financial & private sector development

Australia: Retirement Income and Annuities Markets

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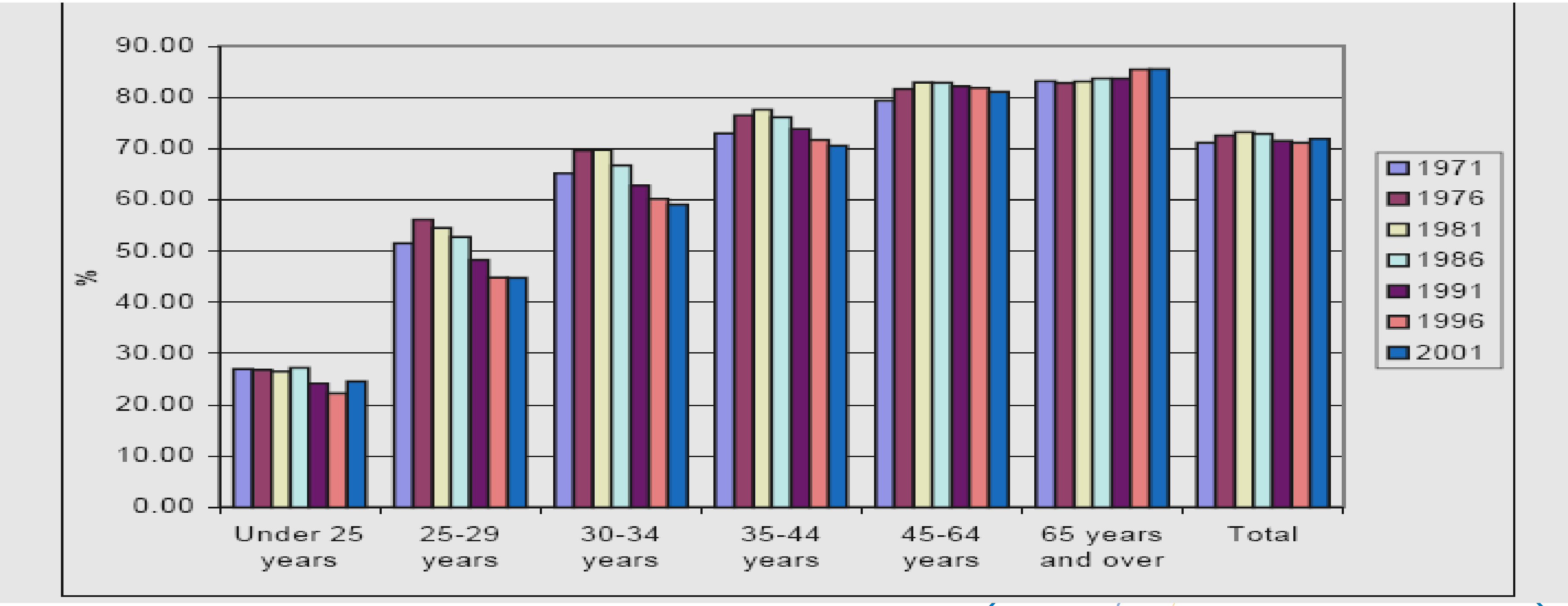
THE WORLD BANK IFC

Pension system

- Age pension in place since 1908, funded on a pay-as-you go basis
- ‘Means testing”. The treatment of income and assets have been an important influence on how people manage their financial affairs
- 1st Pillar pension 25% of average weekly earnings
- Income test which reduces the pension by 40 cents for each dollar earned over a threshold
- Assets test reduces pension if people have assets above a certain threshold
- Principal home is exempt – strong attachment

