Portfolio Construction Forum

Will longevity products now become attractive?

David Knox | Mercer | 30 May 2018

The 2018-19 federal budget announced new means tests for pooled lifetime income products to apply from 1 July 2019. These new rules, together with development of Comprehensive Income Products for Retirement (or CIPRs) to be offered by superannuation funds, have the potential to radically alter Australians' views about retirement income products.

But what do these pooled lifetime income (or longevity) products really look like?

In broad terms, there are four types of products, as described below. For the purposes of this paper, we have assumed that each product would be purchased via a single investment from the individual's retirement benefit. However, it is also feasible they could be purchased by a series of payments over several years.

1. An immediate lifetime annuity

This is an annuity purchased from a life insurance company, which guarantees to pay the investor a fixed or indexed amount every year (or more frequently, as desired) as long as the individual remains alive. The payments commence immediately. The payments could be considered to provide a base level of income for each year in retirement.

2. A deferred lifetime annuity

This is similar to an immediate annuity except that the first payment is deferred for a period, e.g. until age 85. It is designed to provide income protection for the later years of life which may allow retirees to spend their other retirement benefits more quickly, knowing that additional income will be available from the specified age.

3. A group self-annuity

This is a new style of product which is likely to be offered by superannuation funds and other providers. In essence, investors who die leave behind part or all of their remaining investment to be shared between the surviving investors. That is, the outcome depends on the actual experience of the pool. There are no guarantees and, as such, no need for shareholders (or any capital backing) which could lead to better returns to the investors.

4. Variable annuities

These products are popular in the US and can be considered to be similar to an account-based pension but with certain guarantees attached. For example, the value of the capital could be guaranteed by the provider, even if the market falls. Of course, any guarantee is likely to lead to additional costs to the investor.

Although these four examples are all designed to provide income for as long as the retiree lives, the benefit provided will vary depend on the actual product design and any guarantee provided. As always, there is a trade-off for the individual between costs and potential benefits. Simply put, a stronger guarantee is likely to provide greater security but also lead to a higher cost for the investor.

The new means test rules will apply to all these products (otherwise known as pooled lifetime retirement income streams) purchased from 1 July 2019, provided they meet certain rules.

- For the assets test: 60% of the initial purchase price will be counted as assets until the member reaches age 84 (subject to a minimum period of five years); 30% of the initial purchase price will be counted as assets for the remainder of the person's life.
- For the income test: 60% of all product payments will be counted as income.

An example
Mary is single, aged 70 and has $400,000 in assets, excluding her home. She currently receives a part pension of $469 per fortnight. If she was to invest $100,000 into a complying longevity product under the new rules, her assessed asset amount would reduce to $360,000 and her age pension would increase immediately by $120 per fortnight to $589 per fortnight.

These new means testing rules will make investments in products providing longevity protection more attractive for retirees who are currently receiving a part age pension. They are also much simpler than the current rules for immediate lifetime annuities.

Of course, the final question is "What rules have to be followed for a longevity product to be complying and therefore provide the investor with the new means tests treatment?"

In short, the key requirements relate to the member's access to their capital (or initial investment) and are known as the capital access schedule. The maximum access to capital in these products is restricted in the following ways:

- Voluntary access: Reducing gradually from 100% of the initial investment on day 1 to 0% at the member's life expectancy (generally calculated on the day of investment for retirees);
- On the member's death: 100% of the initial investment is permitted for the first half of the member's life expectancy and then as for voluntary access.

The new means test rules and the development of CIPRs will lead to a new range of retirement income products in Australia, many of which are likely to contain a longevity component. It is imperative for practitioners to understand these new products and to recognise that the most appropriate product for a client will depend on a number of factors, including the individual's health as well as their attitude to risk.

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