SUPER SYSTEM REVIEW
FINAL REPORT

CHAPTER 7

Retirement

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CONTENTS

KEY THEMES

Issue

The retirement income product market has been under-developed, largely reflecting the relatively small balances that many retiring workers hold as a consequence of the quite recent introduction of the compulsory SG Act system (being less than 20-years old). Australians have historically favoured lump sum superannuation benefits, partly because that is all that most funds have offered.

Currently, the market is dominated by account-based products in which the risks associated with investment markets and inflation (and longevity) are directly borne by the member. There is a need with an ageing population for more retirement products to be available for members.

Proposed solution

The Panel proposes measures, including:

- requiring MySuper trustees to offer a retirement product to MySuper members;
- requiring MySuper trustees explicitly to consider longevity and inflation risks when developing investment strategies for post-retirement members; and
- requiring MySuper trustees to offer pro-actively advice periodically to members planning for, or already in, retirement.

Benefits for members

Members will benefit from these measures to improve the design and availability of retirement products as:

- members can use intra-fund advice when planning for retirement and selecting retirement income products (including income streams);
- the market may respond with more innovative products as trustees focus more explicitly on members' longevity risks; and
- members will have the ability to stay in one MySuper product while working and in retirement.

1 RETIREMENT

1.1 Retirement income as the primary rationale of the superannuation system

While much of the focus in superannuation is on the accumulation phase, the primary reason for the existence of Australia's superannuation savings regime is to provide income for Australians in their retirement. This is already reflected in the 'sole purpose test' — the statutory definition of the purposes for which a superannuation fund must be maintained.[1] More broadly, the Panel considers the government and the superannuation industry should be emphasising to members that the retirement phase of a person's participation in the superannuation system is the key purpose for the accumulation of superannuation savings.

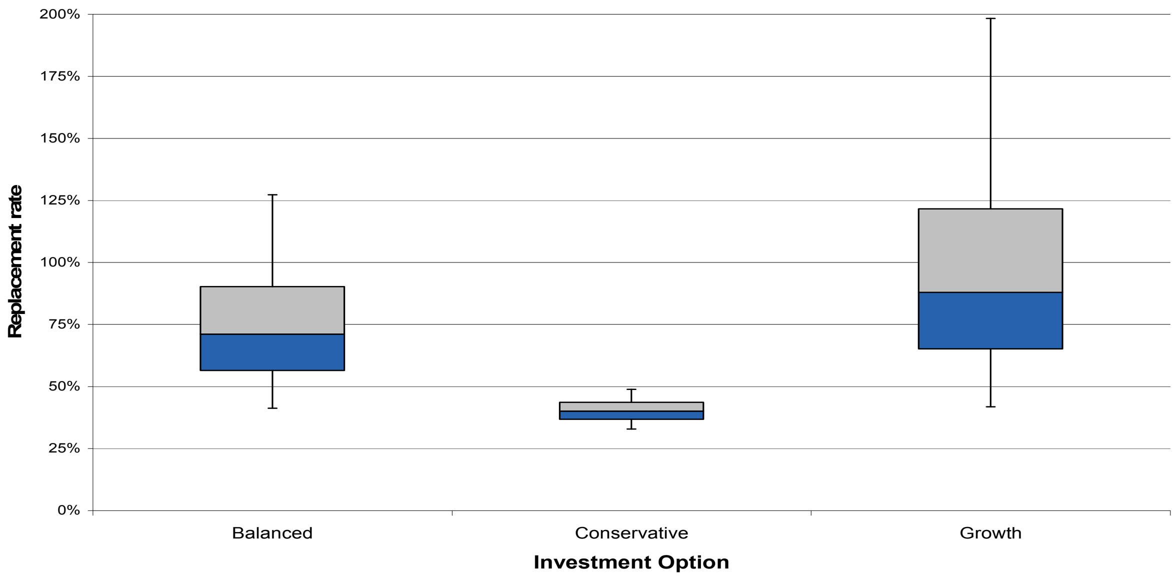
1.2 Superannuation as an element of the broader retirement system

The superannuation system is part of a broader 'retirement system'. Superannuation provides a government assisted capacity to generate private income, and this is supplemented by extensive direct public support for retirees (through the age pension, public health support, aged care provision etc), as well as other personal saving and assets, principally the family home. All of these factors help shape the retirement experience of individuals. It is important that these policies work in a coherent way to ensure that people have the right incentives and support to maximise their wellbeing in retirement. These are not matters within the scope of this Review. However, it is important that funds, members and advisers take account of these broader issues.

1.3 Managing investment risk up to retirement

As the great majority of Australians are in defined contribution schemes, their final superannuation benefit is substantially affected by investment returns and associated risk. This is shown in Figure 7.1 below.

