Institute and Faculty of Actuaries

Longevity Risk

Policy summary

Key findings

Individuals may not understand the implications of longevity risk when planning their retirement income and without support to mitigate longevity risk individuals may become unable to meet their daily financial needs.

Uncertainty around an individual's life span often means they underestimate how long they are going to live for. In addition, the range of responses to longevity risk may be daunting and a robust information and advice framework is needed to help consumers respond and make good choices.

We have identified five principles for mitigating longevity risk:

- Adequacy
- Information
- Flexibility
- Equity
- Sustainability

We believe there are three main focuses for Government, regulators and product providers to ensure individuals are equipped, as far as possible, to mitigate longevity risk. These three areas are:

- Guarantees
- Pathways for decumulation
- The guidance and advice framework

December 2015

Ageing population

Background

The roll out of auto-enrolment means that over five million additional people are contributing to a Defined Contribution (DC) workplace pension than in 2012. DC pensions differ from more traditional pensions such as Defined Benefit (DB) as investment, inflation, market and longevity risk sits with the individual as opposed to the employer sponsoring the pension scheme. In addition, the recent pension freedoms mean that people no longer have to buy an annuity. Annuities guarantee a specified level of income for the entirety of an individual's life, no matter how long they might live.

The growth in DC pension arrangements and the removal of compulsory annuitisation mean that as people come to spend their retirement income, variation in the length of life, particularly around the risk of living to very advanced ages, could mean they exhaust their financial assets during their lifetime. Without support to mitigate this risk individuals may end up unable to meet their daily needs or become reliant on State benefits.

Longevity risk in retirement planning

Longevity risk can be defined as 'the risk that members of some reference population might live longer on average than anticipated'.[i] Longevity risk can have significant consequences for individuals with DC pension savings when they come to retire. In particular:

- the risk that people outlive their retirement savings; or
- the risk that people underspend their savings, leading to a lower income over retirement.

Individuals may not fully understand longevity risk, or consider its implications, when they come to plan their retirement income. Three causes for this are uncertainty, underestimation and complexity.

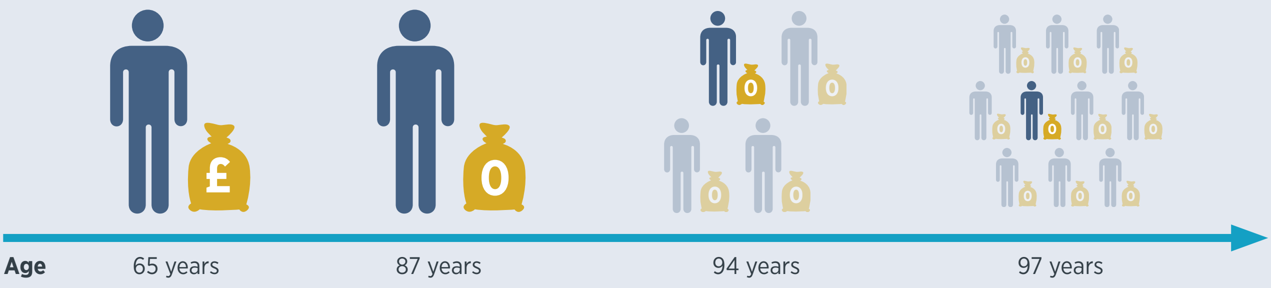
Uncertainty

An individual who retires at age 65 may have a life expectancy of 85, but has some chance of dying at age 70 or living to age 100. For this reason, self-insuring longevity risk carries a significant cost.

Table 1 illustrates the likely life expectancy of a male dependent on their current age. For example, a male currently aged 65 has an average life expectancy of 87; however he has a one in four chance of living to 94 and a one in ten chance of living to 99. If individuals in this cohort saved expecting to live to 87 (this is assuming underestimation is not an issue), a quarter will have under-saved and live for a further 7 years, potentially without an adequate income.

