

# **Prudential Blueprint for an Australian Lifetime-income Transfer Regime**

*Draft Framework: Technical Design of a Portability and Transfer Value (TV) Regime*

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*The authors thank Tony Boffinger, Philip Clark, Martin Considine, Ben Hillier, Estelle Liu, Brnic van Wyk and Shang Wu for their comments and discussion that have greatly assisted in the development of this document.*

## **Background**

In the [linked Actuaries Digital article](#), we argued that introducing portability for lifetime income streams would make them more attractive to potential purchasers, due to relaxing the irrevocable nature of their purchase. Furthermore, introducing portability to lifetime income streams brings greater consistency with the accumulation phase and account-based pensions in the retirement phase.

Choice of Fund was introduced to Australia in 2005 to allow (most) employees to select which fund their Superannuation Guarantee contributions would be allocated to. Individuals can hence choose where their defined contribution balance will be held, both in the accumulation phase, and for account-based pensions in the retirement phase. This choice extends to portability of the balance between providers at any time of their choosing.

At present those who purchase a lifetime income stream will typically have choice of provider upon initial purchase, but this initial choice is then irrevocable.

The purpose of this document is to outline a draft framework for the portability of lifetime income streams. Transfer value (TV) calculations would determine the amount of assets to be transferred from the original provider to the new provider and used to set up a replacement income stream.

The starting point for these principles reflects the requirements for scheme actuaries in the UK to calculate cash-equivalent transfer values (CETVs) under the Pension Schemes Act. In the UK, this is primarily used for defined benefit pensions before payment, whilst the scope of these principles is broader to include income streams in payment.

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## Document structure

We start by summarising the relevant product landscape and defining which of the products within this landscape these principles would be relevant to.

We then introduce a prudential blueprint (“framework”) for consideration. The framework is numbered for ease of reference. It is not our aim to present a complete framework. Rather, many of the items are only presented briefly, to identify their importance within a complete framework, and to encourage discussion. The sections of the framework are:

1. A **scope** which is broadly complete.
2. Information on **calculation of transfer values**. This is the most detailed part of the framework and is, in our opinion, complete.
3. A **calculation and governance framework** which briefly identifies key considerations.
4. Detail on **communication to members**. This is mostly complete, although 4(e) will need more detail.
5. Some brief points on **mandatory advice requirements**, which are for discussion.
6. Description of the **transfer process**, which is short but should not need substantial discussion.
7. Identification of **anti-selection safeguards** to be applied as part of the framework.
8. Thoughts on whether portability should be made **optional or mandatory**.

Following the numbered items, we provide a brief description of the **key risks** of implementation of portability.

Footnotes and endnotes are both used. Footnotes are typically used to provide references for the point of discussion, whilst endnotes are typically used to provide additional examples and discussion to help explain and justify the framework.

## The superannuation product landscape and scope of this framework

Australia now has a wide range of superannuation product types covering the accumulation phase and retirement phase. An overview of these is set out in Figure 1.

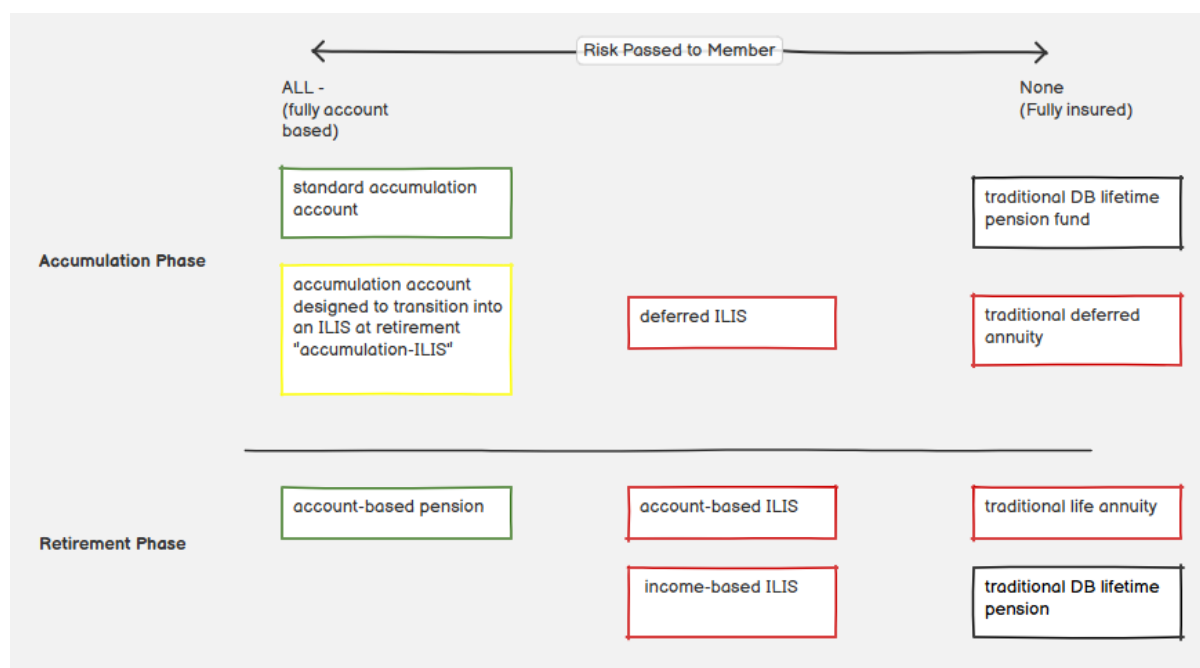
In recent decades, the most common product type has been defined contribution accounts for the accumulation phase and account-based pensions in retirement. Less prevalent, but important historically, are defined benefit funds – which are typically closed to new members.

