Ontrack

by Kaplan Professional

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Part 1: Debunking annuity myths

Lifetime income streams are a vital component of the world's retirement system. They include lifetime annuities, lifetime pensions, government pensions (such as Australia's age pension), and any other products that pay income for exactly how long as the client (and their partner) lives: no less and no more.

When lifetime income streams are provided by governments or by an employer sponsored defined benefit plan, they tend to be very highly valued by the recipients. However, when they are presented as an option that people must decide on and buy with their own money, this enthusiasm can be replaced with resistance — potentially fuelled by several myths.

Part 1 discusses lifetime annuities and lifetime income streams and some examples of common myths.

Part 2 will delve further into additional myths. Both modules will assist advisers to apply an evidence-based approach when considering these products and provides tools to explain key concepts to their clients.

Learning outcomes

After completing this module, you should be able to:

- understand the answers to common myths in relation to lifetime annuities
- analyse new product features that can address previous shortcomings with annuities — and assist clients with a wider range of objectives and preferences
- identify how lifetime annuities can enable clients to generate higher and more sustainable retirement income in retirement.

Lifetime income streams and annuities

A lifetime income stream is a product that pays income for the rest of the client's life. Most people are familiar and comfortable with the age pension, which is also a lifetime income stream.
Unlike a typical investment or superannuation account, with a lifetime product, the client holds a contract that sets out what they will receive in the future. This allows for products that are a more specific match for certain objectives like retirement income—where the client does not know how long they will live.

Behavioural research consistently shows that when retirement options are properly explained, a significant proportion of mature Australians will choose to allocate some of their savings to the solution which pays income for life, even at the expense of a lower bequest or a reduced ability to withdraw a lump sum later in life (Altschwager & Evans 2020; Hiscox et al. 2017).

Some behavioural research resources:

Behavioural Economics Team of the Australian Government (BETA)—Supporting retirees in retirement income planning (page 7)
https://behaviouraleconomics.pmc.gov.au/sites/default/files/projects/supporting-retirees-in-retirement-income-planning.pdf

Melbourne Business School—Allocating retirement funds and annuity attribute preference findings
https://mbs.edu/-/media/PDF/Research/Orford-Initiative_Allocating-retirement-funds-and-annuity-attribute-preferences.pdf?rev=eb040ee1a8da46a3bc4195413df4a077

As such, it's not that Australians do not like lifetime income streams. The research indicates that many Australians do like the concept of 'salary continuation' as there is less worry about running out of money (Altschwager & Evans 2020; Hiscox et al. 2017).

So why are lifetime annuity sales not a higher percentage of all retirement savings?

One challenge is that it can be hard to assess whether a lifetime product is good value compared to other retirement products. An assessment requires forward-looking assumptions about things such as

(1) how long the client could potentially live

(2) what investment returns could be

(3) future inflation

(4) what the client's needs will be over the rest of their lives.

Important: Law changes were made in 2017 to address several issues with traditional annuities and allow a wider range of products to be designed. This has accelerated the emergence of a new category of lifetime annuity that can offer more income, more choice and more flexibility as part of retirees' overall portfolios.

What is an annuity? (Quick reminder)
An annuity is a contract between a client and an insurance company. The client invests a lump sum and in return receives regular payments over an agreed period. There are lots of design features to consider.

The agreed period can either be a fixed term (a 'term annuity') or for the entire life of the client (called a 'lifetime annuity' or 'life annuity'). In this module, the focus will be lifetime income products, which includes lifetime annuities and lifetime products being developed by super funds to sit alongside existing account-based pensions (ABPs).

Regulatory changes have expanded the range of features a lifetime income stream can have. *Superannuation Industry (Supervision) Regulations 1994* (SIS Regulations) 1.06A refers to "innovative superannuation income streams". The new rules enable annuities to be 'unbundled' and allow clients to enjoy longevity protection without having to lock into long-term fixed investment guarantees.

Super funds can even create lifetime pensions without an insurer (e.g. group self-annuitisation schemes), but APRA would require an insurer, if guarantees are involved.

Lifetime annuity: An example

Client: 70-year-old single male

Purchase price: $200,000

Increase rate options to choose from:

a) Fixed income for life.

b) Income that increases by a fixed percentage each year.

c) Income that increases with CPI.

d) Income that moves in relation to investment performance (e.g. of the client's chosen investment option).