Figure 7.1: Distribution of final superannuation benefits by investment option (based on 12 per cent SG contributions)

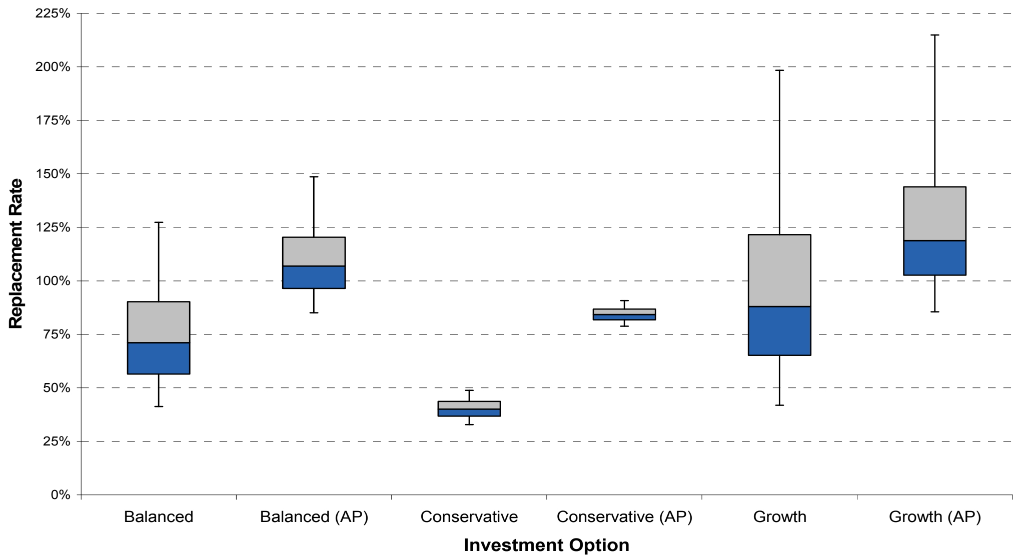


Note: Boxes represents interquartile ranges. The range represented by the line is from the 95th percentile to the 5th percentile of outcomes. The range represented by the grey box is from the 75th percentile to the 50th percentile, while the range represented by the blue box is the 50th percentile to the 25th percentile. The line in the middle of the box represents the median outcome. The replacement rate is the average annual CPI-deflated retirement income as a percentage of a person's final pre-retirement net income. The AGA modelling is based on a final pre-retirement net income of $50,000. Replacement rates are calculated using an assumption of constant earnings during the retirement phase and assuming a draw down such that capital is exhausted when the member reaches average life expectancy. Source: Australian Government Actuary.

This shows that there can be significant differences in superannuation balances at members' preservation ages depending on the investment option chosen, whether by the trustee in its MySuper strategy or by members in the choice environment. However, even for a given asset allocation, returns can vary substantially because of variability in asset performance over long periods of time. In other words, different 40-year accumulation periods can result in very different superannuation benefit outcomes.

While this shows that members face substantial uncertainty, the situation is substantially altered once the age pension system is taken into account. The age pension both increases retirement incomes for those who experience adverse investment outcomes from their superannuation during the accumulation phase and, due to the age pension taper rate, reduces the variability of retirement incomes. For low and middle income earners, the age pension increases retirement income whether or not they have adverse investment outcomes.

Figure 7.2: Distribution of final superannuation benefits by investment option, with and without the age pension (AP)



Source: Australian Government Actuary.

Another important consideration is that Australia does not require members to take their superannuation as an annuity on retirement. In countries with compulsory annuitisation, members of defined contribution schemes can be locked into lower income streams if markets fall shortly before their retirement as the value of the annuity is based on the value of their lump sum and market conditions on retirement day. In contrast, Australians can continue to invest in growth assets after retirement and thus potentially benefit from subsequent market upswings. The income guarantee provided by the age pension means that members experience minimal downside risk from an exposure to growth assets throughout their working life, while having considerable upside. This outcome has also been recognised by AustralianSuper, which recently reviewed its default investment option for pension accounts and decided to retain the balanced option as the default until age 75.[2]

While the age pension reduces the effect of investment risk on low and middle income earners, the Panel also considered other means of reducing investment risk in the pre-retirement phase; specifically life cycling investment options and reserving. However, the analysis suggested that there is not a strong case for mandating either lifecycle investing or reserving mechanisms to smooth investment returns. Submissions also argued against mandatory measures in this regard. Instead, the Panel believes the best approach is for trustees to consider carefully default investment options in the light of overall member needs and for members to consider their individual circumstances as they approach retirement.

2 THE RETIREMENT PHASE

While the ultimate purpose of superannuation is to provide benefits in retirement, the majority of the industry's attention to date has been paid to the accumulation phase. This is not particularly surprising given that the system is still maturing. It is only since 2002 that workers have had the benefit of the 9 per cent SG level. Accordingly, superannuation balances on retirement are typically small and make a modest contribution to the total income an average worker will receive in retirement. The median superannuation balance for people aged 55-64 years old in the accumulation phase is only $72,000.[3]

A feature of Australia's system is the flexibility people have in how they take their retirement benefits. Unlike some other countries, people are free to take superannuation as a lump sum, whether to invest outside the super system, repay debt or for immediate consumption. For those who take their benefits in whole, or in part, as an income stream, the system is dominated by account-based products in which the risks associated with investment markets, longevity and inflation are directly borne by individuals to a greater extent than most, if not all, other comparable jurisdictions.

The market currently offers a range of retail and individual products to convert a lump sum to a retirement income stream. Examples include guaranteed lifetime or term annuities and account-based pensions. A common characteristic is that they do not accept contributions.