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In 2017, law changes defined ‘innovative’ lifetime income stream ILIS products to enable a wider spectrum of risk sharing between customers and providers. There are three main requirements for ILIS products<sup>1</sup>:

1. Must provide annual income for life – using an objective basis set out in the governing rules
2. Cannot unreasonably defer benefits to later life
3. Requires some commitment of capital (restricted access to withdrawals and death benefits)

**Figure 1: Range of superannuation product types in Australia**



- Green border** Fully account-based and portable under current rules
- Yellow border** Fully account-based and portable but requiring a simple law change
- Red border** Some form of lifetime income protection by the provider. **These products are the focus of this blueprint.**
- Black border** Defined benefit pensions that are not publicly available. We do not consider these in this blueprint.

It is helpful to provide some background information on the various product types relevant to this blueprint, as the issues around portability differ significantly.

- Lifetime products that deliver an income or deferred income, where members are shielded from some or all financial risks. These have a red border in Figure 1.

<sup>1</sup> [https://treasury.gov.au/sites/default/files/2019-03/c2017-t166981-Explanatory\\_Memorandum.pdf](https://treasury.gov.au/sites/default/files/2019-03/c2017-t166981-Explanatory_Memorandum.pdf)

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The promise to policyholders in these products may be expressed in the following ways:

- *Products framed around an income level that is contractually defined.* This might be in the form of a guaranteed income payment for life (**traditional life annuity** and **traditional deferred annuity**), or by variable payments that transfer investment risk and/or some mortality risk to policyholders (**income-based ILIS** and **deferred ILIS**).
- *Products framed around an account balance plus longevity protection (**account-based ILIS**).* The initial purchase price is the starting balance, with adjustments to the account balance being similar to that of an account-based pension, plus an additional regular longevity payment, which may be guaranteed or pooled. The combined effect delivers a lifetime income where investment performance and non-guaranteed mortality experience is passed to policyholders.
- Deferred products that will transition into a lifetime product at retirement but in the mean time are purely account-based. *All financial risks are transferred to members during deferment with the provider only taking on risk once the transition occurs.* These have a yellow border in Figure 1. Since no reserves are required to be maintained for financial risk in the deferment phase, assets can be fully allocated to individual members at all times.

### Framework

#### 1. Scope

- a) This Framework applies to the portability of products that contain longevity guarantees or pooling.
- b) Portability is prohibited between products where benefits upon death or withdrawal are more generous in the new product than the old product. In particular, transfers from a lifetime product to an account-based pension are prohibited. This is to preserve the integrity of mortality risk sharing.
- c) The Framework does not seek to regulate ordinary superannuation rollovers where no intergenerational or longevity risk-sharing exists.
- d) Nothing in this document is designed to impact bulk-transfer projects managed by APRA / trustees; e.g. if two providers wished to merge.
- e) This Framework does not yet consider defined benefit pensions that are not publicly available.<sup>a</sup>

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## 2. Calculation of Transfer Values (TVs)

- a) For *pre-retirement phase* products that have an explicit accumulated account value, and no guaranteed longevity rates or provisions have accrued to the member yet, the TV must be equal to that account value.
- b) In all other cases apart from 2(a), TVs must be based on the **actuarial present value (APV)** of all remaining future payments the member would have received if they remained in the current product, including the value of future guarantees. This includes:
  - i. All guaranteed income payments, including any guaranteed or expected increases in income or bonus rates. This includes estimation of any income adjustments based on partial year experience and not yet applied to income payments.
  - ii. Reversionary/spouse benefits.<sup>2</sup>
  - iii. Death benefits, including capital access schedule limits to the benefits payable.
  - iv. Any embedded options (e.g. minimum return guarantees, inflation linkage).
- c) In calculating the APV under 2(b), the core TV assumption basis is:
  - i. Income payments reflecting that currently being paid, or accrued to be paid, to the member.
  - ii. Mortality assumptions reflecting the current pricing basis<sup>b</sup>, with the exception that any age-period selection effects for new business may be applied based on the age and timing of original product purchase.
  - iii. Discount rates reflecting the current pricing basis (where income payments are not impacted by underlying asset returns) or the hurdle rate equivalent to the current income payment (where income payments are dependent on underlying asset returns).
  - iv. Future costs reflecting the current pricing basis.
  - v. Where a current pricing basis does not exist (e.g. for products closed to new business), assumptions in 2(c)(i)-(iv) should instead reflect liability valuation assumptions.