Table 1: Results of Office for National Statistics (ONS) 'How long will my pension need to last?' tool for an adult man with 10 year age intervals[ii]

Male				
Current age	Life expectancy from now	1 in 4 chance of reaching	1 in 10 chance of reaching	Chance of reaching 100
25	88	99	104	20.7%
35	87	97	103	17.0%
45	86	96	102	12.7%
55	86	95	100	10.9%
65	87	94	99	8.8%
75	88	94	99	7.4%
85	92	95	99	6.9%
95	98	100	102	20.5%
105	106	107	108	



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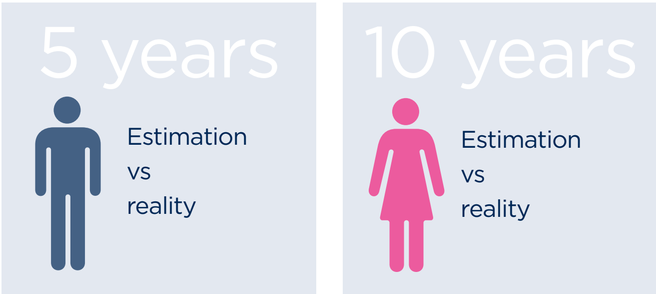
Underestimation

Longer life expectancies lead to increased longevity risk and the impact of this is exacerbated by the fact that people frequently underestimate their life expectancy. A study by MGM Advantage, found that on average males aged 55-64 expect to live to 81, whilst females in the same age range believed, on average, they would live on until they were 79. Both of these estimates were considerably below the national average life expectancies of 86 and 89 for men and women.[iii]

Figure 2: Underestimation of life expectancy



Complexity

People in DC schemes face an often daunting prospect of navigating a complex range of possible investment and spending decisions when they come to retire. It is important that information, guidance and advice are available as well as an appropriate range of products that better equip individuals to understand and take steps to mitigate their longevity risk.

Principles for mitigating longevity risk

Adequacy

Accumulating adequate savings over the course of one's working life is crucial and we support the Government's initiative of auto-enrolment (AE) to help individuals work towards this. The introduction of AE will better enable individuals to fund their retirement income needs. Current contribution levels are unlikely to be sufficient to provide an adequate level of retirement income for many and so helping individuals to understand how they can turn these savings into adequacy of retirement income throughout their retirement is of paramount importance within the freedom and choice framework.

Information

People need information, not just at the point of retirement, but leading up to and beyond it. The Government has made a significant first step to help people make financial decisions about their retirement by setting up Pension Wise. However, this alone will not ensure that individuals have an understanding of how long their financial assets might have to last them in retirement, and therefore, the level of assets needed to provide retirement income for the duration of their retirement.

Helping individuals to achieve a basic understanding of how to save, how to manage their savings to last a lifetime and how personal financial products can play a role is essential to achieving true financial security. Education is central to lifetime financial and retirement security.[iv] We suggest that more could be done to help individuals understand the consequences on their quality of life should they underestimate their life expectancy and run down their funds in later retirement.

Flexibility

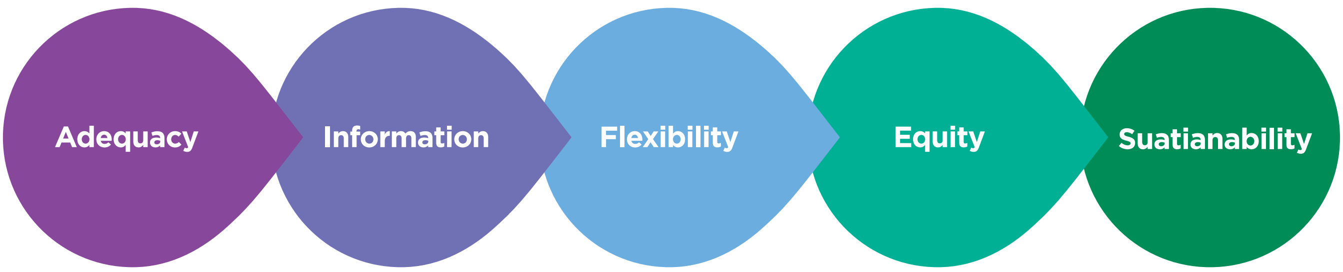
A robust regulatory framework is critical for ensuring that individuals' retirement income is appropriately safeguarded. There should however, be sufficient flexibility in the regulatory framework to support innovation. Innovation by product providers will allow consumers to select solutions that best reflect their needs, both anticipated and actual.