In Australia, account-based pensions account for about 88 percent of the post-retirement assets compared to guaranteed lifetime or term annuities which account for the balance.[4] Although account-based pensions provide a regular income stream, they cannot, on their own, guarantee the security of income over a member's lifespan in retirement though, as noted in section 1.3 above, the volatility of an individual's income is cushioned by the availability of the age pension.

However, the retirement product market is changing for three key reasons: increasing account balances as the SG system matures; an increasing number of people in the market with the retirement of the baby boomers; and higher life expectancies. These factors have led to a surge of new ways to deliver post-retirement solutions — and presented challenges to industry participants, regulators and the government to structure, manage and supervise these solutions.

Longevity risk is increasing given that life expectancies are increasing. As both the number of retirees and their account balances increase, the importance of managing longevity risk will increase substantially.

2.1 Size of the post-retirement superannuation system

The number and proportion of Australians drawing pensions from superannuation funds has increased substantially in recent years, although the proportion of total account numbers is still quite modest at around 2.3 per cent, as seen from table 7.1. However, as a proportion of the total population of pensionable age, the share is much more significant at around 23 per cent, and growing strongly. Treasury estimates that the number of people receiving some form of superannuation pension will roughly double to 1.4 million by 2035.

Table 7.1: Pension members in large APRA funds

	2004	2005	2006	2007	2008
No. of pension accounts	399,486	447,769	519,115	581,564	689,158
No. of super accounts	24,380,516	25,966,194	26,952,436	28,261,950	29,781,552
No. of people of age pension age	2,794,392	2,811,623	2,872,792	2,904,716	2,983,222
Pension accounts as % of all people of pension age	14.30	15.93	18.07	20.02	23.10
Pension accounts as % of super accounts	1.64	1.72	1.93	2.06	2.31

Note: Account figures exclude exempt public sector superannuation schemes.
Source: *2010 Intergenerational Report* and *APRA, Superannuation Fund Level Profiles and Financial Performance,* December 2009.

Pension accounts are typically of a much higher value than accounts in the accumulation phase so that the share of assets in the retirement phase, estimated at 20 per cent of all superannuation assets in 2009 (refer to table 7.2), is far higher than the 2.3 per cent share of all super accounts. This asset share will grow substantially. Analysis by Rice Warner Actuaries suggests that by 2024, post-retirement assets will comprise more than a third of total assets, up from a fifth at present and will be worth $1.5T in nominal terms. Similarly, Treasury estimates that post-retirement assets will more than triple by 2035 to reach $850B in real terms.

Table 7.2: Post-retirement market: assets

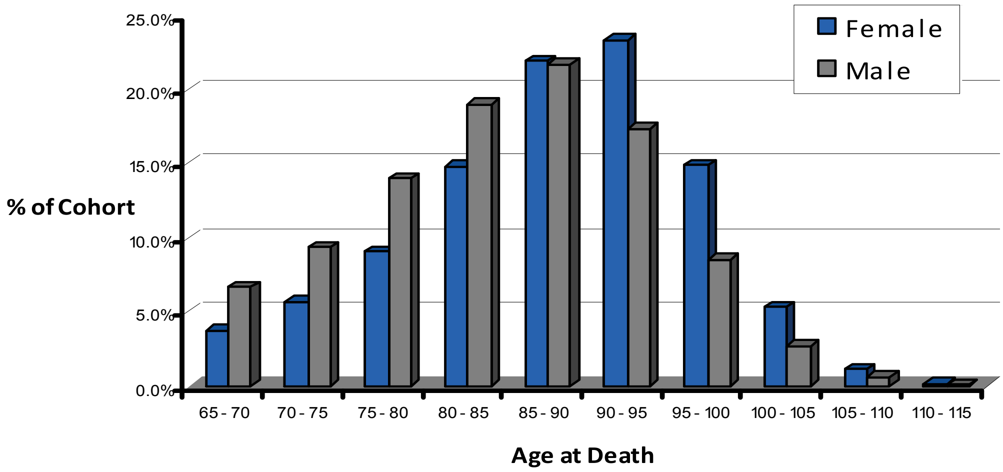
	2009		***2014***		***2019***		***2024***	
	$M	%	$M	%	$M	%	$M	%
Corporate Funds	7,030	3.3	6,514	1.4	3,012	0.3	1,239	0.1
Industry Funds	18,810	8.8	76,113	16.8	193,560	22.0	367,429	24.8
Public Sector Funds	32,353	15.1	49,950	11.0	74,382	8.5	113,304	7.7
Retail Funds	97,162	45.4	204,305	45.0	399,486	45.5	675,581	45.7
SMSFs	58,693	27.4	117,068	25.8	207,698	23.7	321,312	21.7
Total Post Retirement Market	**214,048**		**453,950**		**878,139**		**1,478,864**	
% of all Super Assets		**20%**		**25%**		**31%**		**35%**

Source: Rice Warner, *Surviving Longevity,* March 2010.

2.2 Managing the drawdown phase

Longevity risk is the uncertainty about how long a particular person (or group of people) will live. Figure 7.3 below shows the substantial variability in age of death, which makes it virtually impossible for a person to manage their own superannuation drawdown in an optimal manner. A retiree who aims to draw down their assets so as to deplete them on reaching average life expectancy has a significant risk of running down their superannuation savings too quickly or too slowly. If they die 'early', their remaining superannuation benefits will flow to dependants or to their estate. If they live longer than life expectancy, their superannuation savings will run out, leaving them fully dependent on the age pension. To help guard against the possibility of outliving their savings, retirees might draw down their assets too conservatively, resulting in them failing to enjoy the living standard during their retirement that they otherwise could have had.

