OPTIMUM PENSIONS

HAS AUSTRALIA ‘OUTLIVED’ THE ACCOUNT BASED PENSION?

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Recent research from National Seniors Australia indicates that almost a quarter of seniors aged 75 to 79 have run out of savings. This proportion increases to almost a third for those aged over 80.

A typical household has two or three sources of income in retirement including: the Age Pension, income from superannuation and income from non-super investments. Running out of savings means living solely on the Age Pension which is $23,598 per annum for singles or $35,573 per annum for couples.

The Age Pension is significantly less than what the Association of Superannuation Funds of Australia (ASFA) deems a ‘modest’ standard of retirement. It covers basic living costs but includes no budget for things like home maintenance, household items, any creature comforts, health insurance, running a car or holidays.

BALANCING THE SCALES

For those wanting a lifestyle that’s higher than the Age Pension, a complex balance needs to be met between how much they spend now and preserving some assets for spending later in life. Retirement savings ideally should be managed with great care and vigilance.
If you spend too much early in retirement you risk running out later in life and becoming a potential burden on family and loved ones. But if you’re too frugal you may not get to enjoy the retirement you saved hard to secure. The balance needs to be ‘just right’.

The superannuation product typically used by retirees to manage the balance between spending and capital preservation is the Account Based Pension (ABP). With an ABP your superannuation remains invested in the investment option of your choice and you simply draw down on your account balance for income. The level of income you take is subject to a minimum percentage of your balance each year. The minimum is 4% of your balance for people up to age 65 and then steps up at key age bands to peak at 14% for those aged 95 or more.

ABPs, and their predecessor the 'allocated pension', were designed around 1992 - with the purpose of providing an income that broadly reflects a CPI linked lifetime pension up to age 80[1]. However, for many retirees their ABP has not and will not deliver anything like a CPI linked income for the whole of their lifetime.

THE MARKET RISK OF AN ACCOUNT BASED PENSION

As we saw in the GFC in 2008, investment returns over, and above inflation can be very uncertain.

Chart 1 shows the projected income (in today's purchasing power) from an ABP invested in a balanced portfolio using the recommended assumptions in ASIC's MoneySmart retirement calculator. This illustration assumes a rate of return of just 4.8% per annum, less fees of 1.1% per annum and a 3.2% allowance for cost of living increases throughout retirement.

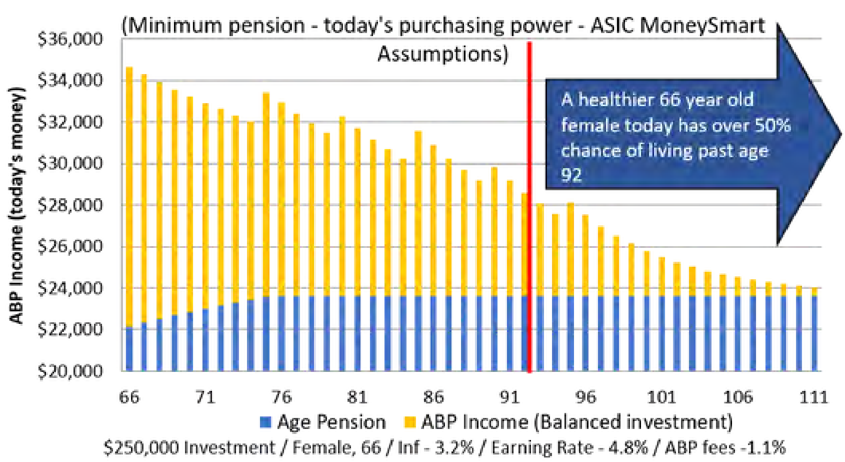
Presumably ASIC are being conservative to allow for the fact that ABPs carry considerable market risks.

If your actual investment returns are less than the amount you are required to draw, then you're actually spending your capital. Retirees need to use conservative assumptions in order to have any reasonable degree of confidence that their lifestyle will last for life and their savings won't run out prematurely.

The assumed starting balance for Chart 1 is $250,000 invested in a balanced portfolio at age 66. It assumes the standard minimum percentage is drawn as income each year.

You can see that by age 95, the spending power of the income from the ABP under this scenario has dropped to around one third of what it was at age 66. This is a far cry from the product's objective when it was designed in 1992 – to provide a CPI linked pension.

CHART 1: ABP INCOME



LONGEVITY RISK IS INCREASING

Longevity risk is increasing, and this is a problem. Particularly given that more and more retirees are living well into their 80's and 90's now.

The world has seen significant advances in medical research particularly over the past 50 years.

With each decade that passes, retirees find their life expectancies increasing further and further. Recent research has found that the cashflow projections used by financial advisers aren't always continued to the end of the Australian Life Tables. If they were then retirees would see how the real income from their ABP reduces at older ages. By not projecting this far into the future many members may be lulled into a false sense of security, particularly if their health status is better than average.

The ABS publish age data on all those who die each year. Looking at older Australians (aged 65 or more), half of those who died in 2016 were age 86 or more. The figure was higher for females with half being over age 88.

