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Part 2: 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.

This series is a two-part module designed to equip advisers with the knowledge to make informed annuity decisions, debunking common myths. Part 2 builds on the examples from Part 1, focusing on debunking additional myths that advisers may come across. 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
- identify what is required to properly assess whether these myths are valid
- analyse new product features that can address previous shortcomings with annuities and assist clients with a wider range of objectives and preferences

Myth four and five

Myth four: One would have to live an extremely long time to make it worth while

When it comes to financial planning, it is important to remember nobody knows how long they will live. A particular client could die this week (e.g. be 'hit by a bus') and another could live until the end of the Australian life tables (age 109) or more. Individual lifespans are subject to randomness (Australian Government Actuary 2019).

Table 1 shows what would happen if an advice firm had 1,000, 70-year-old males as clients. The second column is a projection in line with the Australian life tables showing how many of these clients are expected to remain alive at each future age. It uses the 2015–17 tables with the '25-year' improvement rates (Australian Government Actuary 2019). The latter allow for the fact that mortality rates are expected to continue to reduce (i.e. life expectations increase, due to several factors including medical advances). This approach is called 'cohort' life expectation and is important to always use in financial advice — as the results may be closer to the future reality than a continuation of the past.

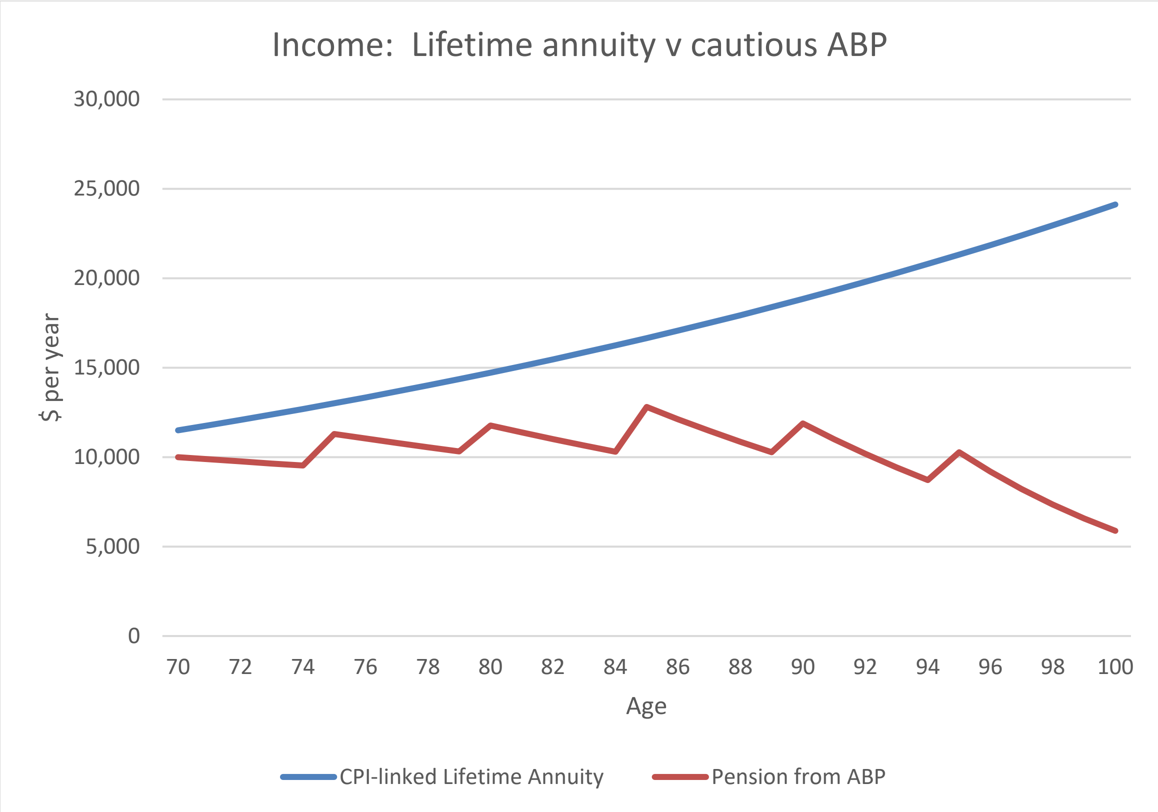
Table 1: Example if an advice firm had 1,000, 70-year-old male clients

Exact age	1000 clients: How many are still alive?
70	1000
71	988
72	975
73	961
74	946
75	930
76	913
77	894
78	874
79	853
80	829
81	804
82	776
83	745
84	711
85	674
86	634
87	590
88	542
89	493
90	441
91	389
92	337
93	288
94	242
95	200
96	162
97	129
98	100
99	75
100	55

The following example compares what would happen if all these clients purchased a CPI-linked annuity at age 70, versus using an account-based pension (ABP). This example assumes they are all conservative investors and for the ABP, draw the minimum income to avoid running down and possibly running out of income at advanced ages. It assumes the ABP is invested conservatively and earns 4% p.a. returns, net of all fees and charges.

