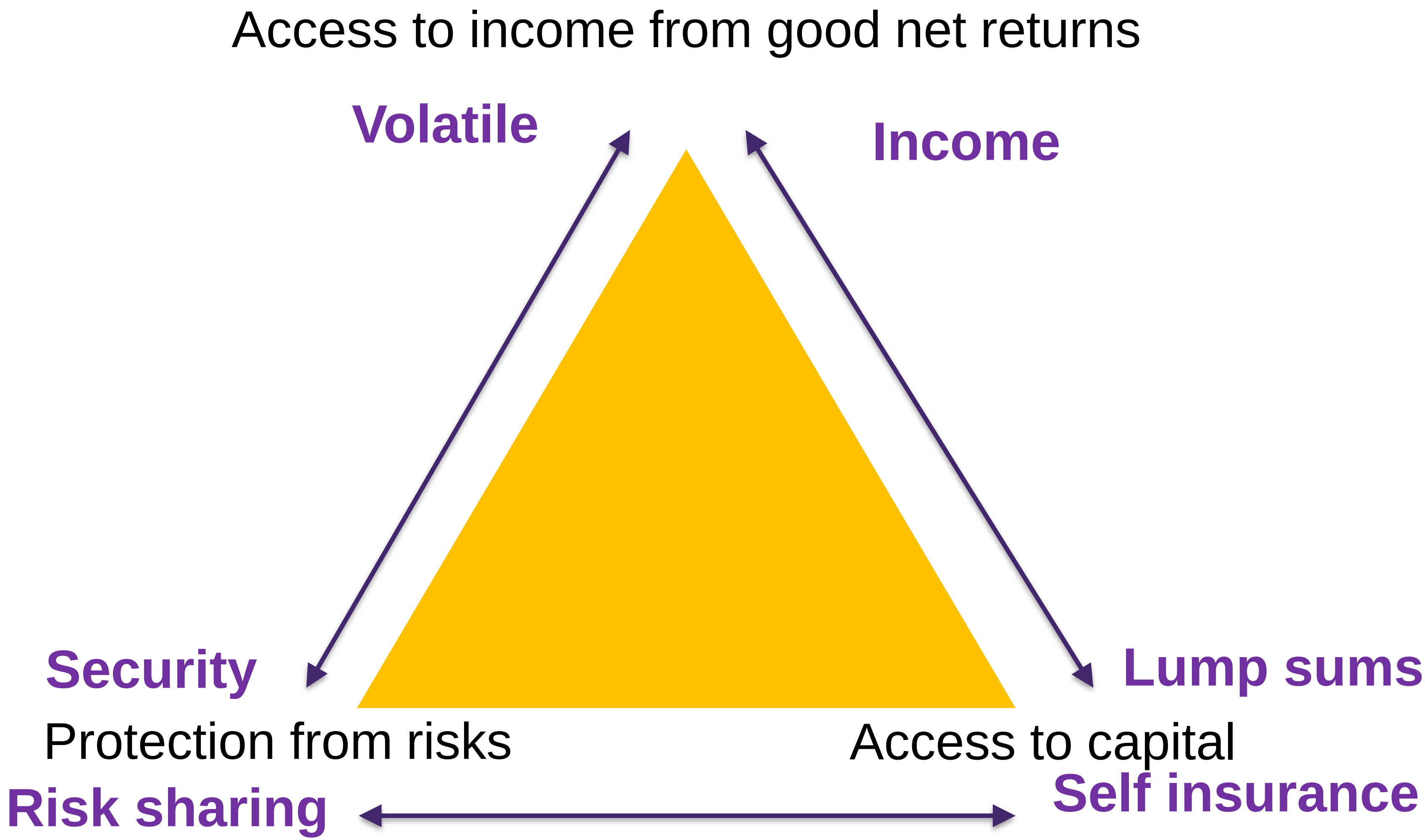
Access to income from good net returns
(this is uncertain)



Protection from risks
(this is expensive)

Access to capital
(this may run out)