Equity

It is important that whilst those individuals who might live longer than expected, or outlive their retirement income, are protected from poverty. It seems reasonable to find some way of ensuring that those who benefit from living longer contribute to the increasing costs.

Sustainability

Pensions are under pressure from the increasing number of retirees, improvements in life expectancy and the uncertainty around future improvements in life expectancy. It is important to balance contributions to expenditure for the State system to remain viable.



What can the UK learn from international comparisons

Australia

In December 2013, the Australian Treasurer appointed an independent committee to undertake a Financial Services Investigation (FSI) and establish the direction of the Australian financial system over the next decade. In the final report, released on 7 December 2014, the inquiry concluded that, while the superannuation system is critical to helping Australia deal with the challenges of an ageing population, the "retirement phase of superannuation is underdeveloped and does not meet the risk management needs of many retirees."[v] The FSI also concluded that greater use of pooled longevity risk products could increase retirement incomes and recommended that superannuation trustees be required to pre-select a Comprehensive Income Product for Retirement (CIPRs) for members, and that impediments to retirement income product development be removed.

United States of America

In the US, policymaking and regulatory bodies have made efforts to facilitate individuals to seek guaranteed lifetime income options for decumulation of DC plans, but as yet have not accomplished that goal. Recent Treasury regulations permit 401(k), and similar qualified plans, to offer Qualified Longevity Annuity Contracts through an exemption system. Longevity annuities in the US are purchased as a person nears retirement age but payments are deferred to start in the future. For example, a 65 year-old at retirement may buy a longevity annuity with a commencement of payments at age 85, thus using the majority of their pension to provide withdrawals until age 85. If the retiree is still alive at age 85, the longevity annuity provides the necessary living expenses until death.

What does this mean for the UK?

To achieve the principles outlined in this paper and taking learnings from international comparisons, we believe there are three areas where Government, regulators and providers should focus their efforts to ensure individuals are equipped, as far as possible, to mitigate longevity risk. These three areas are: guarantees; pathways for decumulation; and the guidance and advice framework.

Guarantees

In the UK the shift from DB to DC and the removal of compulsory annuitisation has reduced the demand for products with an element of guarantee. However, we believe such products remain an important part of helping individuals to make their retirement income last a lifetime and protect them against longevity risk. Providing incentives for retirees to take their retirement benefits predominantly as an income stream, to protect against longevity, will be important in ensuring the equity and sustainability of the UK pensions framework.

Pathways

Retirement solutions with 'intelligent pathways' can provide retirees with secure income streams. The Government should seek feedback from industry with regards to the most appropriate types of default income stream products. Trustees of funds could be required to licence their default income stream products and be accountable to their members for the design.

Guidance and advice

In order to help people identify the most appropriate retirement income product for their circumstances, quality information and advice is needed – not just at the point of retirement, but leading up to, and beyond it. Steering people towards guidance and advice is important. Government, those who provide retirement solutions and employers should share responsibility for helping people to navigate retirement income choices.

[i] Blake et al. (2006) *'Longevity Bonds: Financial Engineering, Valuation and Hedging'* Journal of Risk and Insurance 73, 647-672, American Risk and Insurance Foundation

[ii] **http://visual.ons.gov.uk/how-long-will-my-pension-need-to-last/**

[iii] MGM Advantage (2014) *Retirement Nation*. [Online] Available from: **www.mgmadvantage.co.uk/retirement-nation/** [Accessed: 6 November 2014]

[iv] American Council of Life Insurers (2011) *A National policy for Lifetime Financial and Retirement Security*

[v] Australian Government the Treasury (2014) *Interim report of the Financial System Inquiry. Commonwealth of Australia 2014*

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