Figure 1 compares the annual income payments from this annuity with the pension that would be paid from the conservatively managed ABP. The result is that at all ages, the lifetime annuity pays more than the ABP income.

Figure 1: Annual income payments versus ABP



Note: Balanced investors may consider using new investment-linked lifetime products as an alternative to a guaranteed CPI-linked product or conservative ABP.

Columns three and four in Table 2 shows the projected total payments received by clients who died at that age. The figures include the total income payments received up until death plus the lump sum benefit on death which, for the ABP, is the remaining balance at the time. The annuity used for this example is the same as used previously (a CPI-linked lifetime annuity as per Table 1 from Ontrack module 'Part 1: Debunking annuity myths'). It assumes the capital access schedule (CAS) maximum is paid on death.

The figures in Table 2 show that different clients get a different result from each product depending on how long they live. The overall present value of each product at the time of purchase (gross of fees and margins) is the same, they just distribute benefits to clients in different ways.

For a client who dies at age 75, the total amount paid from the annuity (including income payments plus death benefit) came to $260,448. Whereas the total amount paid from the ABP (including income payments plus balance on death) came to $237,099.

For a client who dies at age 85, the total amount paid from the annuity (income payments plus death benefit) came to $217,538. Whereas the total amount paid from the ABP (income payments plus balance on death) came to $300,231.

For a client who dies at age 95, the total amount paid from the annuity (income payments plus death benefit) came to $392,814. Whereas the total amount paid from the ABP (income payments plus balance on death) came to $340,072.

The shading, on Table 2, indicates which product delivered a higher result for those who died at that age.

Note that it is impossible to predict exactly how long a healthy retiree will live. There is an 8-year standard deviation around life expectancy for a new retiree (Hennington and Young 2020).

Table 2: Example projected total payments received by clients

Exact age	1000 clients: How many die that year?	TOTAL RECEIVED ON DEATH (total income paid + death benefit)	
		Lifetime annuity (assuming 2.5% CPI) (in dollars $)	**ABP** (conservatively managed — 4% return net of fees) (in dollars $)
70	12	200,000	200,000
71	13	211,500	207,600
72	14	223,288	215,109
73	15	235,370	222,527
74	16	247,754	229,857
75	17	260,448	237,099
76	18	273,459	244,178
77	20	286,795	251,099
78	22	199,836	257,865
79	23	201,269	264,480
80	26	203,053	270,946
81	28	205,195	277,200
82	31	207,705	283,249
83	34	210,593	289,099
84	37	213,867	294,758
85	41	217,538	300,231
86	44	222,873	305,411
87	47	239,944	310,313
88	50	257,443	314,952
89	52	275,379	319,343
90	52	293,764	323,498
91	51	312,608	327,344
92	49	331,923	330,904
93	46	351,721	334,199
94	42	372,014	337,249
95	38	392,814	340,072
96	33	414,135	342,597

97	29	435,988	344,855
98	25	458,388	346,875
99	20	481,347	348,682
100	12	504,881	350,298

Assumptions:

- Lifetime annuity: CPI-linked with a starting income of $11,500 p.a. The lump sum death benefit is based on the CAS maximums as per Table 1 from Ontrack module 'Part 1: Debunking annuity myths'.
- ABP: Conservative invested (4% return net of all fees and charges) and taking the age-based minimum withdrawals. On death, the remaining balance is paid as a death benefit.

There is projected to be 126 clients who die before age 78. For these clients, the lifetime product paid more in total benefits than the ABP.

There is projected to be 537 clients who die between age 78 and 92. For these clients, the ABP paid more in total benefits than the lifetime product.

There is projected to be 337 clients who live past age 92. For these clients, the lifetime product paid more in total benefits than the ABP, often significantly more. Living longer pays off.

As such, this myth is invalid. Almost half (463) of the 1,000 clients received a better outcome from the lifetime product than the ABP. This is far more than just people who live an extremely long time.

Statistics indicate that people who bought lifetime products in the past generally live longer than the average population. Often this is because they were in good health when they chose to purchase the product. Clients in poor health, who anticipate lower than average life expectancy, might be better served with an ABP (Actuaries Institute 2018).

Given improvements in medical treatment and lifestyles in Australia over past decades, living beyond age 92 is no longer extreme. Advisers are aware that wealthy clients tend to live longer than the general population and couples get two chances of living to advanced ages and need their money to be able to last longer, as demonstrated in Table 1.