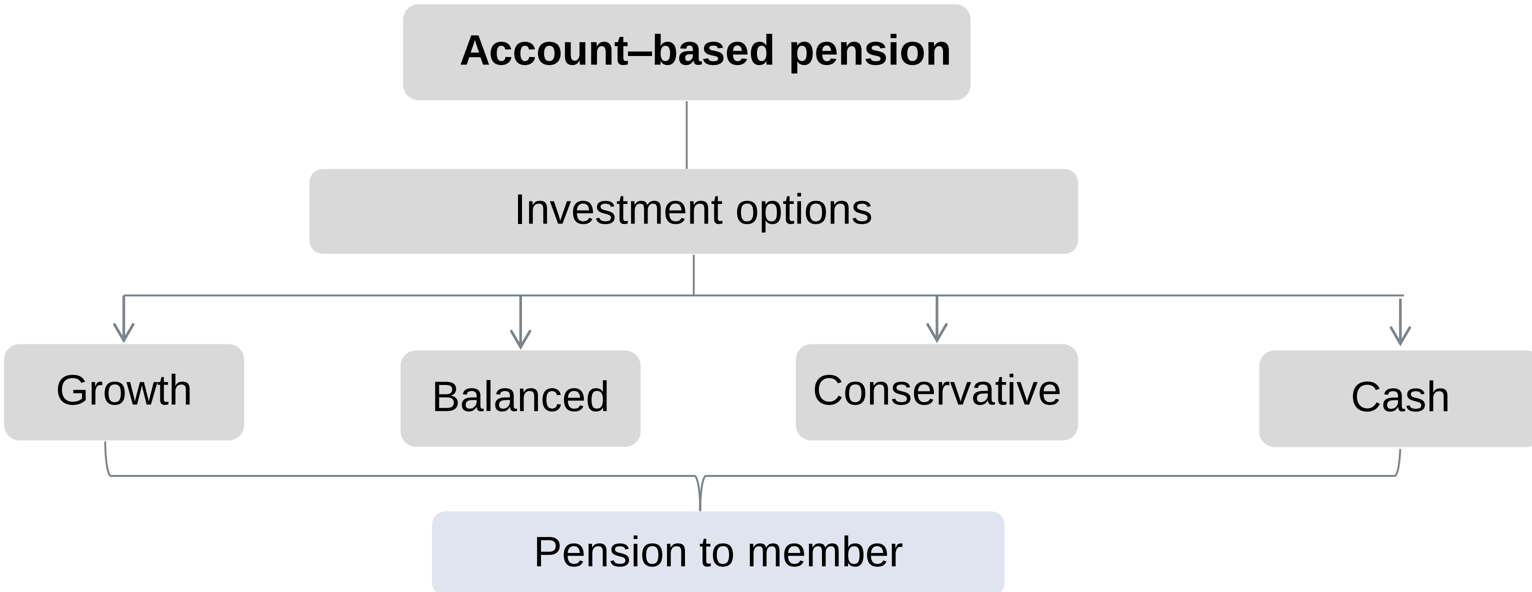
But what is the right mix? There are tensions



