An Introduction to Australian Annuities

2020

simplyretirement

A Short Introduction to Retirement Annuities

Introduction

As we mention within the SimplyRetirement website, annuities are fundamentally a simple product, involving the upfront payment of a capital sum to purchase a future income stream.

However, there are a huge range of options available with respect to annuities that provide enormous flexibility, but also introduce considerable complexity - particularly when it comes to making an assessment of whether a product or service meets your specific requirements, and especially whether it represents “value for money”.

We believe that annuities, particularly because they offer “set and forget”, guaranteed rates of income regardless of the market or general economy, have the potential to play a much larger role in the Australian retirement market. But any participation in annuities should be based on a prior discussion with experienced, independent financial advisors, and retirees should have a thorough understanding of the product. This is primarily because you typically entering into very long term commitments, often with substantial sums at stake.

Types of Annuity

Annuities offer considerable flexibility to meet individual circumstances; consider just some of the options/choices available:

Period: an annuity can be paid for a fixed term (e.g. 10 years) or for your lifetime.

Immediate or deferred: annuites can commence immediately or can be deferred for a particular period – for example, they can be purchased at age 65 to commence on your 70th birthday.

Indexation: an annuity can include a provision which sees the payment increase to cover inflation, or by a specific % amount each year.

Residual value: an annuity can provide for a full or partial return of your upfront payment at the end of the payment period, no residual value or a full repayment should you die within a prescribed period.

Impaired annuities: if you have a reduced life expectancy because of an illness, or other circumstances, it may be possible to access an impaired annuity – one that provides for higher payments because of your reduced life expectancy.

Minimum payment term: if you have a “minimum payment term” then, if you die before the term of the annuity, your spouse or dependents can continue to receive payments for the rest of the term, or they may be paid a lump sum. This is sometimes referred to as a “guaranteed death benefit”.

Reversionary annuities: you can buy a reversionary (or joint owner) annuity, which means that your spouse or partner will receive the income payments should you die during the annuity period, but often at a reduced rate.

Just remember that there are **explicit or implicit costs attaching to almost all these options** when it comes to annuities. Some of them are obvious - for example, with a lifetime annuity the annuity provider takes a risk in terms of how long you will live and this needs to be reflected in the product price; whilst a reversionary or guaranteed death benefit either increases the chance that a benefit will be paid, or that it will be paid over a longer period, and therefore is an added expense to the provider.

Similarly, opting to be paid monthly rather annually will increase administration costs and reduce provider investment returns. In short, choosing more options means that you will normally receive a lower income stream in relation to any lump sum payment you make.

This doesn't make choosing particular options wrong, quite the contrary. However, you need to ensure that any annuity fits your circumstances as far as possible; it is just a case of ensuring that you understand "what you paying for", and receive value.

For example, we think that individual's purchasing lifetime annuities **should normally opt for some form of indexation to provide protection from inflation and their spending power.** We have lived through periods of high inflation and seen the adverse impact on individuals with fixed incomes.

Some Examples

We believe that the best way to understand how annuities work and the impact of choosing options is to provide some worked examples.

The examples below are based on quotes provided by a leading Australian annuity provider as at April 2019, and are illustrative only. Note particularly that Adviser Service fees have not been included in these figures.

Example 1

Annuity: Variable term: no indexation: no residual capital value (RCV = 0)

An annuity can be paid for either a fixed term (a "term" annuity) or until the holder dies (a "lifetime" annuity). **Table 1** provides some examples of annuity options with different terms.

Note that in these examples the term annuities offer zero "residual capital value" (RCV); meaning that there is no return of your upfront capital payment at the end of the annuity. In effect the capital is paid back to you regularly over the term of the annuity as part of your income.

Table 1 - Variable Term, No Indexation, No Residual Value

Details	Type of Annuity	Scenario	Monthly Income
Initial Investment $100,000 **RCV = 0**	Term Annuity	10 Years	$994
RCV = 0	Term Annuity	15 Years	$726
RCV = 0	Term Annuity	20 Years	$545

Example 2

Annuity: Lifetime term; with and without indexation and no residual capital value

Indexation allows an annuity to be linked to inflation (preserving the "spending power" of the annuity payments), or not, as shown in the example in **Table 2** overleaf

You can choose a fixed percentage indexation, or for CPI (consumer price index) adjustments to apply, with your regular annuity payments increased by your chosen mechanism each year.