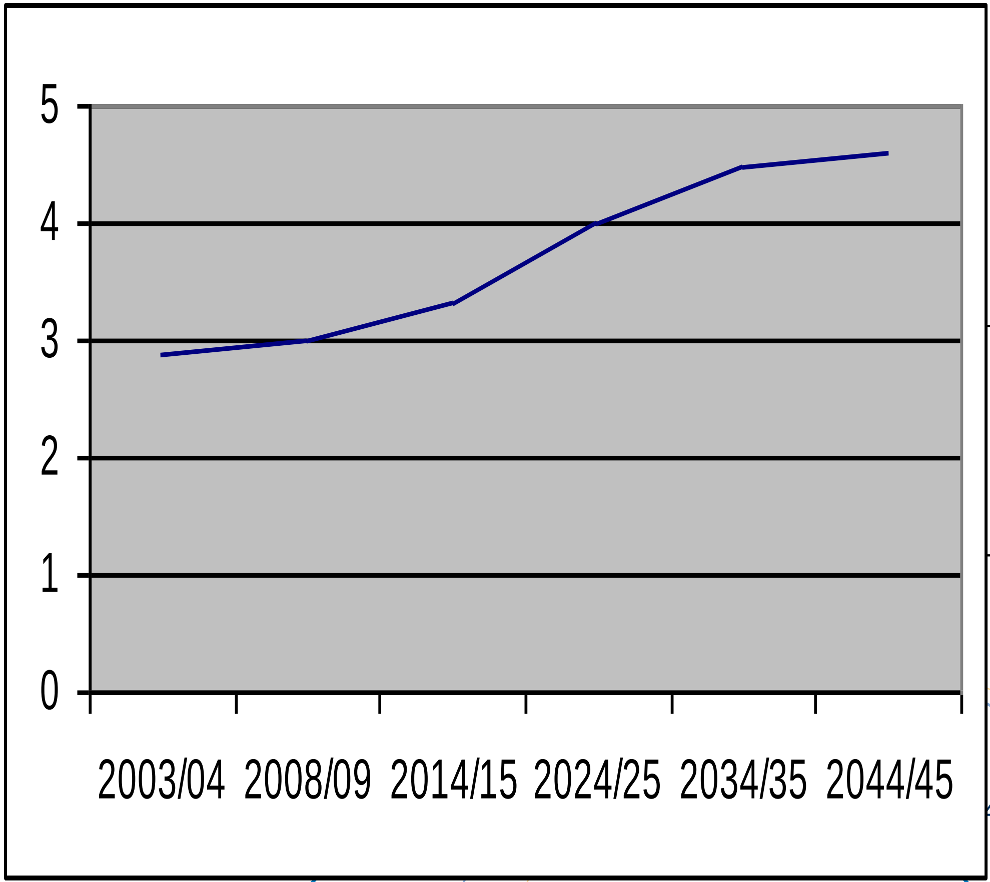
Home ownership

- High levels of home ownership
- Source of support in retirement



Cost of pensions

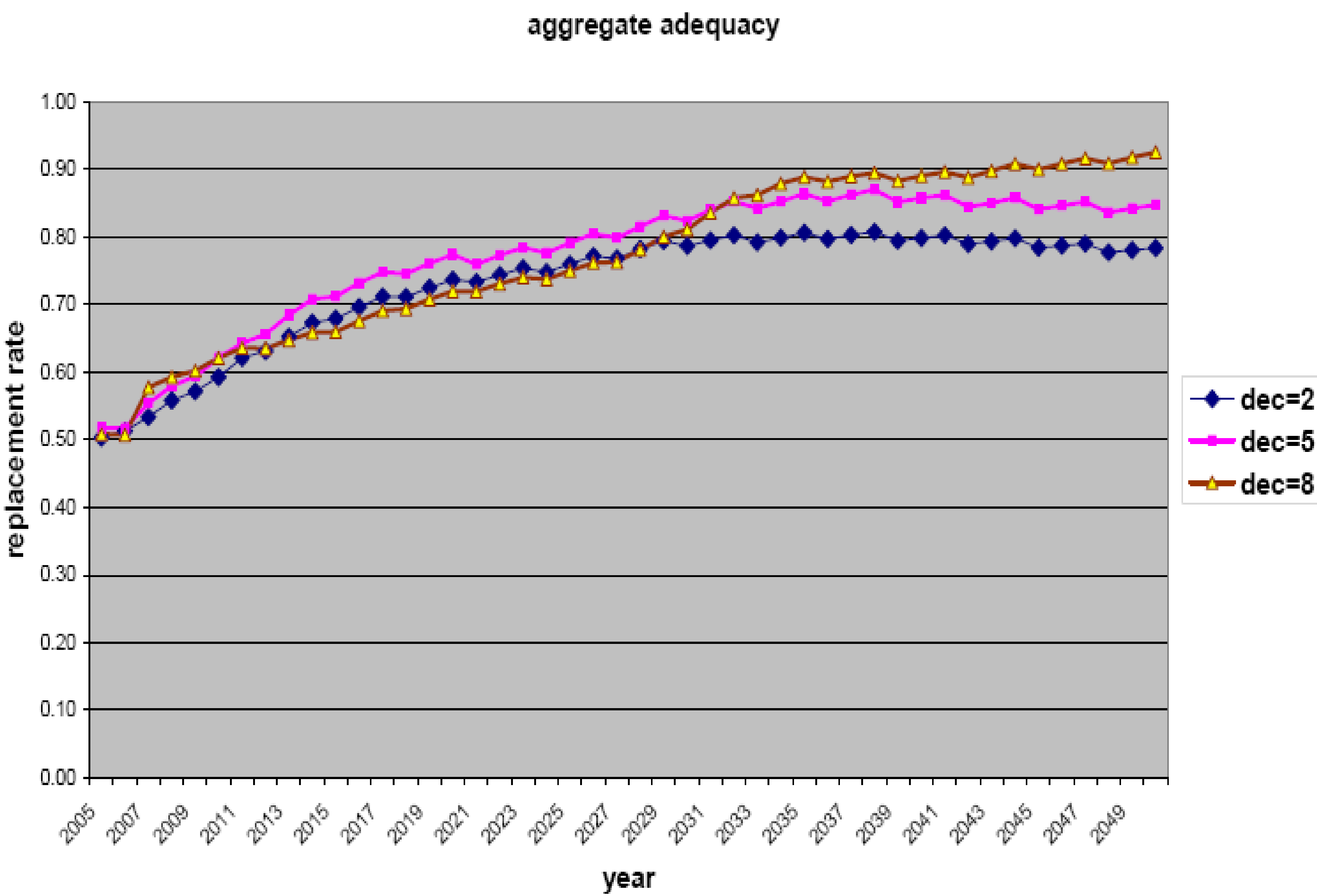
- Cost of first pillar is relatively modest
- Population ageing is material but manageable
- No large future liabilities
- ‘Future Fund” for government’s own superannuation liabilities



