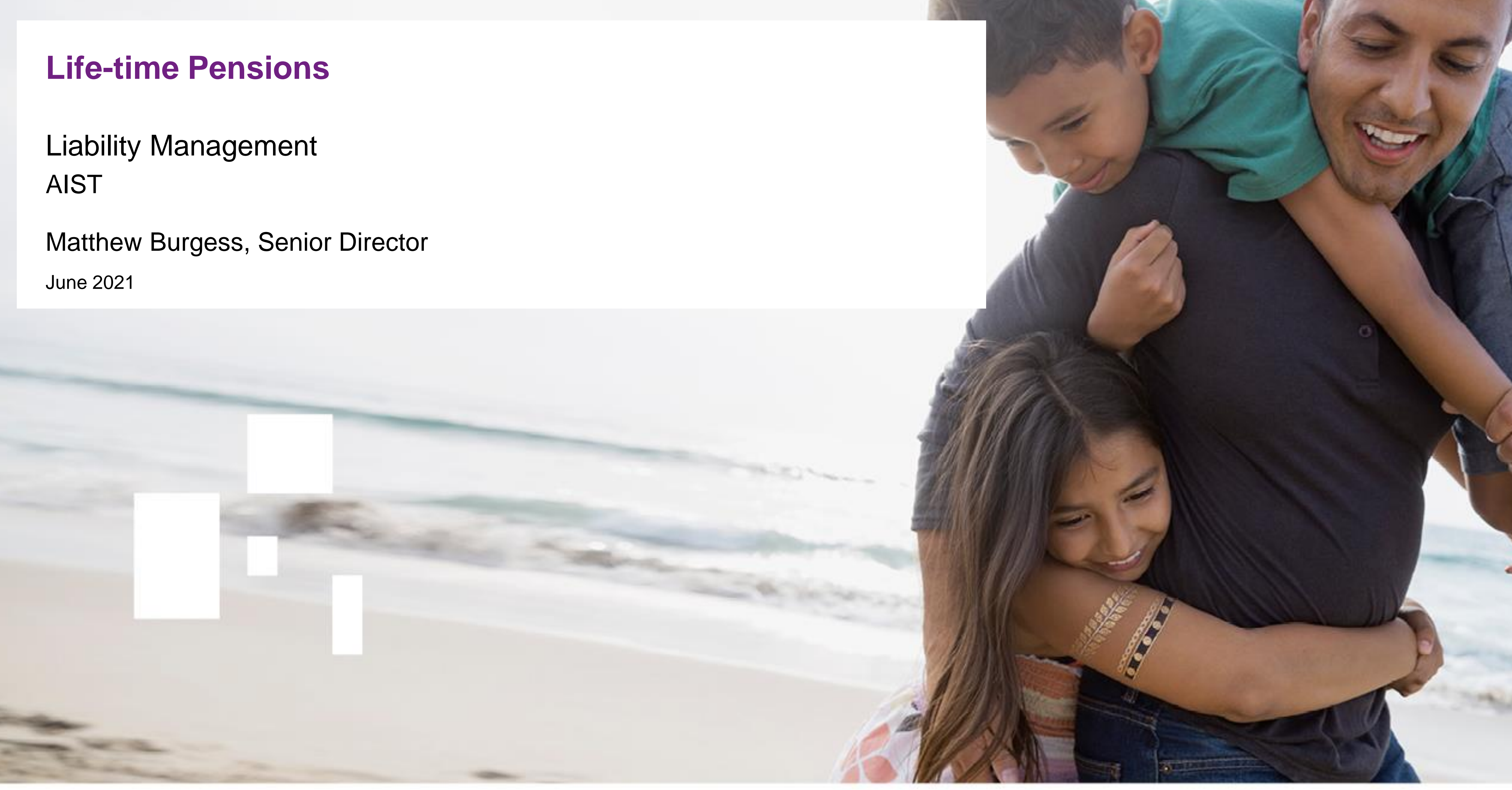

Life-time Pensions

Liability Management

AIST

Matthew Burgess, Senior Director

June 2021

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Willis Towers Watson

Outliving savings is one of the main worries of retirees, particularly for those in good health

