JUST.

THINK

A FRESH PERSPECTIVE

MORTALITY: HOW A LACK OF CROSS-SUBSIDY CAN BE A REAL DRAG

Mortality cross-subsidy and mortality drag are two terms at the heart of the 'guaranteed income for life solution (GIfL) , provided by an annuity, versus drawdown' conundrum. Understanding the principles of cross-subsidy and the corresponding drag effect can be a challenge for a retiree – but it can also have a big impact on the decision they make.

So why do the two mortality factors matter?

With pension freedoms now firmly in place, people can use their hard-earned pension pots for whatever they see fit (rather than just for income). So why do we need to worry about cross-subsidy and drag effects?

The short answer is: they both still matter and are ignored at the retiree's peril. The long answer's more involved but can help when explaining both concepts to retirees – so it's worth reviewing.

Firstly, we tackle the science bit: explaining what mortality cross-subsidy and mortality drag are and how they work.

Mortality cross-subsidy

The cross-subsidy effect exists within a 'pooled risk' and applies to GIfLs. The provider works on the basis that some plan holders will die sooner than their anticipated life expectancy. These people subsidise those who live longer than expected.

The people who live longer than expected benefit from proportionately higher rates. These income rates exceed those they'd get if they lived to their exact life expectancy. This is paid for by the people who die early.

Of course, this isn't an exact science. Longevity is a game of averages. But with a big enough pool of people, those guesses become highly educated ones.

Mortality drag

The drag effect is caused by the absence of a cross-subsidy. It means trying to describe the impact of something that isn't there. This can be a really difficult concept for retirees to understand.

You could describe it as follows:

When a retiree moves into drawdown, their risk is based on a pool of one – they're on their own. So, they don't benefit from other retirees dying earlier than expected and subsidising their own income if they happen to live to a ripe old age. The drag effect represents the additional investment growth needed to justify a retiree not securing GIfL.

The missing link?

When comparing GIfL against drawdown, it's important to understand how these two principles work and fit in. Confusion about them leads to a blurring of the lines between what they represent in terms of insurance and investment.

The difficulty, in part, is that mortality drag is trying to describe the 'value' associated with the longevity insurance element of GIfLs. But this value is presented in an investment context. If retirees can't see the benefits of the hedging effect that cross-subsidising represents, they can't easily quantify the equivalent additional growth required within their drawdown portfolio.

Challenging the myths

The post-freedoms shift from GIfLs towards drawdown has been partly due to a desire for flexibility on the part of the retiree. If this point is challenged robustly enough, it's often a short term objective which ultimately belies simply retaining access and control.

Another anti-GIfL perception is that "they don't pay much", or "the returns are poor". This leaves aside the fact that underwritten GIfLs counteract this assumption. And it's this view that sums up the 'insurance vs investment' confusion.

A little context might help retirees understand the decision they're making regarding the different products. A GIfL is designed as an insurance against outliving your money, not as an investment vehicle for growth.

As for rates of return, ask a fund manager how challenging it is to commit to paying 5% income using a finite amount of capital – and only investing in gilts and corporate bonds. Consider it has to be guaranteed never to fall, year-in year-out, for an open-ended term. In this light, the 'value' question takes on a different perspective.

Great expectations

The effect of mortality drag is an ongoing problem for anyone in drawdown. It starts the minute they become invested, and steadily increases with age. And if retirement income is the objective from a drawdown solution, it may become increasingly unsuitable over time.

Every year a retiree's in drawdown, they become increasingly reliant on a robust review of their plan. This is to make sure it keeps pace with their objectives and for comparison with the income they could've bought with a GIfL.

Working out the impact of mortality drag when comparing a GIfL with drawdown is complicated. GIfL rates used for comparison within the critical yield calculations may not be the most appropriate to use – if they're based on standard GIfLs.

If underwriting isn't reflected, the potential for achieving an increased personalised GIfL rate will be missed. This means the expectation of investment returns required from a drawdown review will be negatively skewed. And it makes the critical yield figure meaningless. Also, the continued use of standard GIfL rates in critical yields only leads to future confusion and disappointment for drawdown investors.

Even if drawdown providers are fulfilling the criteria as laid down in the original rules, the world has moved on. And new improved underwriting expertise means many people now qualify for personalised GIfL rates.