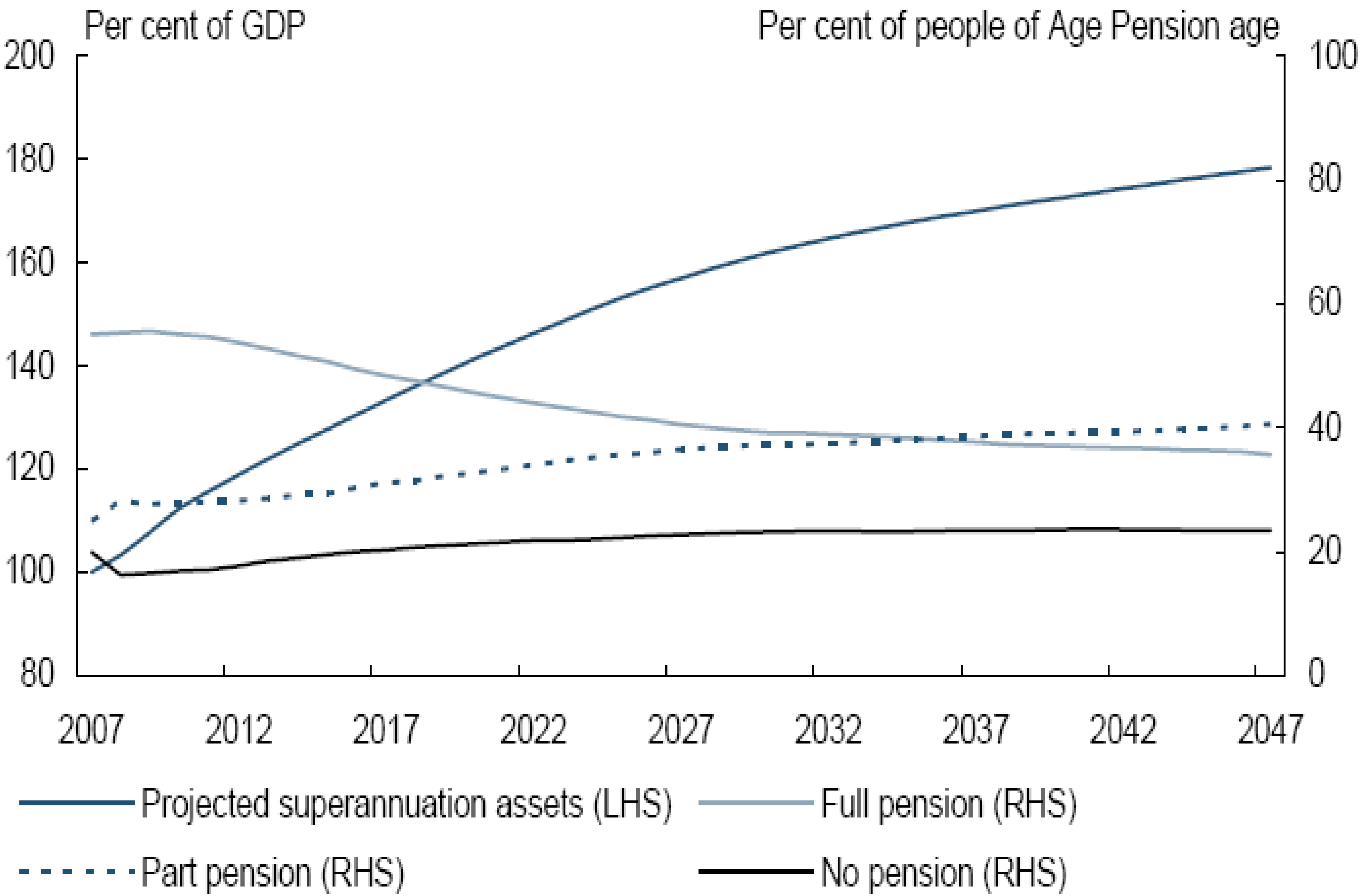
Replacement rates

- Pension provides for people to live in modest comfort. Low replacement rate by OECD standards
- Pillar 2 (superannuation guarantee) and private savings encourage move towards income maintenance
- No target replacement rate but experts suggest between 60 and 65 percent is desirable
- The combination will result in replacement rates above 70 percent by 2032
- Plus private savings

Replacement rates



Trends in Age Pension Eligibility



Occupational schemes

- Long history of occupational schemes but limited to large employers
- Initially no integration with first pillar
- Favored taking lump sums or invested to maintain entitlements in the first pillar
- Those with small balances had little incentive to purchase an income stream

The superannuation guarantee

- Mandatory second pillar created in 1992
- Contributions now 9 percent of wages
- Vastly increased the level of superannuation assets and public interest in such schemes
- Move towards defined contribution
- Growth in multiemployer schemes
- Other initiatives to increase coverage – spouse contribution and co-contribution

The payout phase

- No regulation
- Can take as lump sum, pension or annuity
- Range of products to meet retirement income needs
- Encouragement for retirement income streams to facilitate capital drawdown during retirement
- However, radical changes in 2007 which change the dynamics of the market

The product menu

- Allocated income streams
- Market-linked income streams
- Lifetime income streams
- Life expectancy income streams
- Fixed term income streams

The product menu

Features	Market linked income streams	Allocated Income Streams	Lifetime income streams	Life expectancy income streams
Account based	Yes	Yes	No	No
Annual income payment guaranteed	No	No	Yes	Yes
Investment choice	Yes	Yes	No	No
Fixed term	Yes	No	No	Yes
Access to capital	No	Yes	No	No
Recipient can vary annual income received	No	Yes	No	No
Residual Capital Value allowed	No	n/a	No	No
Income tested	Yes	Yes	Yes	Yes
Death benefits payable	Yes	Yes	Possible	Yes

