JUST.

TECHNICAL
BULLETIN

LONGEVITY IN FOCUS

The introduction of pension freedoms led many to question the role of longevity insurance – typically in the form of an annuity – in the future of retirement solutions. The transfer of risk away from insurance providers and onto individuals poses a risk to advisers with the advice they give. Some clients may decide there's no longer a need for longevity insurance. Others may see some value in it but perhaps insure a smaller amount of retirement income. And others might defer when this longevity insurance takes effect.

Whatever conclusion is reached, the main consideration will be the risk of the client running out of money. Factors that could lead to this include:

- longevity risk;
- inflation risk;
- investment risk;
- ongoing costs; and
- risk of making mistakes or irrational decisions.

This bulletin focuses on the impact of longevity risk.

What do we mean by longevity?

Longevity is a term used to define the length or duration of a life.

The life insurance industry invests a significant amount of expertise, resource and time into understanding the chances of individuals or groups living to, or dying at, a particular age. Clearly, there are significant costs at stake if the actual life expectancy experienced is different to the predictions made. The benefits of collective risk pooling (mortality cross-subsidy) and access to additional capital, in the form of reassurance, means insurers can manage their longevity risk.

One impact of the April 2015 pension changes is that some of this longevity risk has been transferred away from the insurance industry and onto individuals. This is because of an increase in people using drawdown products instead of annuities. This presents a particular challenge, as this group will now need to come to terms with this additional risk – an annuity is the traditional hedge against the risk of living longer than expected.

Clients planning their retirement should consider the risks of:

- living longer than anticipated and potentially running out of money; or
- underspending because they're worried about running out of money.

We believe it's important that customers don't underestimate how long they may live. Research by the Pensions Institute highlights the fact that people tend to significantly underestimate their own life expectancy. Whilst this underestimation decreases with age, men in their 60s underestimate by an average of five years and women by three years[1].

[1] http://www.pensions-institute.org/wp-content/uploads/2019/workingpapers/wp1409.pdf

Assessing longevity

Many financial advisers incorporate cash flow modelling as part of retirement or long-term care decisions and the inclusion of a terminal age becomes increasingly important.

Part of such modelling includes working out a credible life expectancy figure. Too low an age, and the client may be encouraged to deplete resources faster than is sustainable. Too high, and the client will underspend and not make use of all their wealth.

Most pension providers now offer a range of tools to help clients during their retirement journey, including considerations around life expectancy. Our longevity tool, available on justadviser.com, draws on actuarial data for individuals to underpin the outputs. This tool focuses on the chances of living to a range of ages rather than the expected age. We believe it's important, not only to consider when you might be expected to live to on average, but also what your chance of living beyond this is.

The Office of National Statistics (ONS) regularly publishes data on trends in life expectancy, which feeds into their longevity calculator. You can find out more about this on the ONS website under 'How long will my pension need to last'. This tool provides an average life expectancy based on the general population (and is therefore using different data from our tool). It also highlights the chances of reaching a later age than the average. There's no certainty that an individual will live to the average life expectancy, they could die before it or live beyond it.

It might be tempting to try and simplify the longevity question and assume an average life expectancy – but then, what is average?

Within the ONS data, life expectancy is shown to vary between gender, countries within the United Kingdom (England, Wales, Scotland and Northern Ireland) and for regions within the UK. For example, ONS life expectancy for a 65-year-old man in England is shown to be highest in Kensington and Chelsea (where he is expected to live a further 21.6 years) and lowest in Manchester (where the corresponding age is 15.9 years)[2]. So, even before an adviser considers any specific factors that might apply to a particular client, it's already apparent that relying on an average age should be treated with caution.

Impact of health on longevity

In recent decades, there have been rapid advances in medical research and the treatment of disease. If those medical advances continue, people might end up living for longer. Counteracting that is the rise of lifestyle-linked diseases such as diabetes. All of which makes current predictions even more transitory.

We understand that health has a significant impact on life expectancy. That's why we've incorporated this added factor into our longevity calculator – to show the impact that different health conditions have on longevity.

The following examples use health assumptions to show what 'good' and 'poor' health might look like:

- A person in 'good health' is typically a non-smoker, neither over nor under weight, who looks after their health and doesn't take any prescribed medication for controlling particular conditions.
- 'Poor health' assumes a person has had a more serious medical condition or risk factor. For example, they've had cancer, their diabetes is difficult to control or they've recently suffered a stroke or a heart attack.

An inaccurate estimation on the quality of a client's health (and therefore longevity prospects) could have drastic consequences on their financial position. This could lead to an over or underspend of retirement wealth.

Regardless of the retirement solutions used, it should be considered good practice to get some key information from the client to help form a view on how long income is required.

This information could focus on:

- personal health;
- lifestyle (for example, do they smoke?);
- family medical history (to identify any inherited factors which may impact them); and
- employment history (for example, exposure to harmful materials).

Clearly an inaccurate estimation on the quality of their health and by extension longevity could lead a client to over or underspend their retirement wealth.

[2] https://www.ons.gov.uk/peoplepopulationandcommunity/birthsdeathsandmarriages/lifeexpectancies

Managing longevity risk

Clients with defined contribution pensions will need to consider longevity risk most carefully. This longevity risk might be less significant for clients with access to other sources of retirement income such as final salary pensions, state pensions or further capital.

Those who rely heavily on their defined contribution savings will need access to a stable and reliable income stream for life. They can get this kind of income stream from a number of differing retirement solutions and investment strategies.

It is possible to assess how sustainable that income may be. However, this will always be underpinned by an assumption about how long the income will need to last before the client dies. Therefore the presence of longevity risk remains in those calculations and will still need to be considered.

The main benefit of an annuity is that people transfer their longevity and investment risk to the provider. Their perceived drawbacks are lack of flexibility and loss of capital – particularly if the customer dies earlier than expected. However, there are now a number of different features available to address this. These include extended guarantee periods and value protection.

Now that drawdown is being used more widely in retirement, regular financial reviews are needed by retirees not only to consider investment performance but also how long the funds are needed.

Positioning these retirement reviews as a series of retirement phases may help engage the client, as well as guide thought processes.

Clients in their 60s and 70s are more likely to want flexibility for their funds. Retired clients – those in their 70s and 80s – might want the additional certainty of income, and simplification of financial affairs.

Alternatively, it may make sense to discuss a client's personal minimum income requirement early on in retirement discussions. This will vary between clients. An annuity can help secure their personal minimum income requirement, which in turn reduces the impact of any residual longevity risk associated with those elements of retirement wealth that are to remain.

Conclusion

Longevity risk must be carefully considered and, where it is not immediately hedged, regularly reviewed.

Just as each client's retirement is different, so too are their potential retirement solutions. Whatever strategy they go for, they need to protect themselves against underestimating longevity and overestimating investment returns. If they do this, they can minimise unexpected retirement outcomes.

Given the complexity of longevity risk, managing it effectively is a crucial part of ongoing retirement planning. We have to ask; how many clients are aware of the longevity risk present as a result of selecting drawdown? Even if they do understand that risk, can they effectively manage it themselves?

FOR MORE INFORMATION

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