Retirement income insights

Trustees testing their Retirement Income stategies

You may think that account-based pensions are an optimal retirement strategy for member cohorts, however, also offering your members access to longevity protection (or mortality credits) is much more likely to produce optimal member outcomes.

Here's why

Retirees are faced with the challenge of extracting an income from their savings and the Age Pension that will last them a lifetime.

They're faced with uncertainty around how much retirement income they need and how long they'll need that income to last. They face risks including investment (market fluctuations), inflation and longevity (the risk of outliving their assets).

Most retirees, especially those working with a financial adviser, can estimate their income needs and implement strategies to manage market risk.

However, it's very difficult, if not impossible, for an individual to manage their mortality risk.

Why is mortality risk different?

- Reward in the form of additional returns is expected for taking market risk. No additional returns are paid for taking on longevity risk.
- There's a certain level of randomness to a member's own mortality, with a large range of outcomes possible. In other words, it's unlikely a member will live exactly to their life expectancy, and there's a considerable chance of living longer than expected. One in twelve 65-year-old women are expected to live ten years longer than their life expectancy.[1]
- Superannuation funds, product providers and advisers have devised numerous techniques for managing and reducing market risk. A retiree cannot reduce their exposure to longevity risk other than via longevity pooling – banding together with other retirees to share the risk of living longer.[2]

We know that many retirees have certainty of income high on their priority list. Because they don't know how long they'll live, they manage this uncertainty in an account-based pension by drawing down the minimum income in earlier retirement years. This is suboptimal, as it is a lower standard of living than they can actually afford.

Actuaries are used to working with problems like this, and have applied retiree 'pooling' approaches within superannuation systems over decades (centuries even!). These can dramatically boost 'living' payments compared with the constrained payments possible when support is limited to each retiree's own asset pool.

Actuarial research into the science behind longevity risk indicates that **nearly all members can optimise their retirement income levels by using some form of longevity pooling.**

This benefit applies to:

– members who don't reach their life expectancy

– members who have lower balances

– periods of lower interest rates.

The case study on the next page shows you how this works for Jenny, a typical 65-year-old single Australian female retiree with $330,000. Instead of having her retirement account all in an account-based pension, by deploying some ($50,000) to a longevity protection solution that kicks in at age 80, Jenny could receive on average an additional $570 a year between 65 and 87, and an additional $1,720 a year between 88 and 100.

[1] Australian Life Tables 2015-2017 (with no mortality improvements), shows for females aged 65 an 8% chance of surviving to age 98 (noting, life expectancy is 87).

[2] Where a life insurance company provides a guarantee, the cost of longevity pooling will generally be taken into account in determining the payments. This cost is low because insurers pool many lives together which reduces the level of variability for the total portfolio. Therefore this cost is small relative to the shift in the profile of payments that occurs at an individual member level.

You notice we haven't mentioned annuities so far. Sure, annuities are an effective way of doing this, and may also have favourable social security treatment. We're also seeing innovative new solutions coming onto the market which will allow a range of ways for super fund members to band together and face longevity risk as a group, creating optimal outcomes and thus realising the true benefit of superannuation.

KPMG's 60-strong actuarial team have developed a comprehensive methodology to assess the various retirement income strategies or products available in the market, compare them to your current or planned retirement strategies, and demonstrate the optimal outcome for your cohort(s) of members, under a range of conditions.

KPMG's member outcomes calculator analyses currently available retirement income products/strategies for each cohort of members based on the latest views of future longevity, investment market returns (e.g. expected returns, variability and correlations between asset classes) – as well as applicable social security and tax rules.

This evidence-based approach to selecting products/strategies for member cohorts is also important when funds start to think about guiding members, for example, demonstrating the optimal strategy based on their preferences and circumstances.

Jenny is a healthy retiree, single, aged 65, and owns her own home. She has $330,000 (the typical account balance for 65-year-old women in Australia based on the ATO data on average superannuation balances, at June 2019).

Jenny's preference is to have access to capital in the earlier years of retirement to pursue an active lifestyle (including travel and active sports), but she knows from watching her parents that after age 80 she will want a simple arrangement that gives her certainty. Jenny prefers not to take on market risk later in retirement, and has no strong desire for a bequest.

In the early years, Jenny benefits from the Age Pension rules, as having a longevity solution (such as a deferred lifetime annuity that complies with the social security rules) allows her to access a higher Age Pension.

In addition, through the use of pooling, the longevity solution enhances the living income compared to the account-based pension with the same investment mix. This is because longevity pooling involves re-spreading the death benefit otherwise payable under the account-based pension to living benefits to those members who live longer.

The longevity solution provides more certainty in income past age 80, which in this case is greater than what could be achieved with an account-based pension.