Taxation and social security rules

- Have an important impact on consumer choices
- Concessional taxation of employer contributions subject to a 'reasonable benefits limit' (RBL)
- Much higher RBL for pensions and annuities payable for life or life expectancy than for lump sums
- Concessional taxation of superannuation fund earnings
- Pension and annuity payments taxed as income but a rebate of 15 percent
- Favorable treatment of income streams when assessing asset and income tests

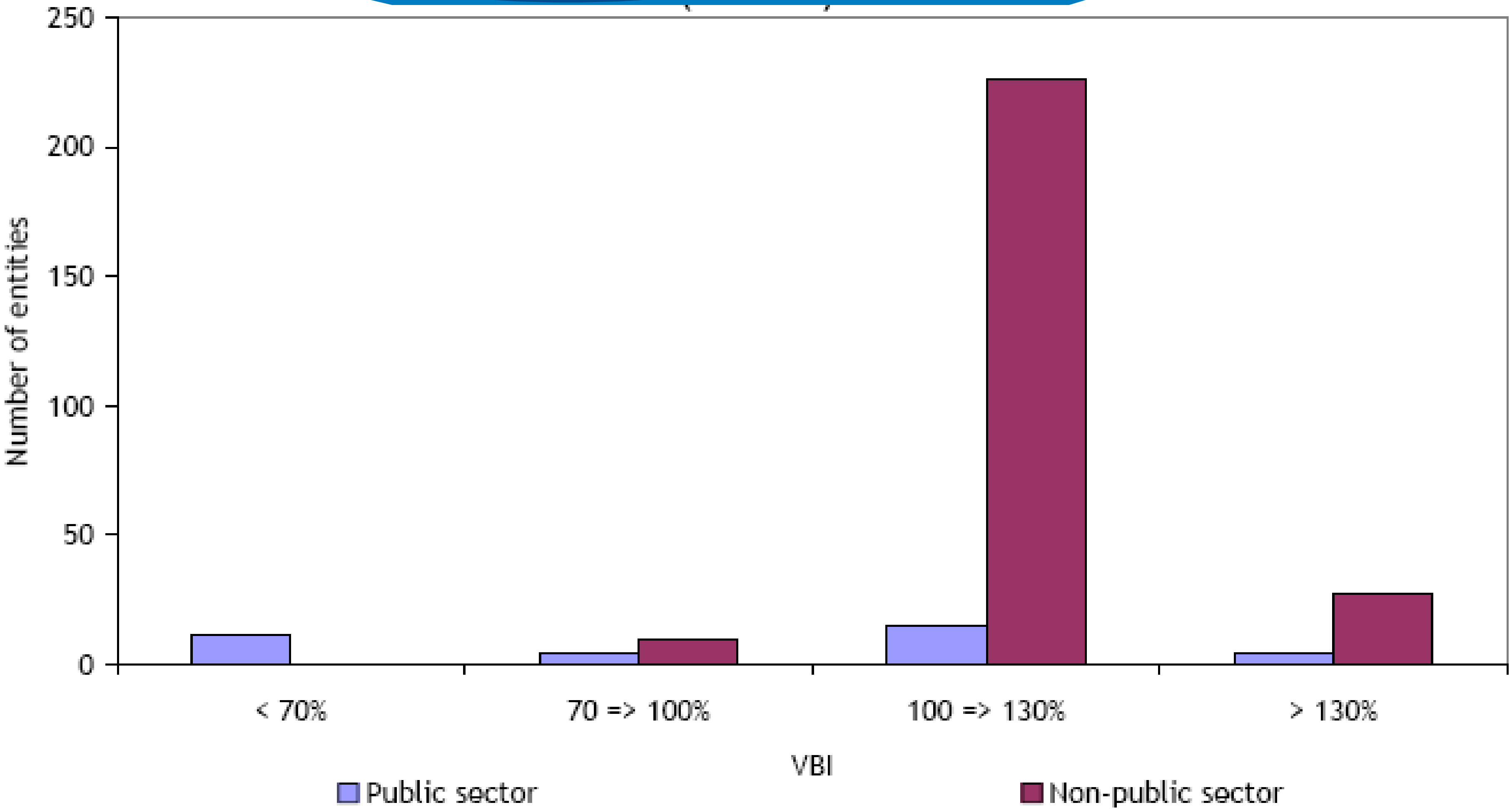
Removal of concessions

- From 1 July 2007 major simplification
- All lump sum benefits paid from a taxed source will be tax free
- All pensions paid from the taxed source will be tax free
- Removal of RBL
- No longer favorable treatment of income stream products for purposes of assets test

Is safety a problem?

- A pension fund which offers a defined benefit pension must be in a ‘satisfactory’ financial position
- Significant role for actuaries
- Increasing focus on ensuring that all vested benefits can be paid
- APRA now reporting the ‘vested benefit index’

