Challenger Tech

For adviser use only.

August 2019

An introduction to deferred lifetime annuities

By Andrew Lowe, Head of Technical Services

The introduction of the Government's 'Innovative Superannuation Income Streams' Regulations has, since 1 July 2017, allowed for the development of new categories of retirement income streams to meet the needs of Australian retirees. These Regulations have allowed for the development of a variety of income streams, including deferred lifetime income streams, and deferred lifetime annuities (DLAs) which are available today as a consequence.

Recent changes to the social security means testing of lifetime income streams has provided certainty of social security means test outcomes for lifetime income streams (including innovative superannuation income streams) commenced on or after 1 July 2019.

The Government's 'Innovative Superannuation Income Streams' Regulations have allowed for the development of a variety of income streams, including deferred lifetime income streams, and deferred lifetime annuities (DLAs) are available today as a consequence.

A Challenger DLA

The Challenger Guaranteed Annuity (Liquid Lifetime) Flexible Income (Deferred payments) option is a DLA. It provides:

- guaranteed income for life (irrespective of how long a client lives or how investment markets perform) after a deferral period of a client's choosing;
- higher payments relative to a comparable immediate lifetime annuity;
- CPI indexation of payments (including during the deferral period)[1];
- a death benefit where up to 100% of any investment amount paid to a client's nominated beneficiaries or estate if they die early[1];
- a withdrawal value for a period based on a client's life expectancy[1]; and
- the option to add a reversionary spouse with payments continuing for the longer life.

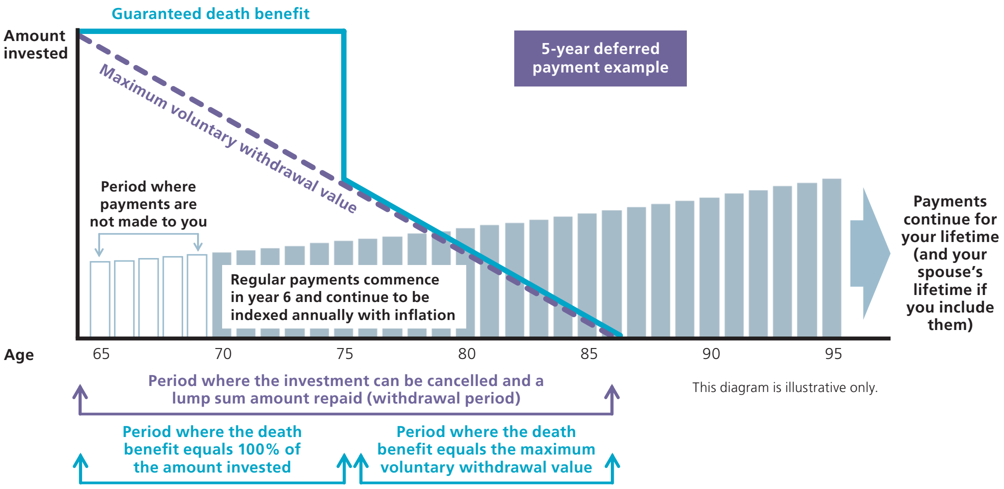
1 This feature can be removed by the client at time of investment in return for higher starting payments.

challenger

An investment in this option can only be made on or after age 60 with unrestricted non-preserved superannuation monies. Any spouse nominated as a reversionary must be aged at least 65 or older.

The deferral period must be in whole years, with a minimum deferral of one year. Payments must start no later than the investment anniversary after a client turns age 100 (or their spouse turns age 100 if they are older and they are nominated as a reversionary).

The image below illustrates a Challenger DLA option with a five-year deferral period for a 65 year-old female client.



The effect of any deferral period on a fixed investment amount, is to increase payments when they subsequently commence following the deferral period. The longer the deferral period, the higher the starting payments available.

The following table illustrates the relationship between deferral period and payment amounts.