Some notes from the Ambachtsheer Letter
June 2016

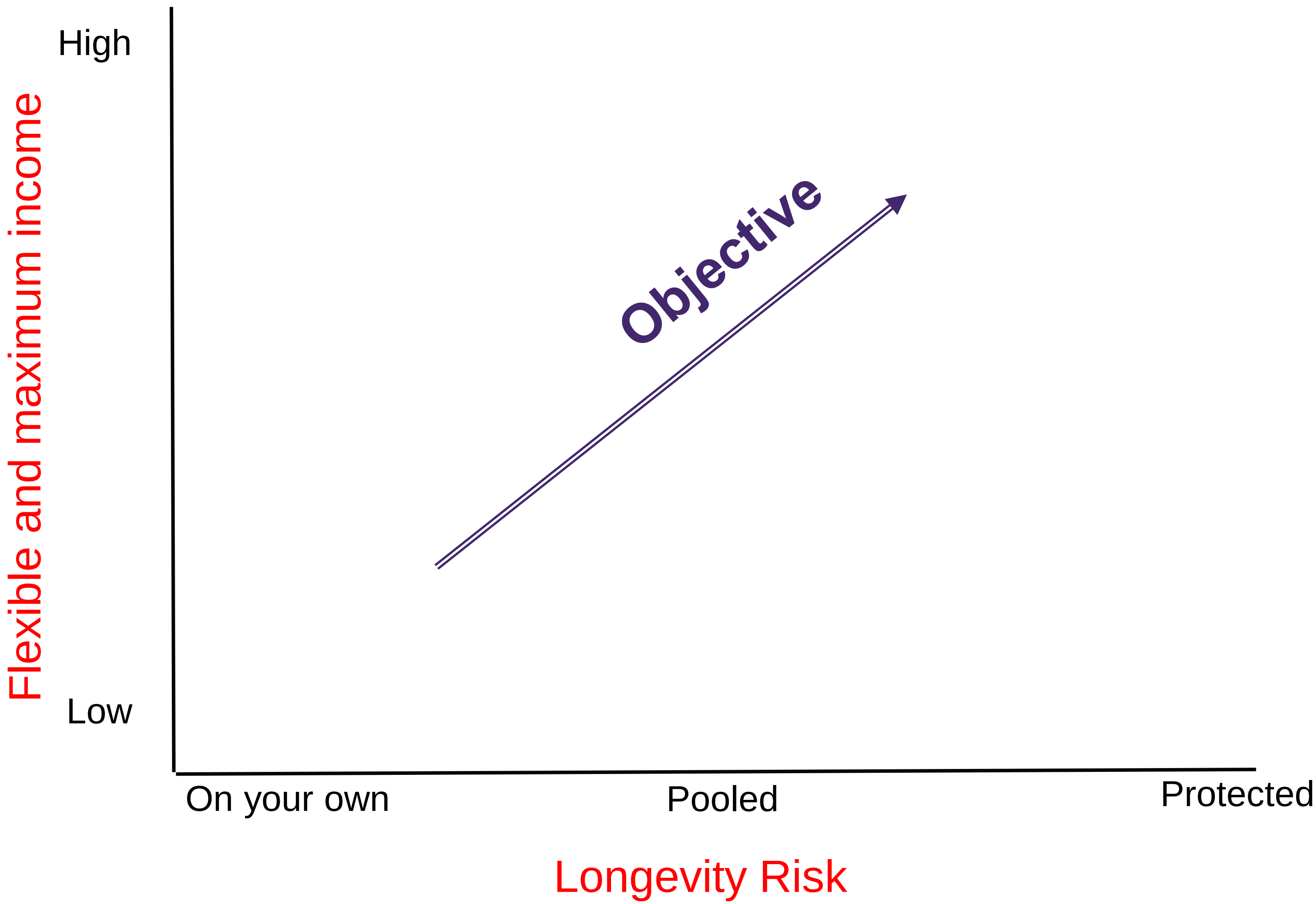
- Two risks in the retirement years – investment and longevity
- The relative importance of these risks change over time
- Their importance is not the same for all households
- Longevity risk can be pooled – we will all die at different ages
- Government benefits can help protect retirees from these risks