The analysis in Table 2 is for conservative investors. For clients with a more balanced investment risk profile, similar analysis can be carried out using the new lifetime income streams that pass on investment performance to the client. There are at least five such lifetime products/funds now and this number is expected to increase significantly as superannuation funds offer options and product mixes that meet a wider range of retiree needs. This creates good opportunities for financial advisers to add value.

Myth five: Kids lose out if one buys an annuity whereas an ABP lets them inherit what is left.
Reviewing the example of Table 2 through the eyes of the children, the lifetime annuity paid higher total benefits than the ABP in many cases. This may make their overall family better off.

For the 126 clients who died between ages 70 and 78, the lifetime annuity paid a higher lump sum death benefit than the ABP. As such, the children of these clients were better off from the annuity.

For the 537 clients who died between ages 78 and 92, the lifetime annuity paid a lower lump sum than the ABP. In this case, the children did 'lose out' from the annuity death benefit being lower, but their parents had more retirement income in every year of retirement.

For the 337 clients who lived beyond age 92, the lifetime annuity did not pay any lump sum, but it did pay much higher total income, which may mean fewer other assets were consumed to support the parents' cost of living. It is possible that having the annuity income protected the inheritance of those children. For example, the 200 clients who live past age 95 are projected to receive at least $100,000 more income from the annuity than the ABP. To this extent, they may have drawn down less on other assets, thus leaving more for their estate.

As such, this myth is invalid for many, if not most, clients. Modern lifetime annuities pay death benefits, whereas traditional lifetime annuities did not always do so. The actual outcome on death for a client depends on how long they lived.

For clients who live a long time, the annuity covers more of their total spending needs, thus protects other assets from drawdown if they live longer than average.

In any event, some children wish their parents to have as high an income as possible to enjoy their years of life remaining. The children may well have many years remaining to earn income before their own retirement.

Myth six and seven

Myth six: Good investment performance can easily beat an annuity

Any discussion about lifetime annuities now needs to consider the full range of products available and the client's retirement risk profile.

- For clients with a very cautious risk profile, traditional annuities may be the focus of this comparison. In this case, a conservative investment inside or outside of super cannot always outperform an annuity as per the Table 2 example in the earlier lesson.
- For clients with a balanced investment risk profile, a portfolio with some exposure to growth assets may be the focus. In this case, new style lifetime income streams that pass on the investment performance to the client need to be considered. An investment portfolio inside or outside super may struggle to outperform this type of annuity as annuities benefit from 'mortality credits' from inception, which are added to the investment returns on the annuity.

With an investment-linked annuity, the client benefits from the investment performance plus what is called mortality credits, which adds an extra source of return.

What are mortality credits?

Put simply, mortality credits come from other retirees who do not 'claim' on their longevity protection. In the context of lifetime income streams, a claim means to live a long time—the converse of life insurance before retirement.

Clients who purchase lifetime income streams effectively enter a social contract with each other, as follows:

- Clients who live to life expectancy accept that they forfeit any lump sum death benefit from that point on. And in return …
- Clients who live past life expectancy continue to receive income for as long as they live.

Clients of lifetime income streams accept this 'deal' because nobody knows how long they will live but they are all worried about longevity risk. Some Australians live to the end of the life tables (age 109) and some will die within a year. The earlier social contract allows every client to have the confidence to spend their super and know that their income will continue for life, even if they live to age 100 or beyond. Research indicates that clients in receipt of regular income are happier and spend up to twice as much as those clients who do not have longevity protection and might invest their assets themselves, even with advice.

Mortality credits are the residual assets that were being held to support the expected future incomes of retirees who pass away. Once they die, those assets are no longer needed by that client and may be used to boost the assets (and investment returns) held to support the income of retirees who survive.

As such, this myth is false. An investment-linked annuity can easily outperform an ABP if the client's objective for that money is to maximise retirement income and have it last for life — as opposed to being left as an inheritance.

It is impossible for advisers to predict or inform clients exactly what their lifespan will be. Tools like the Optimum Pensions Lifespan Calculator help to set a timeframe which gives a high level of confidence, but they are not a prediction per se: <https://optimumpensions.com.au/lifespan-calculator/>.

Myth seven: One does not have any control over how their money is invested

With traditional guaranteed annuities, the insurer makes all the investment decisions in the background. This is similar to products like bank accounts and term deposits where the investor gets a known return, but the bank manages everything else, as its obligation is capital preservation plus a reasonable interest rate.

However, several new lifetime income products let the client have investment choice. There may be a choice of several investment options or a full menu of fund managers or investment options to choose from and build portfolios (including switching and rebalancing over time).

This myth is true for traditional annuities but is false for new investment-linked lifetime income products.