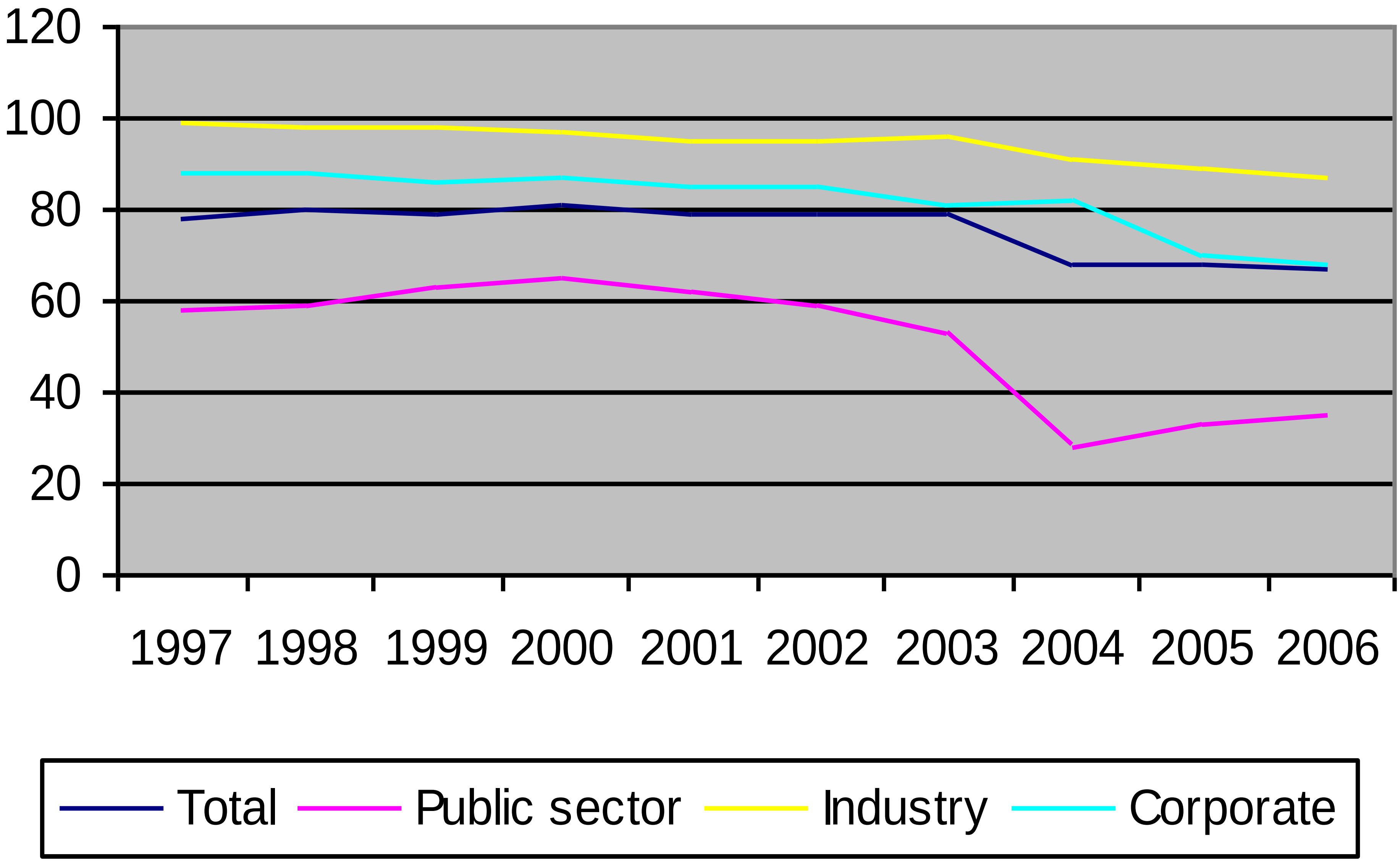
Is safety a problem?



Is safety a problem?

- Solvency and capital adequacy standards for insurance companies which provide annuities
- Not explicitly risk-based but does take into account risk factors and volatility
- Increasing focus on companies having a ‘target surplus’
- Level of target surplus has an impact on the risk rating of the insurer

Lump sums



120
100
80
60
40
20
0
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
Total
Public sector
Industry
Corporate

Lump sums and annuities

- Decline in the percentage of benefit payments taken as a lump sum
- Where the fund pays a pension then people are more likely to take it
- Since the late 1990's more superannuation funds have been paying pensions (allocated not lifetime)
- Growing balances seem to have focused the need to invest properly for the future.