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Making retirement savings last a life-time

Account Based Pensions

Age Pension

Annuity

Group Annuitisation

Defined Benefit pensions

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Introduction to Defined Benefit Life-time pensions

Defined Benefit funds often provide life-time pensions that are

- Great for members, often very generous
- Payable monthly or fortnightly for the life-time of the pensioners
- Often CPI indexed and reversionary pension to spouse (e.g. At 62.5% or 67%)
- Sometimes dependent child pensions are paid
- To be taxed as pensions must meet requirements of SIS Regs 1.06(2)
  - Includes requirement that they not be commuted except in limited circumstances such as in accordance where rules already in place in 2007 or for a family law split

Defined Benefit employer usually bears risk

- The biggest risk is usually poor investment returns, but pensioners living longer than expected increases the assets required to provide life-time pensions
- There is no life-insurance company providing the guarantee
- If assets insufficient employer usually needs to make extra contributions, which is why it is difficult for accumulation funds to offer them
- The Employer can sometimes terminate life-time pension arrangements under the Trust Deed, rarely been done
- The life-time pension liability usually sits on the Employer’s balance sheet and Employers usually do not like the open-ended nature of the contribution promise

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Introduction to Defined Benefit Life-time pensions

Moral obligation

- Employer has promised life-time pension
- Materially impact former employees relying on pension
- Can impact current employees who have a pension entitlement at retirement

Legislation

- Cannot introduce or vary a voluntary commutation option to Trust Deed and retain preferential tax treatment

Cost

- There can be a material cost to employer for elimination of risk, which is explored in the following slides
- Selection risk
- But it is very expensive to administer a small life-time pension pool

Best interests usually dictates that Trustee will want to keep paying life time pensioners, but managing the risk in members' best interest. Employers sometimes want to eliminate or reduce risk.

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Options to manage risks

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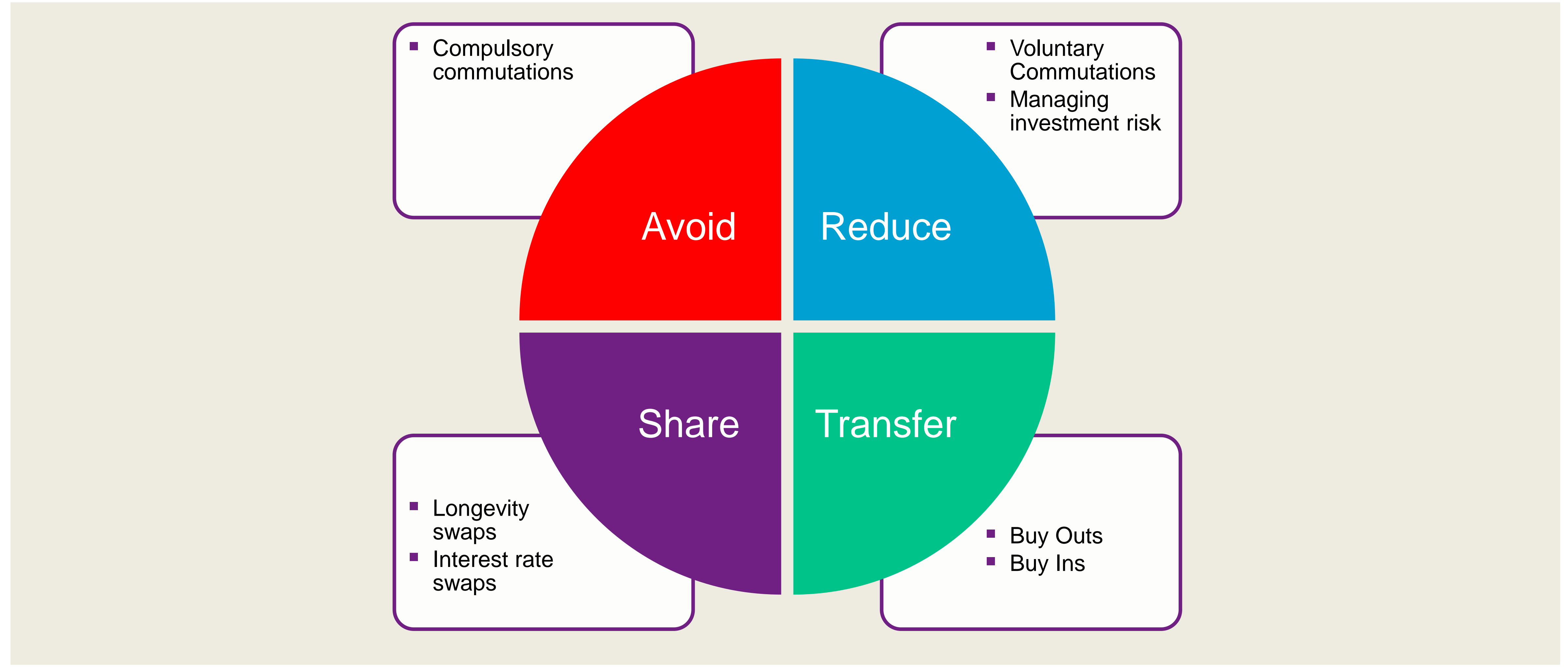
Options to manage life-time pension risk