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<sup>2</sup> See Section 7(b).

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- d) The following additional principles apply to the TV calculation<sup>6</sup>:
  - i. For products where all financial risks are shared between members, the calculation of TV must represent the member's interest in the pool when fully allocating all assets of the pool, taking into account 2(b) and 2(c).
  - ii. There should be no opportunity for arbitrage; i.e. a policyholder should not be able to take a TV and immediately reinvest it in the same product with the same provider to obtain a higher income payment.
  - iii. The TV should not be larger than the *ongoing account balance*, where available.
  - iv. Where an *ongoing account balance* is not available under 2(d)(iii), the TV should not be larger than the calculation of TV using the pricing basis from the initial purchase in 2(c) instead of the current pricing basis.
- e) Exit fees limited to the actual cost of unwinding guarantees and/or sale of illiquid assets are allowed.

### 3. Calculation Governance Framework

- a) The TV basis must be:
  - i. Proposed by the **Appointed Product Actuary** (Fellow of the Actuaries Institute).
  - ii. Approved by the **Trustee board**.
  - iii. Reviewed at least annually.
- b) APRA oversight:
  - i. Mandatory notification of high-level basis description.
  - ii. APRA power to challenge unreasonable assumptions.
  - iii. May suspend transfers under solvency concerns.

### 4. Communication to Members

A TV quote must be available on request by the member and include:

- a) The TV amount.
- b) Information to empower side-by-side comparisons:
  - i. Current income payment level.

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- ii. Embedded guarantees.
  - iii. Factors affecting income payment level, including, where relevant, increase rate rules, investment strategy, hurdle rate and longevity pooling.
  - iv. Information about death benefits, withdrawal benefits, reversionary benefits.
- c) Notification that the TV will change between the quote date and exercise date due to specific factors; e.g. investment returns and indexation adjustments (if applicable), longevity payments, income paid, etc.
  - d) Clear statement on guarantees/benefits and underwriting (see Section 8(d)(ii)) that may be lost on transfer to a new provider.
  - e) Sufficient information to allow an adviser to compare various longevity and market scenarios for the member.

### **5. Mandatory Advice Requirements**

- a) Mandatory independent financial advice if:
  - i.  $TV >$  specified threshold (e.g. \$200,000).
- b) Adviser must:
  - i. Hold retirement income specialist accreditation.
  - ii. Demonstrate understanding of longevity risk.
  - iii. Use appropriate tools including the probability of living to each age.
- c) New provider prohibited from:
  - i. Paying for the client's advice fees.
  - ii. Providing inducements to switch.

### **6. Transfer process**

- a) Previous provider must supply:
  - i. Date of original commencement.
  - ii. Capital access schedule position.
  - iii. Tax and Age Pension asset test components.
  - iv. Spouse's details.

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- v. Underwriting applied. (See 7(d)(ii)).
- b) New provider must:
  - i. Incorporate prior capital access settings.
  - ii. Recognise tax and Age Pension asset test status continuity.
  - iii. Confirm basis for new pricing, where it differs to other new customer pricing, including any transfer of underwriting provisions. (See 7(d)(ii)).
- c) Legislation must allow for this transfer of settings.

### 7. Anti-Selection Safeguards<sup>d</sup>

- a) Prohibit targeted marketing to members in poor health; e.g. since high hurdle rates increase short-term income level, limit hurdle rates that can be applied.
- b) Reversionary benefits:
  - i. Single-life policies: Reversionary benefits cannot be added when switching from one provider to another if not already in place with the previous provider.<sup>e</sup>
  - ii. Joint-life policies:
    - Where both spouses are alive, the new product **must** also have an identical reversionary benefit set up for the same individuals.<sup>f</sup>
    - Where one spouse has passed away, and the TV is now based on a single-life, the new product must also be a single-life policy.
- c) The new provider may not offer more generous death/withdrawal benefits than the member was receiving under the previous provider.
- d) Underwritten (“Enhanced”) lifetime income streams:
  - i. Underwriting can only occur on the first purchase of a lifetime income product. New providers would not be permitted to attract less healthy customers by offering them higher payments by transferring to a product that is underwritten.
  - ii. Where a product was underwritten on first purchase, a ratio of underwritten income divided by “non-underwritten” income would be calculated. New providers could choose to maintain this or a smaller ratio for the transferring customer.<sup>g</sup> Previous providers should issue

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warnings about switching from underwritten to non-underwritten products.