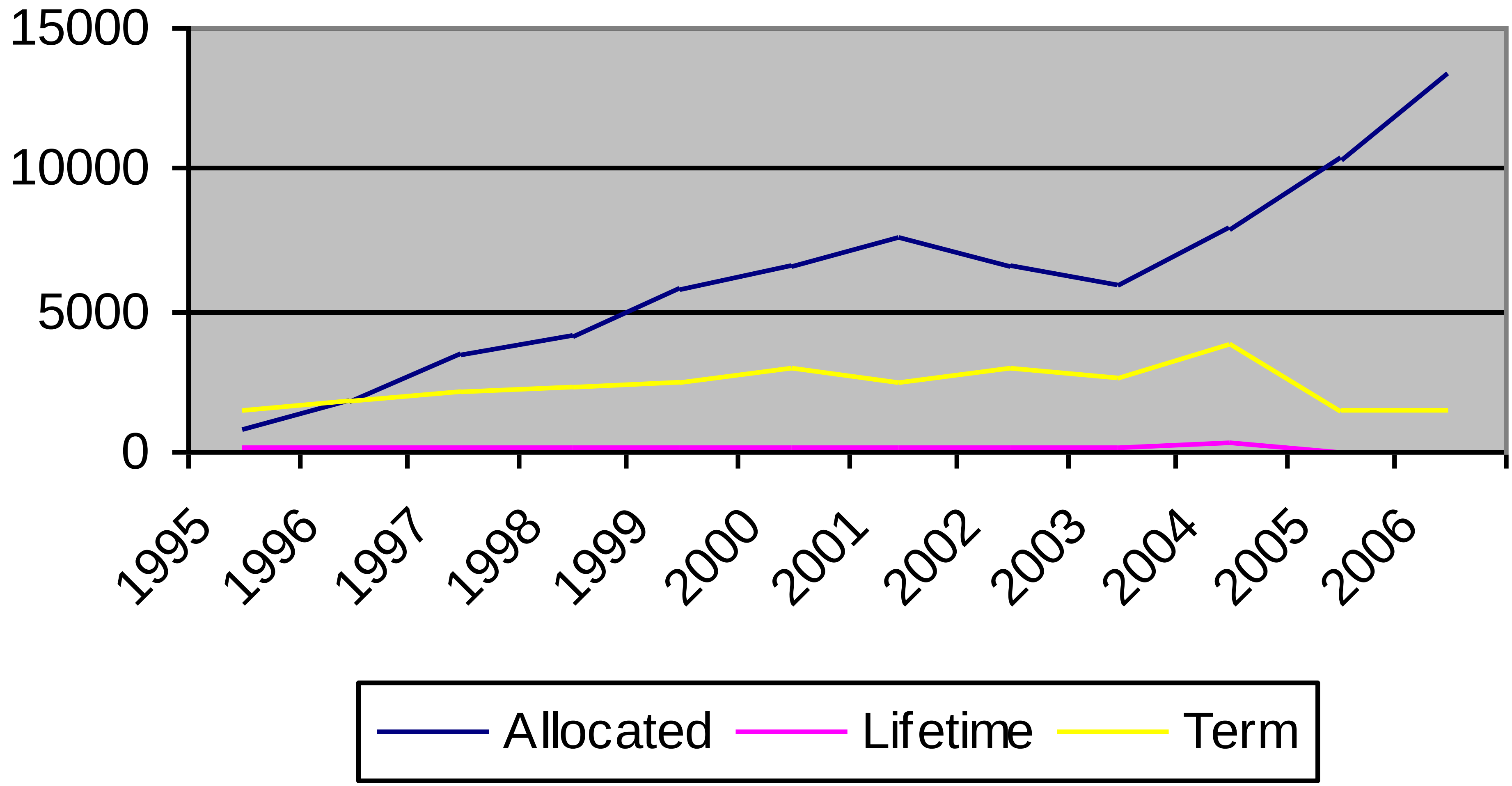
Insurance company annuity business

	2000	2001	2002	2003	2004	2005	2006
Allocated	4337	4629	2971	1999	2237	2551	4576
Term	3173	2392	2807	2507	3565	1293	1242
Lifetime	194	176	171	259	422	28	29

Lump sums and annuities

- Maybe they are not good value
- In 2000 Knox concluded that the Money Worth Ratios compared favorably with other countries
- But in 2007 Ganegoda reports that they have dropped significantly
- Possibly due to high administrative costs and profit loadings
- Maybe concerns about longevity risk
- Probably also due to falling competition

Sales of annuities and allocated pensions



Annuities versus allocated pensions

- Despite attempts to encourage annuity products Australians are averse to products with little or no residual value and no possibility of withdrawal of capital
- Allocated pensions provide many benefits, including taxation advantages, the possibility of a residual sum, control of the portfolio supporting the pension and flexibility regarding the timing and size of the pension

A story of attitudes

- Until the late 1980's the system was voluntary
- The age pension was seen as the principle form of support in retirement
- Private savings were seen as being available to freely use
- Average superannuation balances were small
- Many were used to clear debts, for home improvement and general living expenses
- Only government and large corporates offered superannuation pensions

A story of attitudes

Australians increasingly are understanding the need to save for retirement

- "Australians are convinced that, along with the government, the individual should accept responsibility for funding retirement. That may help explain why, as individuals, many Australians begin retirement planning at an early age"