Generally life-time pension risk is accepted – there are alternatives



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Options to manage life-time pension risk

Compulsory commutations

- Rare
- Legally difficult

Voluntary commutations

- Can not be permitted without loss of tax status if not already in Trust Deed in 2007
- Typically, low take up
- Selection by unhealthy pensioners may actually increase cost

Managing investment risk

- The biggest risk is usually poor investment returns because the assets supporting life-time pensions often include some growth assets
- Can choose to invest only in defensive assets, and it is even possible to match the timing of cash flows to the pension payments. However, because the investment returns expected are much lower this option can be very expensive. An increase in cost of 50% could realistically be incurred, depending on the circumstances
- Degree of growth assets can be chosen based on employer's risk and cost preferences
- Does not manage longevity risk

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Options to manage life-time pension risk

Buy Outs

- Successor Fund Transfer life-time pensioners to a life insurance office
- Pensioners cease to be Trustee responsibility
- Must meet equivalency and best interest requirements, including considering default risk of employer verses insurance office
- Life-insurer takes all ongoing risk, but it comes at a large cost

Buy Ins

- Superannuation fund buys the life-time annuities from life insurance office to pay the pensions, but pensioners remain in the fund.
- Superannuation fund remains responsible for paying pensions
- While assets remain on the superannuation fund balance sheet, the investment is managed by the life insurance office
- Similar large cost to buy outs

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Options to manage life-time pension risk

Other options

Interest rate swaps

- Employers' include pension liabilities on their balance sheets based on bond yields
- An Interest rate swap allows a fund to pay variable interest rates to an investment bank and receive back the agreed fixed interest rate. This can mean that the value of the liabilities is not sensitive to interest rate movements
- Costly in the same way investing in defensive assets is costly

Longevity swaps

- Fund pays insurer cash flows based on expected mortality and insurer pays back cash flows based on actual mortality
- Fund retains assets and investment risk
- Complex so probably only considered for large pension pools, and not yet in Australia to my knowledge