Table 1: The relationship between deferral period and payment amounts

		Deferred commencement				
		3 years	**5 years**	**10 years**	**15 years**	**20 years**
65 male	$4,551	$5,278 (+16%)	$5,879 (+29%)	$7,950 (+75%)	$11,332 (+149%)	$17,642 (+288%)
65 female	$4,296	$4,926 (+15%)	$5,440 (+27%)	$7,191 (+67%)	$9,971 (+132%)	$14,846 (+246%)
75 male	$6,483	$8,169 (+26%)	$9,740 (+50%)	$15,873 (+145%)	$32,119 (+395%)	$89,472 (+1,280%)
75 female	$5,977	$7,379 (+23%)	$8,654 (+45%)	$13,594 (+127%)	$25,065 (+319%)	$65,585 (+996%)

Source: Challenger Liquid Lifetime (flexible income option), $100,000 investment, monthly payments, CPI indexation, maximum voluntary withdrawal and death period. Challenger eQuote (30/07/2019).

The effect of any deferral period on a fixed investment amount, is to increase payments when they subsequently commence following the deferral period. The longer the deferral period, the higher the starting payments available.

For comprehensive product details please refer to the Challenger Guaranteed Annuity (Liquid Lifetime) Product Disclosure Statement (PDS).

Social security means testing of a DLA

Where a DLA commences on or after 1 July 2019, 60% of payments will be assessable under the income test. This means that during the deferral period (where no payments are being made) nothing is assessable under the income test.

Under the assets test 60% of any amount invested in a DLA will be assessed as an asset until age 84, or for a minimum of five years. After this, just 30% of the investment amount will be assessed as an asset.

These means test assessments, relative to other income streams or assets, mean that clients receiving a reduced Age Pension because of either the assets or income test, could immediately increase their Age Pension by investing part of their assets in a DLA.

These means test assessments, relative to other income streams or assets, mean that clients receiving a reduced Age Pension because of either the assets or income test, could immediately increase their Age Pension by investing part of their assets in a DLA.

A DLA in practice

There are many ways that advisers can incorporate a DLA into an income stream strategy for a client. The following application demonstrates the benefit of providing a guaranteed layer of income over and above the maximum rate of Age Pension, with either an immediate lifetime annuity or a DLA, to ensure that a client can always meet their essential income requirements in retirement.

Sally and Steve, both age 66, are a recently retired couple who own their own home. They have $300,000 each in accumulated super assets, $50,000 in cash and term deposits they intend to maintain for a rainy day and $20,000 of non-financial assets.

With your advice they've determined that they would like to spend $60,000 p.a. in retirement to provide what they consider to be a comfortable lifestyle (slightly less than the ASFA budget for a "comfortable" lifestyle for a couple of $61,522 p.a. at June 2019). Sally and Steve are a little less clear on what level of income they could 'get by' on if their retirement assets were depleted over time, but are very clear that the maximum rate of Age Pension alone would be insufficient to meet their need.

In Chart 1 below we see modelling from the Challenger Retirement Illustrator projecting retirement income outcomes if Sally and Steve were to roll their superannuation savings to account-based pensions.