Figure 7.3: Probability Distribution of Age at Death



Source: Rice Warner, *Surviving Longevity*, March 2010.

Life expectancy continues to increase at a significant rate. For example, the *2010 Intergenerational Report* projects an increase in average remaining life expectancy of 60-year olds from 23.4 years in 2010 to 29.2 years in 2050 for males and from 26.6 years to 31.4 years for females.[5]

Longevity risk is not the only reason why retirees might not draw down their superannuation savings optimally. Some retirees might simply want to enjoy their money now and find it hard to reduce their expenditure in retirement or defer access to their superannuation lump sum. There is also the potential for some to use their superannuation savings to pay off debt. On the one hand, it is quite sensible to use superannuation benefits to pay off debts on retirement, rather than continuing to pay interest. However, it would significantly undermine the superannuation system if people deliberately increased their pre-retirement indebtedness on the basis they could repay the debt with their superannuation. This practice would have an effect similar to allowing people to access their superannuation before retirement to fund current day consumption.

Retirees' incentives are also affected by the age pension and tax systems. Given the nature of the Australian age pension means test, people who exhaust their assets quickly can receive more age pension over their lifetime. On the other hand, people who use an income stream product benefit from the earnings tax exemption such that they can enjoy higher overall consumption.

The available evidence suggests that, at present, there is no systemic problem of retirees who start an income stream with their super drawing it down too quickly, with a view to intentionally 'double-dipping' into the age pension system. For instance, Lim-Appelgate and others found that part rate age pensioners are maintaining their wealth in a way that will be sustainable even if they outlive average life expectancy.[6]

The Australian Bureau of Statistics (**ABS**) has estimated that of the approximately 2 million living Australians who had received, or were receiving, a superannuation benefit in 2007, 55 per cent had taken their superannuation benefit entirely as a lump sum, 35 per cent as a pension and 10 per cent as a combination of the two.[7] In addition, ABS data suggest that the number and proportion of people who receive substantial lump sums (worth $60,000 or more) is relatively low (table 7.3).

Table 7.3: Retired persons, value of lump sum payments received in past 4 years

Value of lump sum payments received from superannuation	Number (000s)	%
$1–$9,999	45.1	21.8
$10,000–$19,999	34.5	16.7
$20,000–$39,999	46.0	22.2
$40,000–$59,999	31.3	15.1
$60,000 or more	43.9	21.2
Value not known	6.0	2.9

Source: ABS, Employment Arrangements, Retirement and Superannuation, Australia, April to July 2007, June 2009 (6361.0.55.004).

APRA data also show that the proportion of benefits being taken as income streams is increasing. In 1996-97, of the total $18.5B benefits paid, $4B was paid as pensions and $14.5B as lump sums. In 2008-09, of the total benefits paid of $62B, $30B was paid as lump sums and $32B as pensions. That is, the share of benefits taken as a pension has increased from around a fifth to over a half.

The fact that many in the community are able to conserve assets in retirement without using specific longevity products does not detract from the value of such products. For instance, Challenger analysis suggests a 65-year old with a $500,000 balance who wants to manage their assets on the basis they will live to 95, can buy a lifetime annuity and have an income of approximately $33,000 for the remainder of their life. In contrast, a person relying on an account-based product could have an expected income of only $23,000, depending on the way in which the account was drawn down.[8] Accordingly, it is important that there is a range of products available to help people manage longevity and investment risks in their retirement.

2.3 Product innovation in the income stream market

By far the most popular income stream product today is the account-based pension. People can use their lump sum benefit to start an account-based pension, formerly also called an allocated pension. People can choose what amount of money they wish to draw down each year, subject to a statutory minimum. Their account earns income from the underlying assets which may comprise of growth and/or defensive assets. Accounts can rise or fall in value depending on the performance of investment markets.

Account-based pensions have become more attractive relative to other retirement income stream products in recent years, including through the transition to retirement provisions and the removal of preferential treatment of certain lifetime annuities.

2.3.1 'New generation' retirement products

A number of industry participants have turned their minds to the challenge of product innovation in the post-retirement phase. The broad theme of these developments has been to explore ways to better manage the key risks (investment, longevity and inflation) to which people are directly exposed in the account-based pension framework.

Some of the key product ideas being advanced by different industry participants in this area, and reflected in submissions to the Review, include:[9]

- The conversion of retirement lump sums into lifetime or deferred annuities.

- The adaptation to the Australian market of 'guaranteed minimum benefit' or variable annuity products based on US and European precedents, under which investors retain access to their capital, but can still obtain a level of guarantee (either over a fixed period or for the remainder of their lives) that is underwritten by the offering institution and/or a third party reinsurer.

- Longevity risk pooling products, under which individual retirees opt in to a collective mechanism that is designed to equitably re-distribute the unspent savings of those participants who die before reaching their average life expectancy to those who outlive the average.