Two more decades will pass before those retiring today will reach their mid 80s. By then average life expectancy for a 66 year old is expected to have increased another 2 years2. Those whose health is better than average (i.e. not below average) should anticipate living well beyond these averages.

[1] http://dbpensionreview.treasury.gov.au/content/downloads/rppssf_final.pdf (page 24)

Research being conducted by the Actuaries Institute will show just how much longer healthy Australians are expected to live. These are the retirees without obvious medical problems which will otherwise shorten life expectancies. They live longer than average because the average includes the less healthy retirees.

As an indication, a healthier[1] 65 year old female today has a 50% chance of dying between age 92 and 110. Taking into account that most retired households have a female member, it's a fair question to ask – has Australia outlived the ABP?

MAKING SURE YOUR RETIREMENT INCOME LASTS FOR LIFE

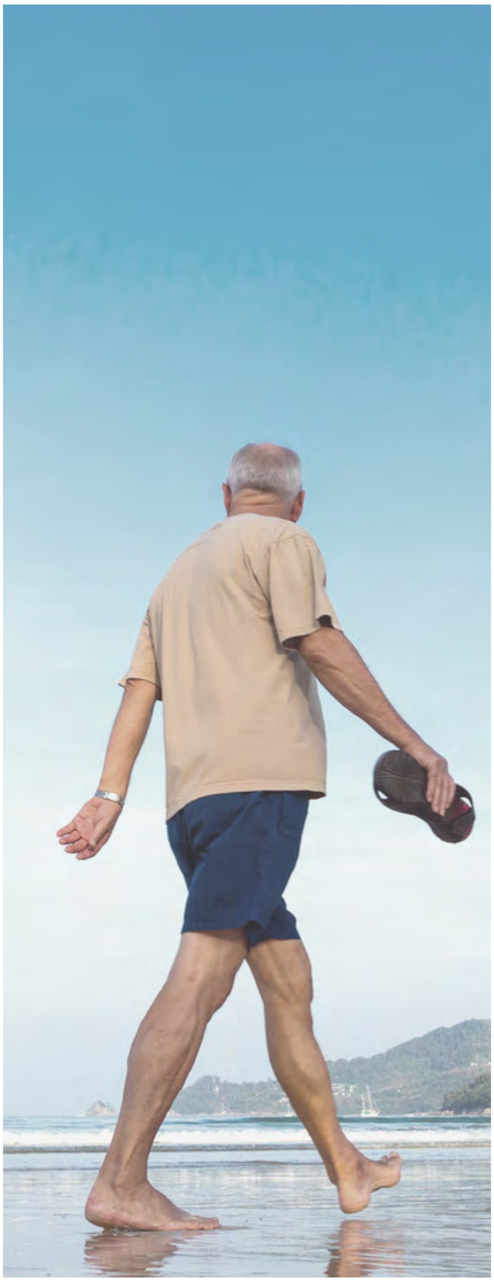
The 2015 Financial Systems Inquiry recommended legislative changes to allow and incentivise new types of retirement income products to solve this critically important problem for all current and future retirees. This legislation has now passed, and new products are coming onto the market that are designed to maximise retirement income while ensuring that income lasts for life – irrespective of how long the retiree lives. From 1 July 2019, these products will receive highly advantageous treatment under planned Centrelink means testing rules.

The options a retiree has for retirement income now include:

(1) The Account Based Pension (ABP) – as described above. As you can see the product carries significant risk including the risk of capital running low or savings running out.

(2) A Traditional Lifetime Annuity. For highly risk averse retirees, this product lets you use your super to purchase a guaranteed, fixed annuity income from an insurance company. For example, a $250,000 balance might secure a lifetime income of $13,500 per annum for a 65 year old with no spouse. In this scenario the income would increase each year with price inflation but there would be no lump sum benefit upon death. If a death benefit option is chosen, the annuity income would be lower.

(3) A Real Lifetime Pension. This is an investment linked lifetime income stream that's guaranteed to last for life but where the payment level is linked to the performance of the professionally-managed investment option you select. It suits retirees with more balanced risk preferences than options (1) or (2). The product allows you to benefit from an exposure to growth assets if you wish but with peace of mind that your income can't run out later in life. The longevity guarantee is provided by a global reinsurer. It means a 65 year old can confidently secure an income in retirement that, depending on how long they live, is 20% - 30% higher than the account-based pension minimum (with the same investment choice) – and without the worry of running out of savings if markets perform poorly or they live beyond their life expectancy.



For those impacted by Centrelink means testing, options (2) and (3) will also result in a higher Age Pension than option (1) from 1 July 2019.

So, for those retirees wanting a lifestyle that's higher than the Age Pension there is now a range of options available to deliver the level of financial security they need. This can help retirees proactively enjoy their retirement and remove the fear they only have the option of trying to exist on the available funds an ABP provides.

[2]Using ALT2010-12 with 25-year improvement factors and a 2-year age adjustment to allow for healthier life expectancy