Axa – Retirement Scope 2007

Retirement Planning

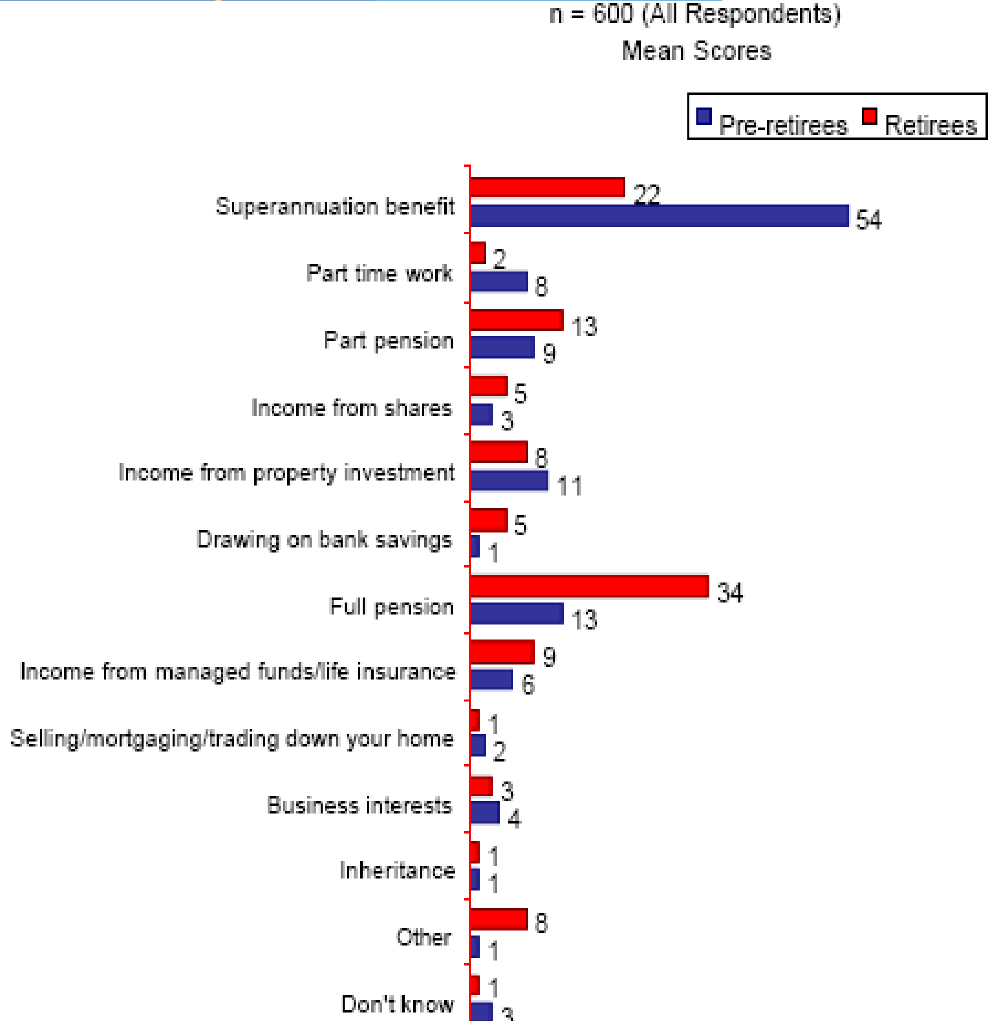
"Among working people, 70% said they were planning for retirement, and had started at an average age of 31, almost a decade earlier than their retired counterparts, who began at 41. This is a significant breakthrough, as just two years ago Australians who were preparing for retirement did not begin to do so until they were 36 years of age."

Change in attitudes

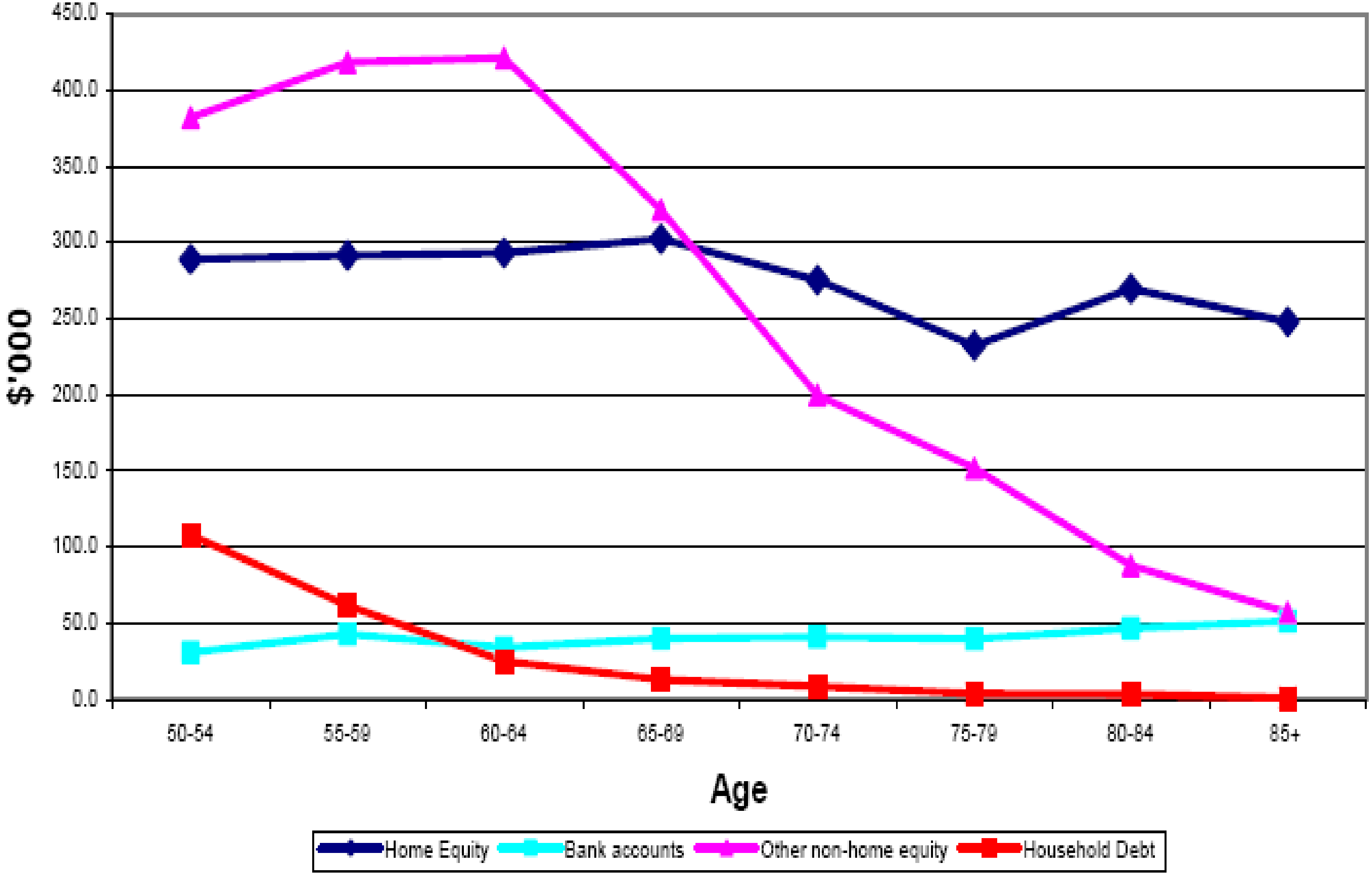
- Cohort studies indicate that pensioners are drawing down their wealth at a slow pace
- They are likely to retain significant assets through many years of retirement
- Home equity will remain a significant asset
- There is increasing reliance on equity release products