A more detailed view of the two scenarios, using real-world economic projections, and the median outcomes, are presented in the following figures.

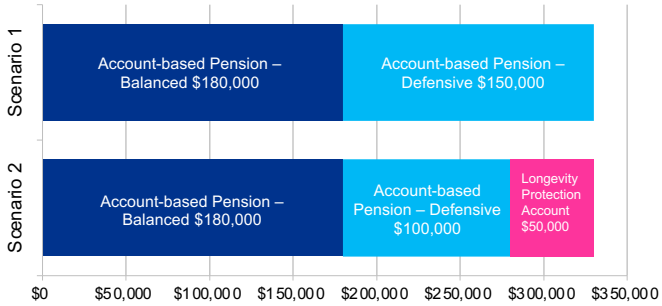
Under scenario 1:

- In the early years, Jenny can expect to draw down an average income of just above $40,000 until age 80, which is greater than the ASFA modest income (which ASFA describes as the amount required for the basics).
- In the later years, Jenny draws down from the account-based pension account with the defensive investment mix, her income eventually falls below the ASFA modest income level.

Under scenario 2:

- Jenny can expect to draw down on average $500 p.a. more than in scenario 1 until age 80. Jenny benefits from the Age Pension rules by deploying some of her retirement account to a longevity protection solution.
- In the later years, the longevity protection account helps keep her income above the ASFA modest income level. Compared to scenario 1, Jenny can receive on average an additional $1,720 a year between age 88 to 100.

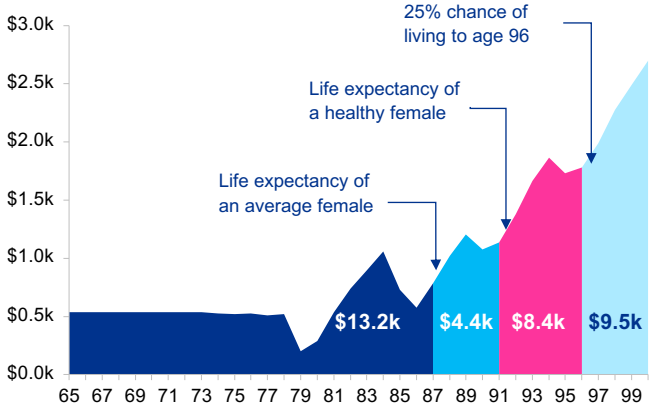
Jenny's case study scenarios



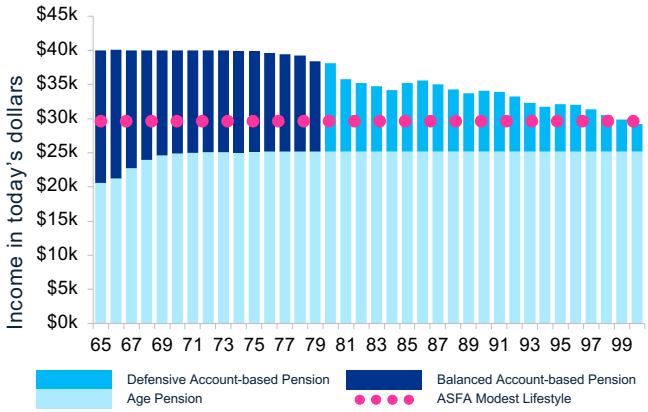
*For illustrative purposes we've used a simple longevity protection solution purchased at 65 which offers a stable income of $4.1k from age 80 onwards (i.e. a deferred annuity – rates available in market at January 2022). Longevity protection solution products (such as a deferred lifetime annuity) that comply with the social security rules receive a reduced assessable value under the social security assets test.

Additional income received

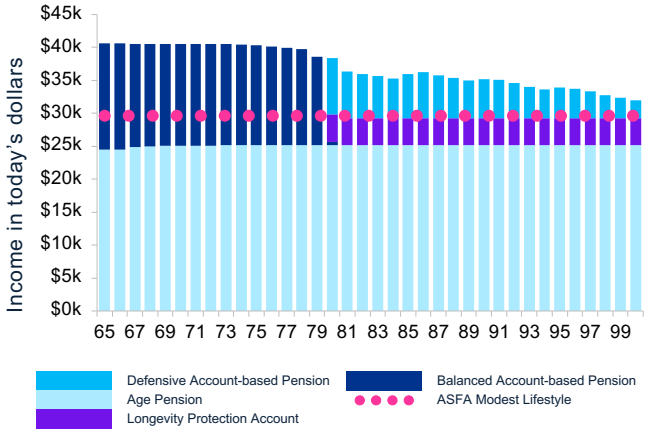
(income is discounted to today's dollars)



Retirement income projection – scenario 1



Retirement income projection – scenario 2



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May, 2023. | 107316521FS.