A flexible drawdown pension in Australia

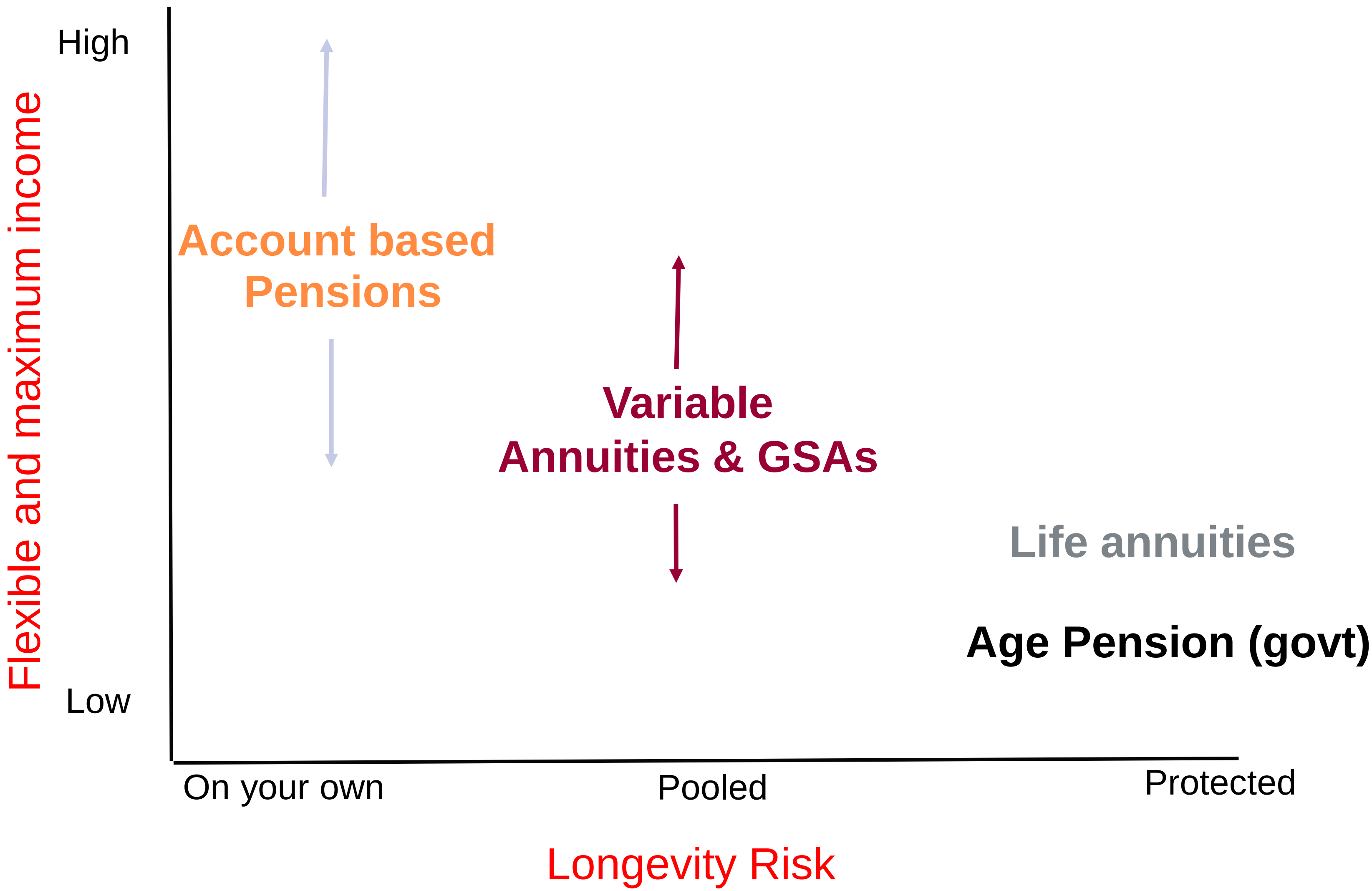


The government requires a minimum pension to be taken each year but no upper limit

What are some objectives from the retiree’s perspective?



What are some objectives?