Also, underwriting parameters are becoming wider. This means relatively minor lifestyle conditions – or even just a postcode – can now have an impact on the rate quoted. So, surely this makes the individually tailored, underwritten GIfL rate the new standard for comparison – the new benchmark? The obligatory standard rate is now outdated and even in danger of being misleading. In the future, could it cause complaints – and even professional indemnity insurance problems – for advisers?

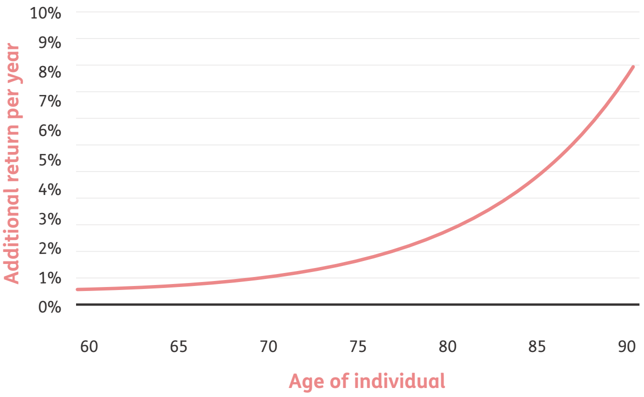
That said, most advisers already include underwriting when conducting a drawdown review. However, we're far from having a consistent approach across the advice spectrum – especially where portal quotes are concerned.

It may not pay to delay...

One further area where both mortality cross-subsidy and drag can have an impact is the age at which a drawdown client buys a GIfL. A common strategy is that the client waits until they're at a much older age to buy a GIfL. This is because income rates will have improved due to their advanced years.

The shape of the mortality drag curve most people are familiar with tends to support this view. As a retiree gets older, the corresponding income rates from a GIfL increase. This means there's an additional rate of return required to match a GIfL with other products that don't have the cross-subsidy effect (for example, drawdown). It also means GIfLs start to look increasingly attractive over drawdown.

Mortality drag increase over time starting at age 60



However, the flaw in this argument is that it's typically based on a comparison with standard, non-underwritten rates. By including underwriting, the retiree can get a more accurate 'age equivalent' rate – effectively creating an individual curve. As a result, it could dramatically change the timing of their drawdown exit.

For example, a 65-year-old with a £50,000 fund could receive a standard income of £2,477 each year. If they waited until they were 70, the standard rate would mean an income of £2,877 each year.

The same 65-year-old could get a personalised GIfL income of £2,774 each year if they:

- were underwritten;
- had type 2 diabetes; and
- high blood pressure.

This means they could get a similar 'age equivalent' rate of a 70-year-old standard GIfL – without having to wait a further five years to attain it.

That's why including underwritten rates in comparisons at reviews could mean retirees can more accurately adapt their retirement strategies.

Gradual phasing, over time, from their drawdown portfolios into a GIfL can have an impact, too. It could shore up their longevity risk and offset the impact of mortality drag.

Summary

For the large majority, a pension remains either the sole or primary asset for generating an income in retirement.

Understanding all the risks attached to particular products can be a challenge for retirees. But perhaps the biggest challenge for advisers is trying to explain:

- the concept of what gives 'value';
- when that value is absent; and
- the measures required to counterbalance and compensate for the risks generated.

Trying to pinpoint a single age someone should exit drawdown to take advantage of GIfL rates is slightly self-defeating. This is because it isn't a straight-line calculation. There are complications to consider, including:

- underwriting;
- personalised rates;
- longevity averages; and
- unpredictable investment returns.

Maybe the last word should be from George Foreman, former world heavyweight boxing champion and grilled-food enthusiast:

"The question isn't at what age I want to retire, it's at what income."

Tony Clark

Proposition Marketing Manager

JUST.

FOR MORE INFORMATION

Call: **0345 302 2287**
Lines are open Monday to Friday, 8.30am to 5.30pm

Email: **support@wearejust.co.uk**

Or visit our website for further information: **justadviser.com**

Please contact us if you would like this document in an alternative format.

Financial Adviser SERVICE AWARDS 2016

1312585.1

06/2017