- The extension of 'lifecycle' investment options not just up to, but also beyond a member's retirement date, in an effort to minimise exposure to investment risks through gradual changes in asset allocation of a retiree's portfolio as they age, through some form of built-in 'glide path' or other mechanism.

- The development of 'collective pension schemes' along the lines of some European and North American multi-employer pension schemes. These schemes combine elements of both defined benefit and defined contribution structures, with the aim of providing stable and predictable retirement incomes for members without imposing open-ended liabilities on employers.

- The transformation of housing wealth into retirement income streams for example, via reverse mortgages. As noted in section 5.1, housing is an important factor in determining living standards in retirement and the ability to manage housing wealth can be significant.

Over recent months, there have been some high profile launches of new products by large investment institutions in this area.[10] The Panel expects that there will be more such activity in both the retail and not-for-profit sectors as more Australians move into the post-retirement phase and competitive market forces play out over coming years.

2.3.2 Role of government and regulation

A key question influencing the development of particular retirement income products is the degree of government support, through taxation, social security treatment or compulsion. These issues were explicitly considered in the Australia's Future Tax System Review (**AFTS Review**).[11]

The AFTS Review found that as people live longer, they will require more options to manage their assets over a longer period and the system will need to become more flexible so it can provide these options.

While arguing that annuities or longevity insurance should not be mandatory, the AFTS Review found that Government should support product innovation and better facilitate their provision by the private sector. It also argued that the private sector is better placed to develop products that meet the needs of retirees.

It found the main longevity product currently available in the market was a guaranteed lifetime annuity which is unpopular among retirees because it has been seen as not offering good value for money. Submissions to the AFTS Review and this Review argued that providers of retirement income products have been reluctant to develop new products due to the prescriptive rules that set out what an income stream is. These rules were designed to ensure that the earnings tax exemption on superannuation pension assets supports only products that deliver a genuine income stream.

To encourage product innovation, the AFTS Review recommended (recommendation 21) that:

- The Government should remove the prescriptive rules in the Superannuation Industry (Supervision) Regulations 1994 relating to income streams that restrict product innovation.[12] (It also recommended that this be done in conjunction with the recommendation to have a uniform tax on earnings on all superannuation assets.) For example, the current minimum annual payment rule prevents the development of products that defer payment of an income stream.

- The Government should issue long-term securities, but only where it is consistent with its fiscal obligations, to help product providers manage the investment risk associated with longevity insurance.

- The Government should make available the data needed to create and maintain a longevity index that would assist product providers to hedge longevity risk. Longevity indexes, known as LifeMetrics, have been established in the UK, the Netherlands, Germany and the US by JP Morgan.

It also recommended (recommendation 22) that the Government should consider offering an immediate annuity and deferred annuity product that would allow a person to purchase a lifetime income. However, it noted that the Government already takes on the overwhelming majority of longevity risk through the age pension.[13]

Submissions to this Review and the AFTS Review also raised the issue of coordination among regulators and between the agencies. Currently, product providers have to deal with many different regulators, including the ATO, APRA, FaHCSIA and ASIC. The AFTS Review noted that taxing fund earnings at a uniform rate would remove the need for there to be specific rules about what products are eligible for tax concessions, and hence remove the need for the ATO to be involved in the regulation of income streams.

While the Government has ruled out offering income stream products itself, it has yet to respond to the other relevant recommendations of the AFTS Review.

The Panel supports the emphasis in the AFTS Review on seeking greater flexibility within the system, including in relation to the prescriptive rules relating to income streams. The Panel also recognises the constraints raised in the AFTS Review such as tax integrity. Submissions to this Review were consistent in relation to reviewing or removing the prescriptive rules relating to income streams as the means of improving the availability of retirement incomes streams in the Australian market.[14]

In the context of the terms of reference of this Review, the Panel notes that post-retirement product innovation, while showing promising signs, is still at a relatively embryonic stage in Australia. At this stage, it appears unlikely that any one product type will produce a panacea for all of the risks and issues confronting Australian retirees and the public pension system that supports them. Consequently, it might unduly distort the market and the scope for further innovation to recommend that any one product type be favoured by regulation to the exclusion of others. At the same time, it will be important for regulators to avoid becoming inhibitors to innovation through unnecessarily rigid rules.

2.4 Net investment performance and fees

Investment returns continue to matter in the post-retirement phase. According to Treasury, around 40 per cent of total benefit (in nominal terms) can be expected to be derived from post-retirement earnings. Treasury estimates that for a person who retires aged 65, their total superannuation benefit will be around 8 per cent higher if they can achieve a 1 percentage point per annum higher net return post-retirement.

Net investment return is a function of gross returns, less fees and taxes. Gross returns are mostly influenced by asset allocation. Asset allocation tends to be more conservative in the drawdown phase than the accumulation phase, which is unsurprising given that people place a higher value on return stability during their retirement years.