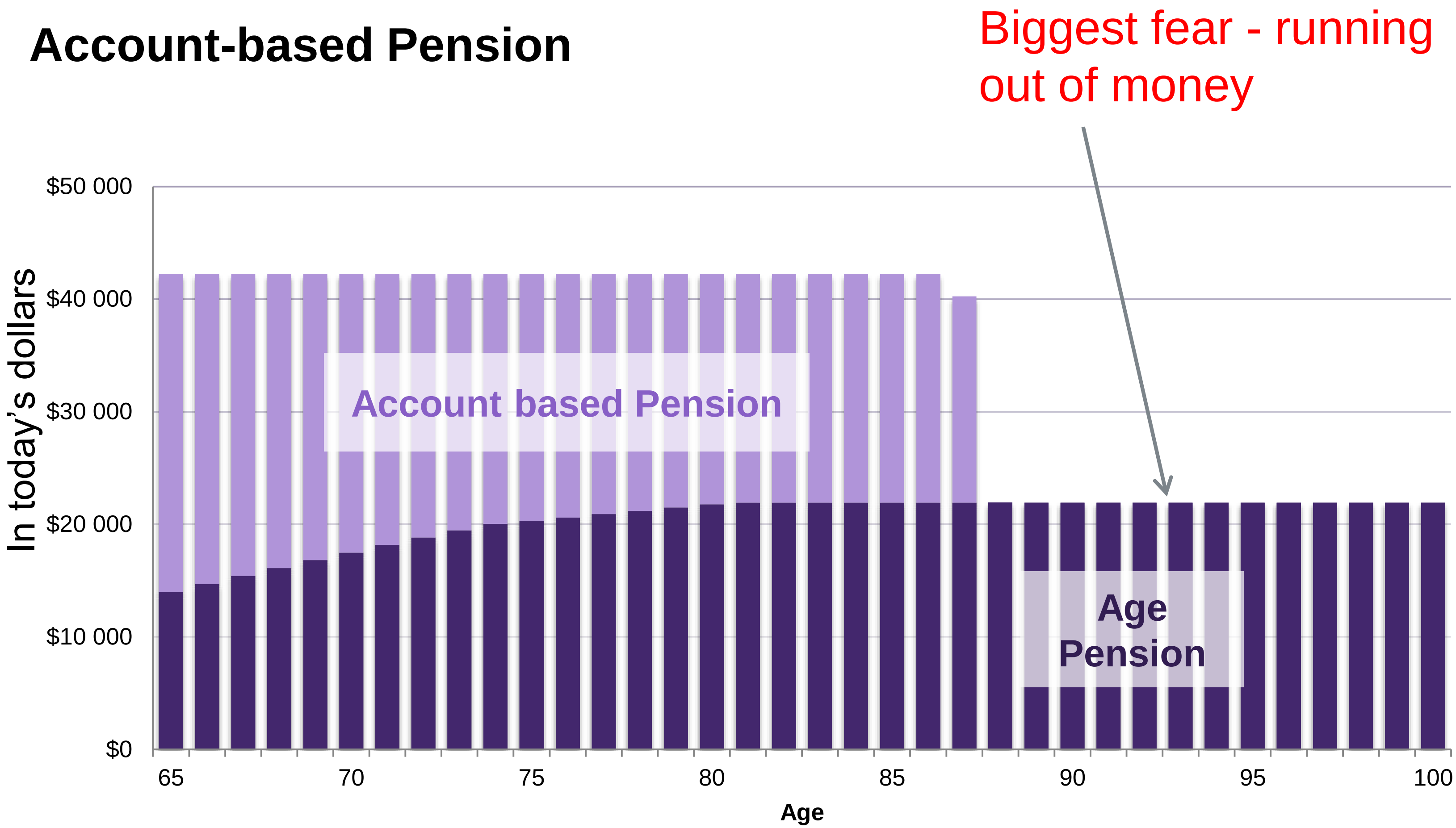


What are some options for retirees?

Option	Longevity risk	Income risk	Comment
Spend the lump sum	Government	Indexed	Basic income
Account – high drawdown	Some Government support	Limited risk	Increased likelihood of running out
Account – low drawdown	Limited	Yes	Frugal; bequest is probable
Lifetime annuity	Protected	Guaranteed	Known; less flexibility; “low” return

Income risk = inflation and investment

A common concern



Is there an alternative? A better way?