Death benefit: The product pays a (reducing) lump sum death benefit if the client dies before average life expectancy.

Withdrawal benefit: A withdrawal benefit is available. This reduces over time as income payments are made.

If the client has a **cautious risk profile** for his $200,000 investment, he might choose a product where the **increase rate is fixed or linked to CPI** (options (a) to (c))**.** His starting rate of income might, for example, be $11,500 p.a. for a CPI-linked annuity (Challenger 2024). This is higher than the age-based minimum from an ABP. His annuity income is guaranteed to keep pace with inflation or CPI for his entire life — even if he lives to age 100 or more. There are no fees or charges deducted directly from his annuity, but the insurance company's costs and profits are in-built into the starting level of income quoted.

If the client has a **balanced risk profile** for his $200,000, he may choose a product where the **increase rate depends on the underlying investment performance** (option (d)). This can provide higher expected retirement income than the other options, but the payment level moves up and down depending on the investment performance of the investment options chosen. These products offer a mechanism where the client can choose to reduce their future increase rate by between 1% p.a. and 6% p.a. in return for having a higher starting payment. Their income then increases by the rate of investment return earned, less asset fees and the rate reduction chosen. The higher the rate reduction chosen, the higher the starting payment level, and the lower the future increases will be. This feature is helpful for retirees who prefer higher income at the start of retirement (when they are likely to be able to enjoy life more) in return for less income later in life.

The earlier examples will be used throughout this module to test several myths.

Myth one

Myth one: If one buys a lifetime annuity and then dies soon, they lose their money

In 2024, all lifetime income streams offer a death benefit, but it is important to check. The rules for each product differ and are subject to a maximum as set out in the capital access schedule (CAS) within the SIS Regulations (Austlii 1994).

The following example in Table 1 is based on a 70-year-old male buying a lifetime income product that pays the CAS maximum on death.

Column A shows the lump sum death benefit that would be paid at each age based on the maximum rules. It is important to remember that not all products pay the maximum, so checking this is an important part of any advice to clients.

Column B shows the cumulative income received up until each birthday. This is based on a CPI-linked annuity design. The last column shows the total he would have received from the product if he died at each age. This includes the total income payments made plus the lump sum death benefit. From the table, it is clear that the client nearly always gets more than his investment back on death.

Table 1: Example is based on a 70-year-old male buying a lifetime income product

Age at start of year	CAS maximum lump sum paid on death (in dollars $) (A)	Cumulative income received (2.5% CPI) (in dollars $) (B)	Total received up to death (based on CAS maximum) (in dollars $) = (A) + (B)
70	200,000	-	200,000
71	200,000	11,500	211,500
72	200,000	23,288	223,288
73	200,000	35,370	235,370
74	200,000	47,754	247,754
75	200,000	60,448	260,448
76	200,000	73,459	273,459
77	200,000	86,795	286,795
78	99,371	100,465	199,836
79	86,792	114,477	201,269
80	74,214	128,839	203,053
81	61,635	143,560	205,195
82	49,057	158,649	207,705
83	36,478	174,115	210,593
84	23,899	189,968	213,867
85	11,321	206,217	217,538
86	Nil	222,873	222,873
87	Nil	239,944	239,944
88	Nil	257,443	257,443
89	Nil	275,379	275,379
90	Nil	293,764	293,764

Source: Orford and Hennington 2024.

Assumptions:

- The annuity is assumed to be a CPI-linked annuity and assumes CPI increases at 2.5% per annum
- On death, the benefit paid is based on the CAS maximum.

The way the CAS maximum is calculated is as follows:

- On death prior to the person reaching half their (statutory) life expectancy, the maximum death benefit is 100% of the purchase price.
- On death at half their life expectancy the maximum drops to 50%. It then reduces on a straight-line basis until life expectancy, at which point the maximum death benefit is zero.

For a 70-year-old male, their statutory life expectancy for the purposes of this calculation is 15.9 years (DSS 2024). By 'statutory', it means the figures set out in the legislation. Statutory life expectancy is significantly lower than actual life expectancy as it does not allow for improvement trends that actuaries and insurers take into account.