2.4.1 Fees for retirement products

In 2008, Rice Warner found that the average annual fee as a percentage of funds under management for allocated pensions (from for-profit funds) ranged from approximately 1 per cent to about 2.5 per cent, with an average fee of 1.86 per cent (table 7.4). While, typically, the fees charged by not-for-profit funds on such products are lower, the bulk of post-retirement assets are managed by the for-profit sector.[15] Chant West also notes that fees paid on post-retirement products in the not-for-profit sector are higher than those paid on accumulation accounts.[16]

Table 7.4: Fees for pension products

Allocated Pension Account Balance	Assets	Administration	Platform	Investment management	Adviser	Expense rate
	($M)	*(%)*	*(%)*	*(%)*	*(%)*	*(%)*
> $1 million	4,166	0.01	0.33	0.63	0.53	1.51
$500,000 — $1 million	12,633	0.01	0.38	0.68	0.53	1.60
$250,000 — $500,000	21,026	0.02	0.44	0.73	0.53	1.73
$100,000 — $250,000	25,435	0.05	0.51	0.79	0.56	1.91
$50,000 — $100,000	9,995	0.10	0.58	0.85	0.63	2.16
$25,000 — $50,000	2,802	0.22	0.67	0.92	0.73	2.54
< $25,000	465	0.99	0.77	0.98	1.17	3.91
Total allocated pensions	***76,521***	***0.05***	***0.48***	***0.76***	***0.57***	***1.86***
Guaranteed annuities	**10,392**	**1.25**	**-**	**0.20**	**0.25**	**1.70**
Total retail post retirement	**86,913**	**0.20**	**0.42**	**0.69**	**0.53**	**1.84**

Source: Rice Warner, Superannuation Fees Report 2008, December 2008

These fees are around 50 per cent higher than those in the accumulation phase and average fees for superannuation products as a whole, on a percentage of assets basis.

The main factors creating higher fees in post-retirement products seem to be advice and product complexity. In addition, and perhaps related, this segment is highly 'retail' and individualised in contrast to the accumulation phase where employers or other associations may bargain on behalf of employees.

It follows that the fees in this segment are broadly similar to those in the personal retail area. On most account balances, fees in the post-retirement phase are higher than for personal accumulation plans. It is not until account balances reach about $100,000 that fees become similar. However, as the average balance in post-retirement products is much higher, the average fee as a percentage of assets is lower.[17]

In common with other products, allocated pensions appear to experience significant reductions in investment management and advice fees as their average account balances increase. In other words, members benefit from economies of scale as their account balances increase.

As part of its research, Rice Warner estimated the average implicit fee for guaranteed annuities (because these products do not have explicit fees) at 1.70 per cent of assets under management in 2008.

Generally, advice fees are bundled with allocated pension products with fees ranging from 1.17 per cent of assets under management for accounts with balances less than $25,000 to 0.53 per cent for accounts with balances over $250,000.

The Panel doubts whether the higher fees for allocated pensions are justifiable. There may be some additional complexity in post-retirement products that justifies the additional fees. This could benefit from further examination.

The Panel considers there is scope for these fees to be reduced substantially. The following policy responses are designed to deliver these reductions:

- the introduction of MySuper products and the requirement that those products have a retirement income stream component should help build scale and place more emphasis on products' financial returns to members; and
- the Government's decision to ban commissions under the *Future of Financial Advice* package should help ensure planners recommend retirement income products that offer good value for money.

2.5 Managing investment risk during retirement

Investment risk in the post-retirement phase is particularly important because of two factors. First, the investment horizon is shorter, though still typically fairly long. Second, there is usually no or limited ability to offset poor returns with higher contributions or other income aside from the age pension which, over the income test taper range, increases by 50 cents for each dollar by which other assessable income falls.

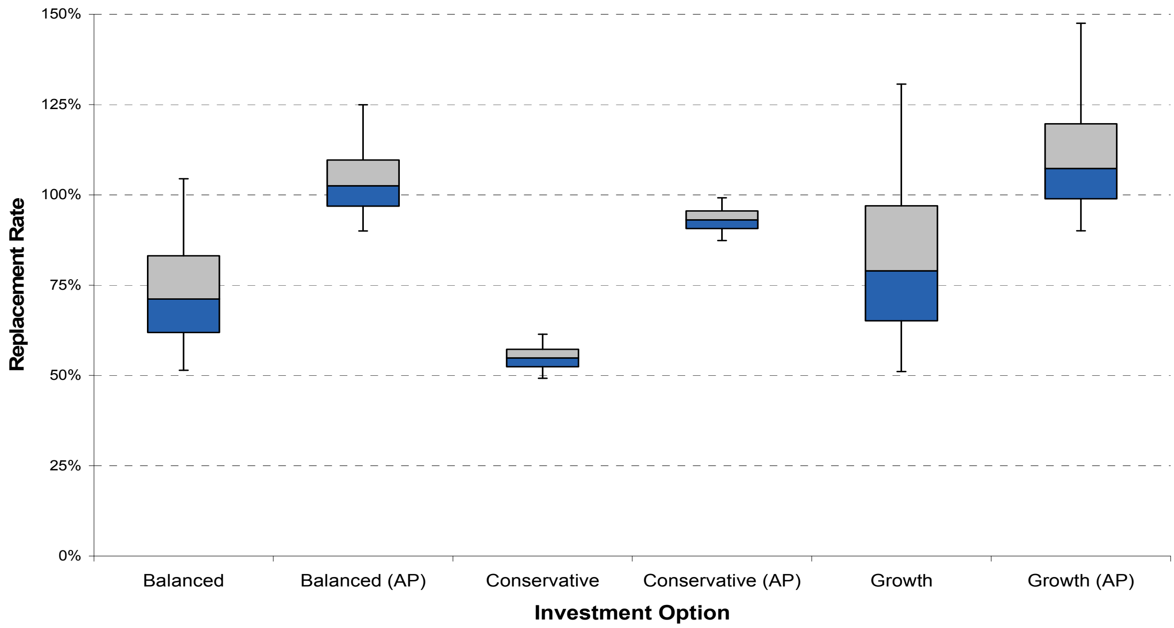
The thrust of submissions to the Review was that it should not be mandatory for trustees to manage pension assets separately from accumulation assets as a means of dealing with investment risk in the retirement phase. Common reasons cited included that to do so would dilute the benefits of scale — by pooling these assets trustees are able to have larger mandates and incur lower investment management costs. Concerns were also raised with respect to the risk of losing investment opportunities and the likely increase in costs.[18] Some submissions also argued that this risk was best addressed through the trustee offering pension members a range of investment options.[19]