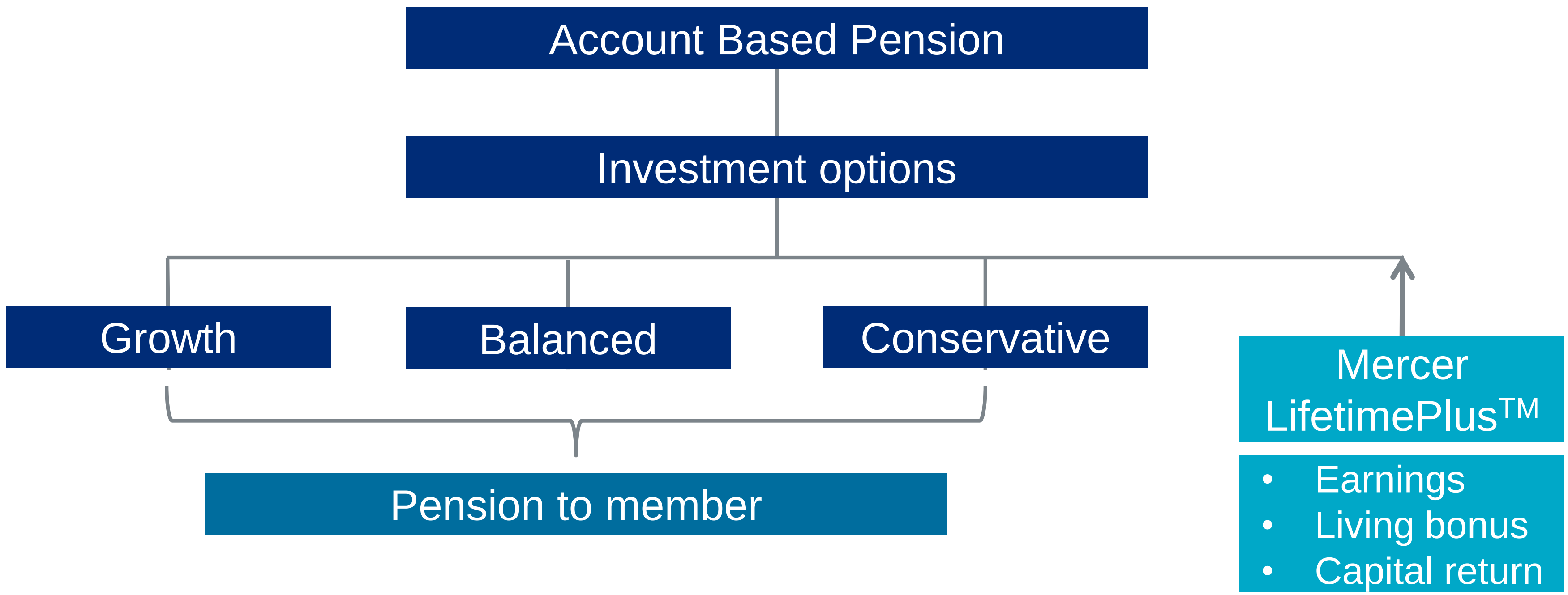
"Managing longevity risk through effective pooling could significantly increase private incomes for many Australians in retirement and provide retirees with the peace of mind that their income will endure throughout retirement."
– Financial System Inquiry, Nov 2014

"The GSA delivers more retirement income than the life annuity in expectation."
– Australian Government Actuary