### 8. Optional vs Mandatory Provision of TVs

Policy design choice:

a) **Option 1 – Mandatory TV regime**

All lifetime income products covered under 1 must offer TVs.

b) **Option 2 – Optional regime (preferred by authors)**

Providers may elect to allow TVs or not; e.g. to give new customers more confidence to buy their product. If offered it must be offered to all customers of that product. Providers may offer a portable and non-portable version of the same product – with different pricing to reflect liquidity implications.

### Key Risks Identified

- Adverse selection. Whilst we have tried to address this in 7, a key unresolved issue is around gender-based pricing. At present, some providers have unisex prices and some have separate-gender prices. There is some potential that this environment may incentivise transfers from females to unisex-priced products and males to gender-priced products, although we are unaware of this currently being an issue in the sale of these products.
- Cost of implementing this regime (admin, actuarial, member communication, adviser education, regulator oversight).
- Product repricing pressure (where TV availability changes the predictability of the risk pool, requiring providers to incorporate additional margins).
- Erosion of fixed cost sharing and/or mortality pooling for some providers; i.e. small pool risks.
- Poor and/or systematic bad advice around transfers.

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## Endnotes

<sup>a</sup> (Section 1(e)) Our rationale for not yet extending the framework to defined benefit pensions is that defined benefit pensions are not subject to choice of fund rules in the accumulation phase, and so can be fairly excluded from portability in this framework. Furthermore, as far as we are aware, defined benefit funds in Australia tend to also offer an alternative defined contribution (accumulation phase) or lump sum (retirement phase) option. Therefore, at the point of retirement, an offer of a defined benefit pension does not preclude participants from instead choosing an account-based pension or transferring any lump sum option into an alternative lifetime income stream.

<sup>b</sup> (Section 2(c)(ii)) Using current new business assumptions when calculating TVs helps to ensure that policyholders cannot arbitrage against providers (see 2(d)(ii) and Endnote (c)).

<sup>c</sup> (Section 2(d)) The principles underpinning TV calculation under 2(d)(ii)-(iv) can best be explained using an example. Imagine a customer owns an account-based product with a balance of \$200,000 at the time of transfer. This product was initially priced on assumption basis A (e.g. mortality rates, discount rates). As per 2(d)(iv) this \$200,000 would also be the TV under assumption basis A, since the account balance can be viewed as the “retrospective reserve” APV using assumption basis A.

Imagine now that the assumption basis had changed so that the calculation under 2(b) gave a TV of \$250,000. This might be because the new business assumption basis B incorporated lower mortality rates and/or lower discount rates than A. The additional \$50,000 represents the difference in value to the customer of the income stream under assumption basis B compared to A. A customer who chooses to transfer their income stream is choosing to give up the guarantees implicit in A. Under this blueprint, the customer would not be compensated for doing so, nor should the provider be required to fund the higher TV. Therefore, as per 2(d)(iii)-(iv), the TV would be equal to \$200,000.

Imagine instead that the assumption basis had changed so that the calculation under 2(b) gave a TV of \$150,000. This might be because the new business assumption basis B incorporated higher mortality rates and/or higher discount rates than A. Were the TV calculated as the ongoing balance of \$200,000, the customer would have an arbitrage opportunity to immediately increase their income stream by transferring \$200,000 to the same product under assumption basis B. Therefore, as per 2(d)(ii), the TV in this case should be equal to \$150,000 to remove this arbitrage opportunity.

What this effectively means is that the TV is calculated as the minimum of:

- (for account-based IRIS products) the ongoing account balance (equal to the valuation under the pricing basis from initial purchase),
- (where an ongoing account balance is not available) the calculation of the TV using assumption basis A, and
- the valuation under the current pricing basis.

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<sup>d</sup> (Section 7) Anti-selection safeguards are implemented to ensure that customers with ill-health are not incentivised to switch to a product that provides higher short-term income, as this would put a strain on the previous provider's finances that was not anticipated when the income stream was initially set up.

<sup>e</sup> (Section 7(b)(i)) If reversionary beneficiaries were allowed to be added on transfer, members with ill-health may opt to transfer to add a healthy reversionary to the new product.

<sup>f</sup> (Section 7(b)(ii)) Similarly to Endnote (e), if reversionary beneficiaries were allowed to be removed on transfer, members with a beneficiary in ill-health may opt to transfer and remove the beneficiary to obtain a higher single-life income level.

<sup>g</sup> (Section 7(d)(ii)) As per 7(d)(i), underwriting is not allowed on transfer. However, 7(d)(ii) allows the new provider to maintain the original or less generous underwriting arrangements, with this being at the discretion of the new provider.