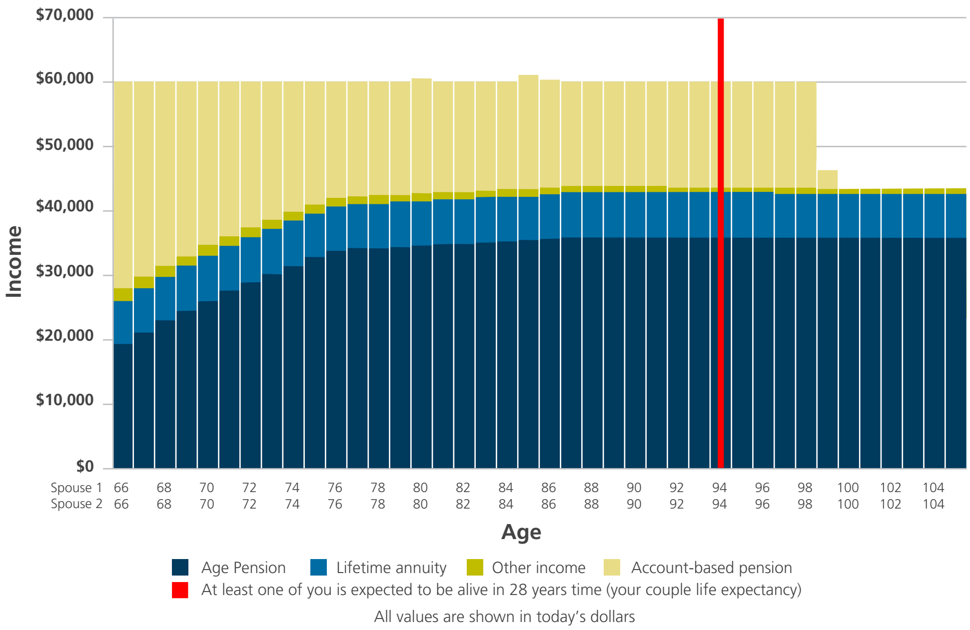
Chart 1: Projected income from an account-based pension only strategy

Source: Challenger Retirement Illustrator as at 09/08/2019. See appendix for assumptions.

We see that Sally and Steve meet their desired retirement income level through to age 94 when their account-based pensions are depleted (coincidentally, the point at which there is a 50% chance that one of them is still alive), but thereafter they are dependant on the Age Pension and a small amount of interest from their cash and term deposits.

If Sally and Steve were to use 25% of their accumulated superannuation to invest in immediate lifetime annuities, we see retirement income outcomes modelled in Chart 2 below.

Chart 2: Projected income from a strategy including 25% invested in an immediate lifetime annuity

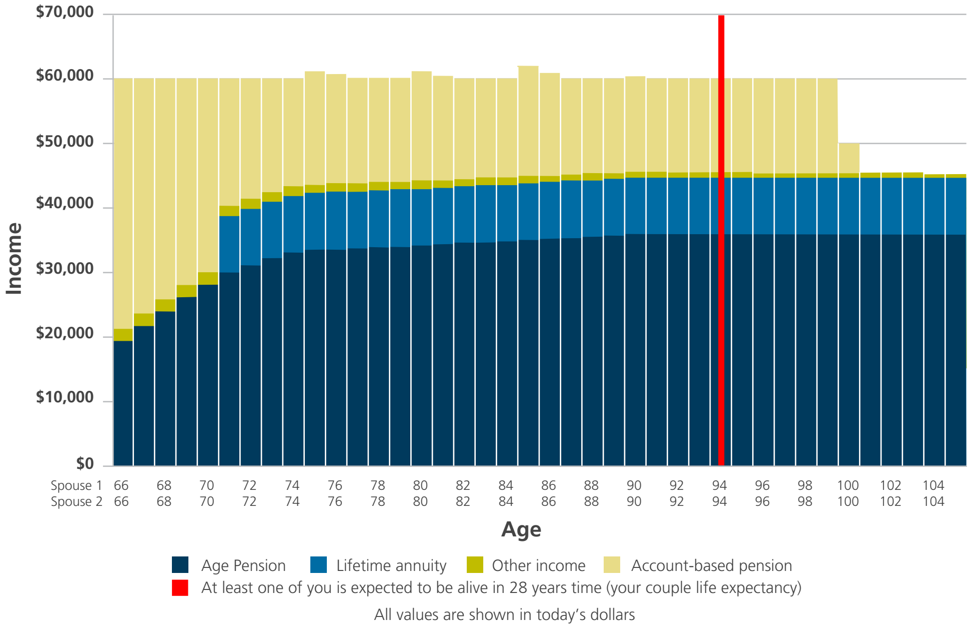


Source: Challenger Retirement Illustrator as at 09/08/2019. See appendix for assumptions.