Change in attitudes

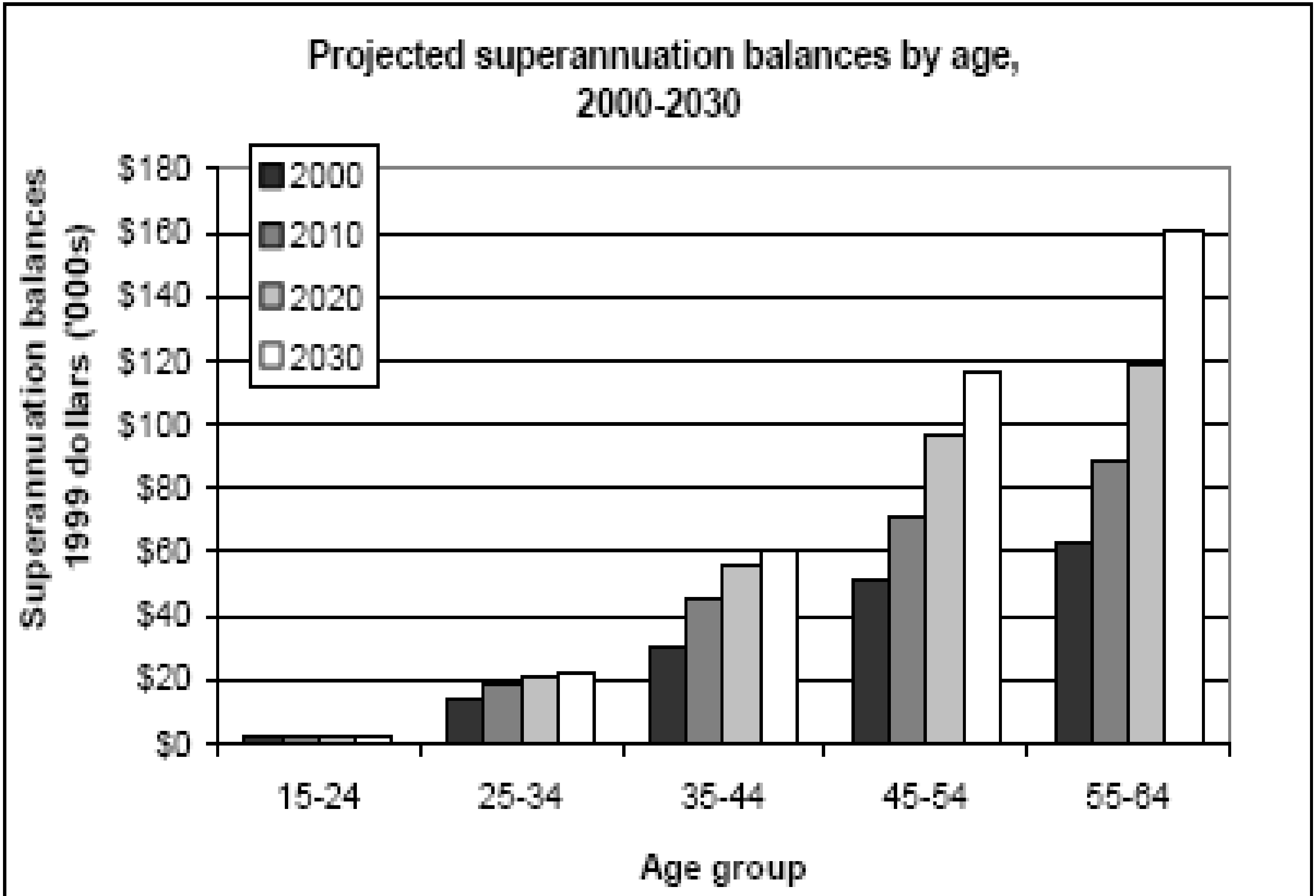
- People now appear to have a clear understanding that superannuation and private savings will be needed if they are to have a comfortable retirement



Average Household Wealth and Indebtedness



Projected Superannuation Balances



Equity release products

- Allow access to home equity without having to sell and move
- Market is developing rapidly – up from $460 million in 2004 to $1.5 billion in 2006
- Lump sums predominate but more are seeking regular drawdowns
- Strong consumer regulation

Concluding remarks

- Lifetime annuities are not popular for two reasons:
  - People can rely of the age pension if they have to
  - A strong desire to have flexibility
- There has been a dramatic change in attitudes with most now feeling that they will need to supplement the age pension
- Growing superannuation and private savings are being invested prudently in a range of retirement income products
- These funds are not being exhausted rapidly

Concluding remarks

- The build up is retirement savings is expected to cushion the impact of population ageing
- There is no “ageing crisis”
- The government seems comfortable to leave to investment of retirement income to individuals
- There is no evidence that there is excessive consumption in the early years of retirement
- There are no significant concerns about longevity risk and therefore limited demand for products to hedge this risk