Submissions generally did not favour diversification requirements or limits on member-level investment choices as a means of attempting to better ensure that post-retirement product distributions are paid. Some submissions argued strongly that decisions regarding the best way to structure their investments, having regard to the different tax treatment of accumulation and pension assets, should be left to trustees as part of their fiduciary responsibility. Submissions also argued that a range of investment options and member education were the most appropriate way to meet the needs of different members.[20]

The Review commissioned the Australian Government Actuary to examine the impact of different investment strategies on retirement benefits, including in the post-retirement phase.

Overall, the results indicate that the type of investment strategy undertaken continues to be important in the drawdown phase. Figure 7.4 shows that while returns are variable, this variability is tilted to the upside. In fact, the outcome for the 'growth' investment strategy exceeds that for the 'balanced' strategy 92 per cent of the time, the 'growth' strategy outcome exceeds the 'conservative' strategy outcome 95 per cent of the time and the 'balanced' strategy outcome exceeds the 'conservative' strategy outcome 96 per cent of the time. Even in the small proportion of time where a more aggressive strategy underperforms, that underperformance is itself relatively small (less than 12 per cent). Naturally, the age pension plays an important part in smoothing out the impact of investment performance on replacement rates.

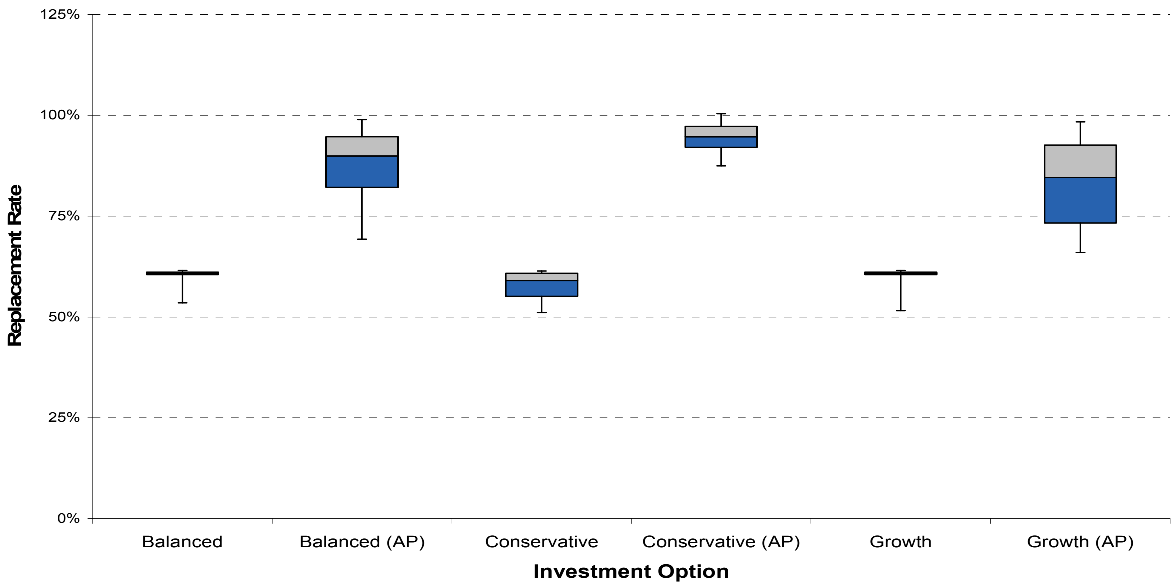
Figure 7.4: Replacement rates with alternative retirement investment strategies, with and without age pension (variable drawdown over 22 years)



Note: The AGA modelling is based on an account balance of $400,000 at retirement, average investment earnings of 6 per cent per annum and variable drawdowns over a 22 year period. Drawdowns are assumed to be the mid point of the former maximum and minimum allocated pension drawdown percentages.
Boxes represent interquartile ranges. For example, a balanced investment option without the age pension is expected to provide a median annual income of about 70 per cent of final pre-retirement income. In 50 per cent of cases it is expected to provide an annual income between 60 and 80 per cent of final pre-retirement income. In 5 per cent of cases it is expected to provide an annual income over 105 per cent of final pre-retirement income and in another 5 per cent of cases it is expected to provide an annual income of less than 50 per cent of final pre-retirement income.
Source: Australian Government Actuary.