The retirement income outcomes illustrated in Chart 2 are interesting. We see that when Sally and Steve's account-based pensions are depleted they have continuing income from the Age Pension, interest from their cash and term deposits and $6,639 p.a. (in today's dollars) from their immediate lifetime annuities sustaining a higher level of spending through their remaining retirement. We also see that the projected longevity of their account-based pensions has been extended because of the combination of higher income from the annuities relative to projected defensive returns and higher Age Pension payments (particularly early in retirement).

However, if Sally and Steve were to use 25% of their accumulated superannuation to invest in DLAs (in this case each shown with five-year deferral periods) we see retirement income outcomes modelled in Chart 3 overleaf.

Chart 3: Projected income from a strategy including 25% invested in a deferred (five-year) lifetime annuity



Source: Challenger Retirement Illustrator as at 09/08/2019. See appendix for assumptions.

We see that when Sally and Steve's account-based pensions are depleted they have continuing income from the Age Pension, interest from their cash and term deposits and $8,500 p.a. (in today's dollars) from their DLAs sustaining an even higher level of spending through their remaining retirement. We also see that the projected longevity of their account-based pensions has been extended further because of the combination of higher income from the DLAs relative to projected defensive returns and higher Age Pension payments (again, particularly early in retirement).

The difference in Age Pension payments between Sally and Steve investing via account-based pensions only, or with a 25% allocation to DLAs is shown in Chart 4 overleaf.

Chart 4: Challenger Retirement Illustrator (Sally and Steve)

Under the lifetime portfolio year 1 Age Pension entitlements changed by: +$4,680 / +$180 fortnight

Current portfolio		**Lifetime portfolio** including $150,000 of Flexible income or Enhanced income annuities	
Total assessable assets:	$670,000	**Total assessable assets:**	$610,000
Total assessable income:	$17,776	**Total assessable income:**	$13,276
Applicable pension test:	Assets test	**Applicable pension test:**	Assets test

Estimated fortnightly Age Pension: $570

40% of the maximum Age Pension

Estimated fortnightly Age Pension: $750

53% of the maximum Age Pension

Estimated Age Pension (today's dollars)	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**5 year cumulative**	**10 year cumulative**
Current portfolio	$14,812	$17,412	$19,817	$22,105	$24,237	$98,383	$247,473
Lifetime portfolio	$19,492	$21,897	$24,146	$26,278	$28,293	$120,106	$280,708
Lifetime portfolio difference	**$4,680**	**$4,485**	**$4,329**	**$4,173**	**$4,056**	**$21,723**	**$33,235**
% Change	**32%**	**26%**	**22%**	**19%**	**17%**	**22%**	**13%**

Source: Challenger Retirement Illustrator as at 09/08/2019. See appendix for assumptions.

Conclusion

While DLAs won't suit all clients they can be an extremely useful additional retirement income stream. They provide guaranteed income for life (irrespective of how long a client lives or how investment markets perform) and flexibility to complement other sources of retirement income for clients.

Appendix: Assumptions used in Charts 1 to 4

- Centrelink rates and thresholds as at 1 July 2019.
- Source is the Challenger Age Pension Illustrator as at 09/08/2019.
- Challenger Guaranteed Annuity (Liquid Lifetime) quote as at 09/07/2019 and based on the flexible income option, monthly payments, CPI indexation, nil adviser fees and maximum withdrawal and death benefit periods, immediate and 5-year deferral periods used.
- Assumes lifetime annuities form part of defensive assets. To maintain an overall asset allocation of 50/50 growth/defensive (including the allocation to the defensive lifetime annuity), the asset allocation of the account-based pensions has been adjusted accordingly.
- Account-based pension growth assets return 7.70% p.a. and defensive assets, 3.70% p.a. before management fees of 0.80% and 0.60% respectively. In addition, platform fees are assumed to be 0.50%. Cash and term deposits return 4% p.a.

Contact details

By phone

Challenger Tech team
1800 176 486
(during Sydney business hours)

By mail

Challenger Life Company Limited
Reply Paid 3698
Sydney NSW 2001

By email

challengertech@challenger.com.au

Website

challenger.com.au

38632/0819