If you do not choose indexation, or CPI adjustments, then your payments will remain the same through the period of your annuity - with the result that the purchasing power of your regular payments will be eroded during any periods of inflation. By choosing indexation, your initial regular payments will be lower than if you buy an annuity without indexation; however, the payments should increase over time - depending upon the level of inflation.

Careful thought needs to be given to the indexation or "inflation proofing" of long term annuities. Even an inflation rate of 2.5% per annum can significantly reduce the purchasing power of money over time; the real value of an income stream reducing by 22% over 10 years and 39% over 20 years.

Whether, and to what degree, indexed payments exceed those payable under a non-indexed annuity obviously depends on the level of inflation during the term of the annuity. Just to provide some backdrop, the average annual inflation rate in Australia since 2000 has been about 2.7%.

Lifetime annuities can of course stretch over very significant periods of time - sometimes over 30 years - and consequently there is very real scope for inflation to reduce the earning power of any payments.

Our view is that the issue of indexation, unless the annuity is very short term, should always be the subject of a discussion with your advisor before you commit t any annuity, and the impact of inflation must not be ignored in any analysis.

Table 2 - Lifetime Annuity, No Residual Value, With and Without Indexation

Details	Type of Annuity	Scenario	Monthly Income
Initial Investment $100,000 **RCV = 0** 10 Year Guaranteed Period	Lifetime (Female aged 65)	Indexed Full Inflation protection	$299 pm $3,583 pa Increased annually by full CPI
	Lifetime (Female aged 65)	No Indexation No inflation protection	$394 pm $4,725 pa No increase throughout the annuity period

Example 3

Annuity: Fixed term, no indexation and a variable residual capital value (RCV)

An annuity can be designed to return a residual amount (RCV) at the end of the term, or otherwise, and the decision will have a significant impact on the monthly payment.

As **Table 3** overleaf illustrates, an RCV = 0 annuity will give you higher regular payments, but no capital at the end of the term - effectively because you have your capital returned to you progressively over the period of the annuity.

In contrast, a RCV = 100 annuity will give you lower regular payments but with all your capital returned at the end of the annuity period.

Buying with Superannuation and Non-Superannuation Money

You can buy an annuity with money from within or outside the superannuation system. However, if you buy an annuity with money rolled over from super then are some additional considerations and restrictions which should be the subject of discussion with your advisor.

For example, when an annuity is bought with super money and you are aged 60 or over, then regular payments will be tax free. There is a limit though on how much of your superannuation can be converted into a (tax free) income stream - this is a known as the “transfer balance cap” and the limit is currently $1.6M.

Note also that if you buy an annuity with super money your reversionary can only be your spouse.

Contrasting Annuities and Account Based Pensions

In an Australian environment, it is useful to contrast the differences between account based pensions (previously referred to as “allocated pensions”) and annuities. Often these exercises are cast in terms of individuals needing to choose between either product. In actuality, we see individuals as typically using both products; with annuities providing a base level of guaranteed income and account based pensions allowing some scope for investment in growth assets to protect total assets over what can be a very long period in retirement.

Table 3 - Fixed Term Annuity, No Indexation and Variable RCV

Details	Type of Annuity	Scenario	Monthly Income
Initial Investment $100,000	15 Year Term Annuity	RCV = 0	$726
	15 Year Term Annuity	RCV = 100	$300

This is often referred to as taking a “layered” or “sandwich” approach to structuring your retirement income.

What are Account Based Pensions?

Once you have reached preservation age and met a “condition of release” you have access to your superannuation and can start to draw from an account based pension - which is usually established with money transferred from your super accumulation account.

Regular payments can be made on a monthly, quarterly or annually basis from your super fund and the only restrictions applying to withdrawals are that you make a minimum percentage withdrawal every year - the amount varies depending on your age, as in the Table below. In effect, you can draw on your account based pension like a bank account until funds are exhausted - including making lump sum withdrawals .