Several other myths

Myth eight: One will lose all their money if the insurer fails

All lifetime income providers in Australia are regulated by APRA — this includes life insurers and super funds.

Insurance companies that provide annuities are also subject to the *Life Insurance Act 1995* (Cth) and prudential standards. Compliance with these requirements is overseen by APRA to ensure that all lifetime income providers are able to meet their obligations both now and in the future.

APRA requires providers to hold sufficient capital backing to demonstrate that they could meet a '1-in-200 year' adverse market event (APRA 2023). Most life companies hold significantly more than the regulatory minimum capital. Some of the main annuity products also set up reinsurance arrangements where the reinsurer takes on some of the longevity risk too.

No annuity provider has ever defaulted in Australia, thanks to APRA and its predecessor's intervention.

When insurers have looked like they are experiencing difficulty in the past, APRA has worked with them to restore solvency, which includes shareholders injecting more capital into statutory funds.

It is the ratio of shareholders' capital and reserves to the annuity liabilities that advisers could check. The key risks for lifetime income providers are:

1. Investment returns not being sufficient to support guaranteed income levels. This does not apply to investment-linked lifetime annuities which pass on investment performance to clients (like other super products do).
2. Annuitants living longer than expected — the mortality risk. Reinsurance helps here.
3. Administration costs being higher than expected.

Some insurers that provide investment guarantees may experience problems with an asset-liability mismatching risk, which arises where some of the assets held in the statutory annuity fund mature but get reinvested at a lower rate than initially assumed.

Investment-linked life annuities have an exact matching between assets and liabilities when it comes to investment performance. The retiree bears the investment risk as they do before retirement and with ABPs.

A high level of reinsurance transfers the mortality risk away from the insurer, so less shareholders' capital is required in the life insurer. Capital is aggregated on perhaps a worldwide basis by the reinsurer — thus further reducing the need for solvency reserves by the insurer.

The quality and risk tolerance of the life insurer's executive team is also an important factor, as is the ability to raise shareholders' capital, if ever required.

The assets that support the annuity are held separately from the provider's own assets. In other countries, even if an annuity provider experiences financial difficulties, clients are more likely to see a reduction in their pension income rather than losing their money.

Lifetime income products that pass on investment performance to the clients do not have to provide long-term investment performance guarantees. This further reduces the chance of provider failure.

Myth nine: If one's income from an annuity increases, they will lose their age pension

Lifetime annuities are treated differently to ABPs when it comes to age pension means testing. Rather than being a deemed asset, most lifetime income products attract concessional treatment as follows (this applies to products sold after 1 July 2019):

Income test: Only 60% of the income payment from a lifetime income product gets included as assessable income.

Assets test: Under the assets test, only 60% of the purchase price is used as the assessable asset value of a lifetime income product. This figure is fixed until age 84 (or a minimum of five years after purchase) at which point only 30% of the purchase price is counted as an assessable asset.

(Services Australia 2024)

This means that many means-tested pensioners who move some of their savings into a lifetime income product see an immediate uplift in their age pension income and those above the upper means-test threshold could potentially become eligible for an age pension (and the pensioner concession card).

As such, this myth is generally false. Having said that, if an ABP balance runs low or actually runs out, then it is likely to have a lower assessable value than a lifetime annuity. So, careful projections are needed. Most lifetime income providers offer online projection tools for this purpose.

Myth ten: Annuities are 'set and forget' and do not need advice

There is a lot to consider when balancing a client's expectations throughout retirement. As with any stage of life, retirement is not static. Changes occur as clients age and this can mean deterioration in health, changes in housing needs, spending levels, and potentially aged care requirements.

Traditional lifetime annuities pay a defined, guaranteed income until death. There is no need to make decisions about the product or make adjustments from year to year. But annuities are just one part of a suitable income mix for retirees. Advice is still required for other investments and cash flow, age pension strategies, estate planning, home equity release, aged care and estate planning. An adviser can help the client continually align their finances with their personal goals and preference sets.

With new lifetime income products, clients also have a requirement to monitor and manage their investment performance and investment options each year. This is in addition to adapting their broader circumstances and income sources as they change over time. For example, this may involve adjusting how much they draw from their ABP, rebalancing the ABP and lifetime income stream and other assets each year and allowing for any impact on their age pension income. The adviser has an active ongoing review role.

As such, the myth is false, particularly for new lifetime income products.

Conclusion

In 2024, over 5 million Australians are in super funds that offer a lifetime income option at retirement. Advisers will be expected to understand these options and to help their clients learn how these options work, assess and compare their merits, and to demonstrate why each client's choices meet their preference sets in light of the age pension incentives on offer.

Advisers will continue to have a growing role in helping retirees manage their retirement product mix including the age pension and lifetime income streams over the course of their retirement.

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