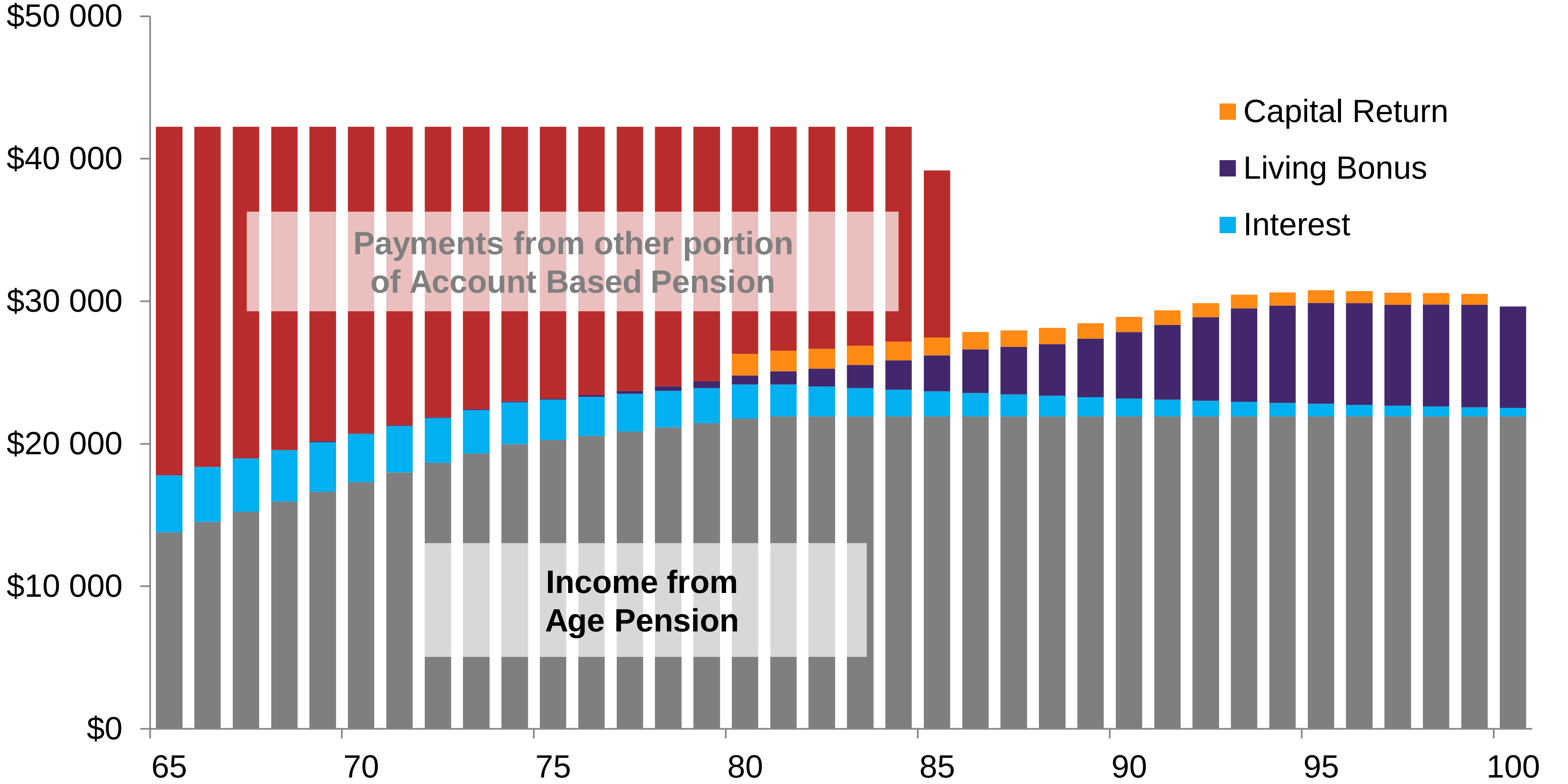
Pooling, a more efficient alternative to solving the longevity problem.

"Importantly, pooling longevity risk allows retirees to enjoy better living standards in retirement than they can enjoy with an account-based pension, but without any increase in the risk of outliving their savings."
– Australian Government Actuary