At all ages the total paid to the client is expected to be more than their initial investment of $200,000 with one exception. If the client died at age 78, they received 0.5% less than they put in ($1,037 less than $200,000).

Therefore, this myth is not valid. Even on death, in this example, the client has not 'lost' their money — it has been paid back to them as income and/or a lump sum death benefit. Different rules apply to different products though. For example, with an investment-linked product, the death benefit may depend on what investment performance has been. Projections should be carried out to ensure the outcomes meet the clients' needs and objectives.

For couples

Where a couple buys a lifetime income product, it is common to choose a reversionary benefit for the spouse. This means if the primary client dies, payments continue to the surviving spouse, potentially at a lower rate. If both spouses pass away before life expectancy, then a lump sum may be payable to protect the amount invested.

Myth two

Myth two: Annuities pay poor rates of income

When considering this myth, it is important to consider what is meant by a 'poor' rate of income. Is it 3% ... 6% ... 9%? What is even meant by the term 'rate of income' when it comes to different retirement products?

In Australia's retirement conversation, there can often be confusion around the terms "retirement income", "investment income" and "retirement spending" and how each one is framed (Hennington & Boal 2022).

'Investment income' is a term used by the Australian Taxation Office (ATO) to include interest, dividends, rent and income received from trusts. Capital gains are treated separately and are not taxed until they are realised and the income is effectively distributed. All these amounts could be regarded as investment earnings or investment return.

'Retirement income' is framed in a range of ways. For assets outside super, it is likely to include the investment income that ends up in a person's bank account and can be spent (or reinvested). For super assets, retirees are likely to consider it as the amount drawn down out of their super fund and paid into their bank account to spend. This is likely to be a blend of investment income and balance withdrawal. For an ABP, it is subject to the following age-based minimum withdrawal rates, as shown in Table 2 (Hennington & Boal 2022).

Table 2: Minimum percentage drawdown by age for 2023/2024 onwards

Age	Minimum withdrawal (income) % of the ABP balance at the start of each financial year
Under 65	4%
65–74	5%
75–79	6%
80–84	7%

85–89	9%
90–94	11%
95 or more	14%

Source: ATO 2024.

All retirement products (whether an ABP, annuity or other lifetime income product) exchange the client's investment for retirement income plus any ancillary benefits. If the objective is to maximise retirement income, then it involves returning all the client's super 'capital' plus investment earnings safely over the course of retirement (i.e. it involves receiving (and being able to spend) more than just the investment income).

Rates of income

With lifetime income products, the rate of starting income is set by the provider and is a function of the client's life expectancy, the assumed investment returns on the underlying assets, expenses, cost of servicing any shareholder's capital invested in reserves, and the cost of providing guarantees.

Clients who have a **low risk profile** for investment and income risk may consider a guaranteed lifetime annuity. The insurer then guarantees the income (which might increase with CPI) for their lifetime. Here the level of starting income tends to take into account interest rates at the time of purchase. With interest rates at historic lows between 2013 and 2021, this has impacted the income levels from these types of annuities. More recently, as interest rates have increased, an increase in the levels of income offered to clients has been seen. The starting rate of income for the 70-year-old male example is 5.7% of the purchase price for the CPI-linked annuity.

For clients with a **more balanced or higher risk profile** for investment, a new category of lifetime income products has emerged. These can offer higher income and a wide choice of underlying investments — but they pass on some or usually all the investment risk (gain or loss) to the client. With these products, the underlying investment performance on the assets supporting the lifetime income stream can be the same as for an ABP. What matters is how the combination of capital and investment returns get turned into retirement income. Some products let financial advisers design portfolios (from available investment options) to meet the objectives of each client in light of their risk profile for investments, income and lifespan uncertainty.

Australia's Financial System Inquiry (Treasury 2014) and the Retirement Income Review (Treasury 2020) each noted that combining an ABP with a suitable lifetime income stream can enable Australians to increase their retirement income by around 15 to 30% compared to an ABP that is drawn cautiously (e.g. using the earlier minimums to avoid running down and perhaps running out of income). The figure of 15 to 30% higher **excludes** age pension uplifts that may be earned by purchasing a lifetime income product.