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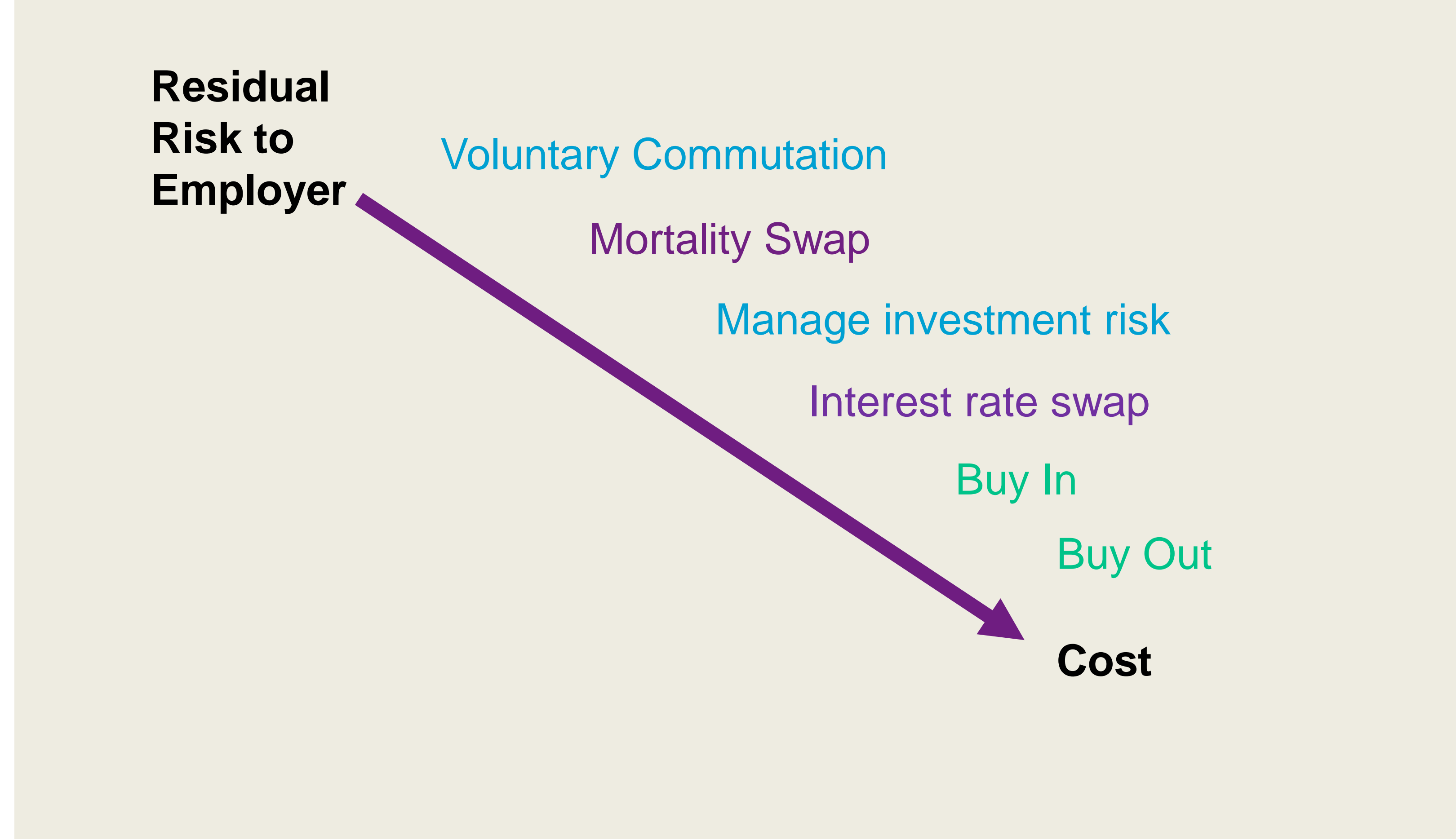
The cost and risk reduction of options

In practice it depends on how they are implemented



While a voluntary commutation can eliminate risk, this is usually not the case due to selection and poor take up. The cost for voluntary commutation and managing investment risk vary materially depending on the approaches taken.

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