Annuities and the Age Pension

How annuities are treated for both the pension income and assets tests can be complicated, and dependent on a range of factors, including whether they are term or lifetime annuities, and whether there is any reversionary.

Generally, however, the income test would include any lifetime annuity income, <u>less</u> that part of the payment that represented a return of capital, and the asset test would include the purchase price of the annuity, <u>reduced</u> by any accrued capital payments. Term annuities would be treated much like other investments, with a deemed rate of return.

Historically, some annuities have also been exempt from the assets tests, either entirely or partially, and these are "grandfathered" within the system. Hence the need for specific professional advice in this area.

Importantly, however, new means test rules for lifetime annuities came into effect from July 1, 2019. For qualifying products, these rules see the income test assess 60% of all payments as income and the assets test assess 60% of the nominal purchase price as an asset until the individual reaches the life expectancy of a 65 year old male (currently age 84)—or after a minimum of five years—and then 30% of the purchase price for the rest of the individual's life.

Let's look at an example provided by the DSS:

"A person purchases a lifetime income stream at age 65 for $200,000. At purchase, the life expectancy of a 65-year-old male is 19 years. Initially, 60 per cent of the purchase price ($120,000) is assessed as an asset under the assets test.

60 per cent continues to be assessed for 19 years, after which point 30 per cent ($60,000) of the purchase price is assessed as an asset under the assets test. 30 per cent is then assessed for the rest of the duration of the lifetime income stream".

These new rules should now make lifetime annuities a product which individuals - who currently qualify for only a partial aged pension, or just fail to qualify for a pension - consider as an option very carefully - with 40% of any purchase price immediately exempt from the assets test. This may be a much better option than investing money in exempt assets - by renovating your family home for example - or simply spending on discretionary purchases.

Account Based Pensions - Minimum Annual Withdrawals

Age	Minimum Annual payment as % of account balance
55-64	4%
65-74	5%
75-79	6%
80-84	7%
85-89	9%
90-94	11%
95+	14%

How Annuities are Taxed

In very general terms:

- Annuities purchased with super money are tax free from age 60
- Annuities purchased with super money before age 60 will have the "taxable portion" of any payment subject to tax at your marginal rate, but you will be able to claim a 15% offset (which reflects tax paid within the fund).

Comparing Annuities and Account Based Pensions

	Account Based Pensions	Annuities
Guaranteed Income	No	Yes
Ability to vary income	Yes, subject to meeting certain minimum drawing requirements	No
Flexible access to capital	Yes	Dependent on product
Choice of underlying assets	Yes	No
Purchase with non-superannuation savings	No	Yes
Death Benefit	Yes, remaining balance of account	Depends on the annuity; whether there are guarantee periods and reversionaries

- Only the income component of an annuity purchased with non-super money is taxable - the rest is regarded as a return of capital.

In Summary

Account based pensions are simpler in nature than annuities and quite transparent in their operation. However, there is no guarantee that the funds will last you through retirement and effectively address what is called "longevity risk". This, subject to there being a life annuity which is indexed to the consumer price index (CPI) , is the main difference between annuity and account based pensions.

As mentioned previously, we see considerable scope for the products to be used in tandem - with individuals having an annuity providing a base level of income and account based pensions providing more flexibility and the ability to invest in selected growth assets over what can now be a long retirement.

Hopefully, in the not too distant future, other products may also be available to assist in managing retirement income and longevity risk - including the CIPR (Comprehensive Income Product for Retirement) - which unfortunately is little more than an unwieldy acronym at present - and perhaps tontines to assist in targeting financing longevity risk more efficiently.

"These new rules should now make lifetime annuities a product which individuals - who currently only qualify for only a partial aged pension, or just fail to qualify for a pension - consider as an option very carefully".

In the meantime, professional advice is strongly recommended to ensure that any products you purchase work together within any broader retirement strategy and that you fully appreciate the legal aspects of the product. The costs associated with making a mistake or later "changing course" because a product has inadequate flexibility can obviously be very substantial and it is clearly important to get the strategy "right first time".

Ω

Complete Retirement Group Pty Ltd
ABN: 46614551843

P.O. Box 338
Ivanhoe
Victoria
Australia
3079

simplyretirement