As such, this myth is invalid. The investment returns from a lifetime income stream can be the same as the returns on other assets. What matters is how the client's savings get turned into retirement income in a way that aligns with the client's investment, income and longevity risk preferences — such as ensuring income lasts for life and the impact of fees (whether obvious or not). Age pension uplifts can increase the attractiveness of a lifetime product further.

Myth three

Myth three: One is locked in for life and cannot withdraw any money or make changes

In 2024, most lifetime income stream providers offer a withdrawal benefit to clients. For example, if the client's circumstances change, they may have an unforeseen need to get part of their investment back. Penalties for making a withdrawal may apply (depending on the provider's rules) and the CAS rules in the SIS Regulations must be considered. People who expect to die in the short term would no doubt like to withdraw as much as possible.

The following example is based on a 70-year-old male buying a lifetime income that pays the CAS maximum withdrawal benefit.

Column A in Table 3 shows the lump sum that could be withdrawn at each age based on the CAS maximum. It is important to remember that not all products pay the maximum, so checking this is an important part of any advice given.

Column B shows the cumulative income received up until each birthday. This is based on a CPI-linked annuity design and assumes CPI increases at 2.5% p.a. The last column shows the total benefits the client would have received from the product if he withdrew the maximum at each age. This includes total income payments plus the lump sum withdrawal benefit. In this example, the total paid is always close to or well above his investment amount.

The rules for each product differ and should be checked carefully.

Table 3: Example by age of withdrawal amount plus total income payments

Exact age	Withdrawal Amount (CAS maximum) (in dollars $) (A)	Total income payments up till that age (assuming 2.5% CPI increases) (in dollars $) (B)	(A) + (B) (ignoring any penalties/adjustments) (in dollars $)
70	200,000	-	200,000
71	187,421	11,500	198,921
72	174,843	23,288	198,130
73	162,264	35,370	197,634
74	149,686	47,754	197,439
75	137,107	60,448	197,555
76	124,528	73,459	197,987
77	111,950	86,795	198,745
78	99,371	100,465	199,836
79	86,792	114,477	201,269
80	74,214	128,839	203,053
81	61,635	143,560	205,195
82	49,057	158,649	207,705
83	36,478	174,115	210,593
84	23,899	189,968	213,867
85	11,321	206,217	217,538
86	Nil *	222,873	222,873
87	Nil	239,944	239,944
88	Nil	257,443	257,443
89	Nil	275,379	275,379
90	Nil	293,764	293,764

*(Note, his total income received by this age is over $200,000)

Assumptions:

- The annuity is assumed to be a CPI-linked annuity and assumes CPI increases at 2.5% p.a.
- On death, the benefit paid is based on the CAS maximum.

The way the CAS maximum withdrawal benefit is calculated is as follows:

- At purchase, the maximum withdrawal value is 100% of the investment value.
- This decreases on a straight-line basis to (statutory) life expectancy (i.e. at halfway to life expectancy, the maximum withdrawal value is half (50%) of the initial investment value, and at life expectancy, the maximum is zero).
- Where the request for a withdrawal occurs soon after purchase, a cooling-off period might apply.

As a result, this myth is only partly valid. For clients who have an unforeseen need to get their investment back, most lifetime products offer a withdrawal benefit. The maximum amount of withdrawal benefit reduces with age and the product rules may apply a penalty. In considering this, it is important to keep in mind that the purpose of a lifetime income product is to convert some of a client's assets into a retirement wage to fund their ongoing spending needs for life. It is a way to safely spend, rather than preserve that money.

In the projection earlier, the withdrawal benefit plus total income paid meant the client always got close to or well above their initial investment back at each age. This is based on a product that pays the CAS maximum withdrawal amount. Different rules apply to different products though and advisers should ensure the outcomes meet the clients' needs and objectives.

Conclusion

In the past, it was common for advisers to dismiss lifetime annuities as a solution for retirees—as they believed they were not financially attractive. In part, this may have been due to several myths that are now false or do not apply to all lifetime products.

Advisers understand the need to robustly assess these myths in light of market developments. This module provided some sound analysis and facts that can be drawn on when doing so.

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Legislation

Superannuation Industry (Supervision) Regulations 1994 (Cth) – Reg 1.06B <https://classic.austlii.edu.au/au/legis/cth/consol_reg/sir1994582/s1.06b.html>