Mercer LifetimePlus – the first pooled longevity product



The impact of investing 25% into LifetimePlus



The components of Mercer LifetimePlus

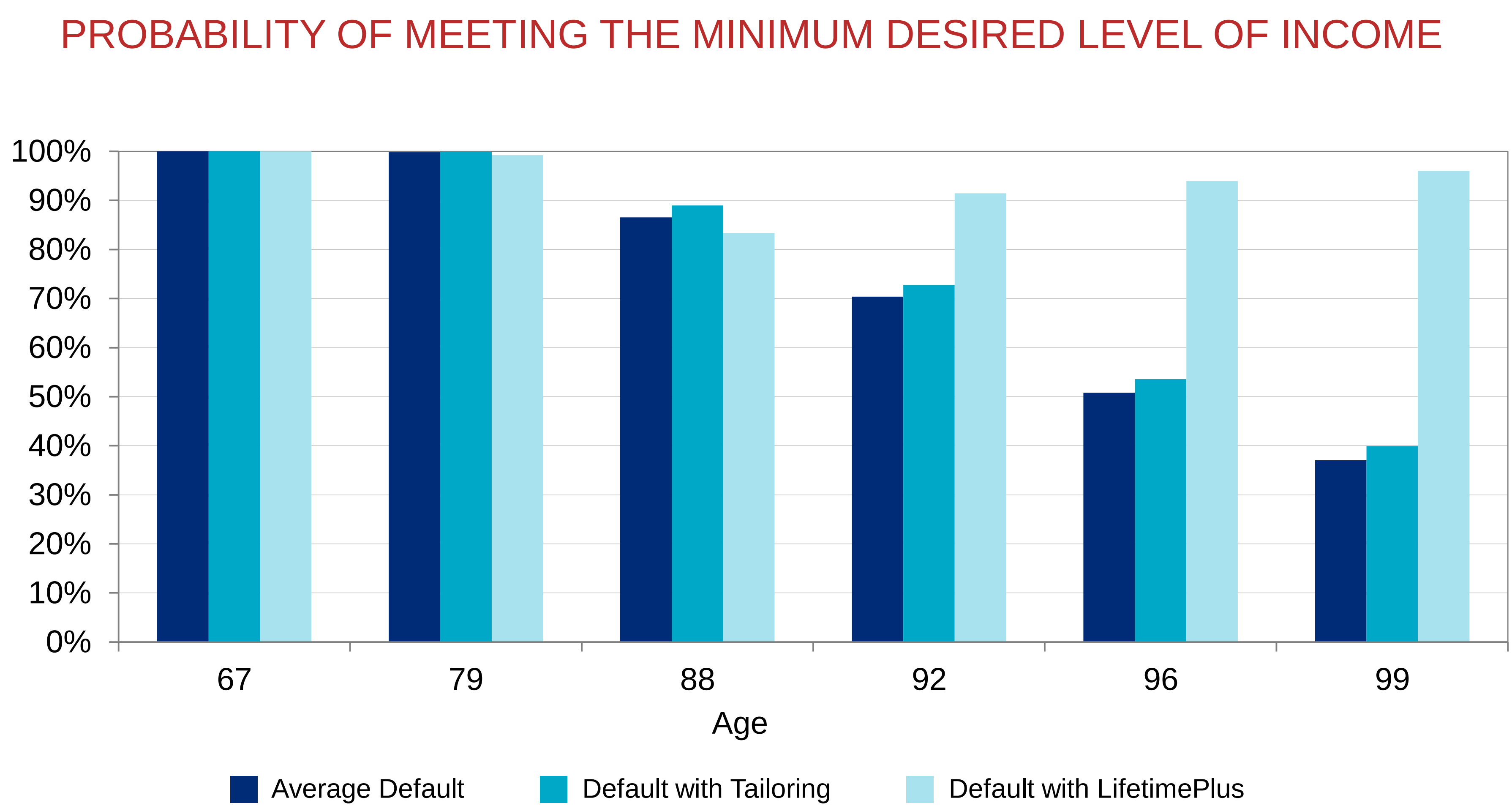
Three simple income streams that can provide retirees with an income for life.

Investment earnings
A defensive investment that targets Cash + 0.6% pa net of fees.

Capital return
Payments of 2.5% pa of your capital back to you after 15 years, for 20 years.

Living Bonus
Longevity risk pooling component

What about the outcome?



Source: Mercer

Protection against longevity risk

- Four options
  - The age pension: - supported by tax payers
  - Defined benefit pensions: - supported by employer
  - Self insurance: - supported by oneself
  - Longevity pooling:
    - Annuities from a life office - supported by capital
    - Group self annuities
      - a mutual product - supported by other retirees

Behavioural finance is important

- Individuals have greater sensitivity to losses than gains
- Individuals do not like losing control – especially DC members
- Retirees are concerned if they lose money to a big company
  – A pooling arrangement may be acceptable
- Framing is really important
  – Is a DC plan there to generate wealth or provide an income?
  – Is a longevity pool there for protection or as an investment?

Different solutions for different members

“Do it for me”

MyPension

“Help me do it”

Building Blocks

“Leave it to me”

Facilitate Choice

Some issues for Government policy and regulators

- What is the best approach?
  - Compel annuities (or other products)
  - A default product (or nudge) with an opt out option
  - A suggested product with an opt in
  - Total freedom with little guidance
- A carrot (eg tax incentives) or a stick?
- How much capital should be required?
  - Protection for investors (eg minimum return/capital protection)
  - Lifetime annuity needs considerable capital
- What is the role of financial advisers?
  - Should there be any limits or protections?

Clear and robust policies are needed

1. **Dignity** in retirement must be the overriding goal
2. We must have a **focus** on lifetime income; not estate planning
3. Support continued involvement in the **labour force**
4. Pension design, tax and any Government pension must be **coordinated**
5. We need to
   - Provide **adequate** benefits in retirement
   - Ensure long term **sustainability** of government costs
   - Ensure the whole system is perceived to be **fair**
   - Keep it **simple** for the member

MERCER