The result above assumes that the amounts drawn down vary with investment performance so that during periods of higher returns, members draw down higher amounts, and vice versa. If it is assumed that members draw down a fixed dollar amount, the results are quite different (Figure 7.5).

Figure 7.5: Replacement rates with alternative retirement investment strategies, with and without age pension (constant drawdown over 22 years)



Note: Drawdowns are assumed to be constant (inflation-adjusted) and equal to the account balance at retirement divided by an annuity factor of 15.
Source: Australian Government Actuary.

In this case, a 'conservative' investment strategy can provide higher replacement rates than 'growth' strategy and with more certainty. This result occurs because, with a 'growth' investment strategy, a fixed drawdown can deplete assets quickly if there is a period of below-average investment performance. On the other hand, the fixed drawdown means replacement rates are not higher in the 'growth' investment strategy even if there is above average performance. The flipside of this result is that a constant drawdown will result in virtually no residual at life expectancy for retirees invested in 'conservative' strategies while often there will be a substantial residual for those invested in 'balanced' or 'growth' strategies. In reality, retirees face substantial longevity and investment risk and both these factors need to be taken into account in both investment and drawdown decisions.

These results suggest that determining a person's optimal investment strategy and drawdown behaviour can be complex, particularly in light of longevity risk. The degree to which members face investment risk depends on the nature of the underlying assets. Higher investment risk is associated with higher long-term returns on average and the appropriate balance between risk and return differs across investors. In addition, the age pension provides a significant dampening influence on investment risk for many people receiving income streams (for those in the taper range), and a minimum floor in the case of the full-rate age pension. People in the drawdown phase will also have varying abilities to access non-superannuation sources of income. For these reasons, different people might reasonably have quite different risk/return appetites and so wish to hold different underlying assets.

Accordingly, the Panel does not consider it appropriate to mandate any particular level of investment risk or asset allocation for retirement income products. Nor does the Panel consider that encouragement needs to be given to products with different investment risk characteristics as the market appears to be offering investors widening choice.

3 LIQUIDITY RISK

Liquidity risk is a particular issue for people in the post-retirement phase as they will typically need access to cash to meet day-to-day living expenses. The GFC demonstrated that assets that were thought to be liquid quickly turned illiquid. The Panel considers that good advice and appropriate 'defaults' are the best means of managing liquidity risk, along with APRA ensuring, as part of its regulatory oversight, that trustees take account of the heightened liquidity needs of members in the retirement when devising their investment strategies.

4 MYSUPER AS AN INTEGRATED RETIREMENT PRODUCT

The Panel believes that MySuper products should not just cover accumulation to retirement, but also the drawdown phase. The Panel views MySuper, in its ultimate form, as a whole of life product, and considers that this is a key part of the MySuper concept.

While the Panel acknowledges that there is not a 'one-size-fits-all' post-retirement product, it notes that allowing MySuper providers to provide multiple choices would increase the complexity of the product. With this in mind, the Panel has decided that a MySuper fund should only be able to offer one type of income stream product, noting that interested members are free to choose any other product in the choice sector.

The Panel acknowledges there would be a range of other issues that would need extensive consultation and development with industry. Options in relation to the types of post-retirement products appropriate for MySuper include products that retain exposure to growth assets after retirement, annuity products and other longevity risk hedging and a range of account-based pension products. The Panel recognises there is a great deal more work that needs to be done in this area. This work should begin as soon as practicable. A particular focus should be considering what, if any, default arrangements should apply to any MySuper income stream products. Of course, the enhanced fiduciary responsibility applying to MySuper providers outlined in chapter 1 would apply with respect to their retirement product.

Recommendation 7.1

MySuper products must include one type of income stream product, either through the fund or in conjunction with another provider, so that members can remain in the fund and regard MySuper as a whole of life product. The Government should consult comprehensively with industry before mandating the post-retirement arrangements to apply to MySuper products.

5 THE NEED FOR ADVICE IN MANAGING RETIREMENT INCOME

In view of the complexity of decision-making that surrounds transforming an accumulated lump sum benefit into an income stream that will ensure a comfortable retirement, the Panel considers that sound advice must play a key role for members.

5.1 Advice approaching retirement

As people near retirement age, they need to consider a wider range of superannuation-related issues. These include the age at which they plan to retire at, how much superannuation they will need to have to achieve the lifestyle they want, whether their housing will suit them as they age, whether they wish to transition to retirement by starting to work part-time and whether their superannuation investment strategy remains suitable. These decisions themselves are affected by not only the superannuation system and the balances they have accrued, but also the age pension and other government policies. These are complex matters which turn on individual circumstances. There is not a 'one-size-fits-all' solution. Most people need to revisit these issues and their choices as they age and their circumstances change.

Many people would benefit from having access to advice on these issues. Superannuation funds can help meet this need through intra-fund advice. Under the Panel's recommendations in chapter 1, MySuper products would be required to have an intra-fund advice facility. In addition to this the Panel believes that MySuper funds should proactively engage with members at an appropriate time before normal retirement age to offer advice so members can start planning to prepare for retirement. For instance, funds could contact members at age 45 and then at five-yearly intervals. The nature of the advice that funds provide would likely evolve over time and funds could link in with other sources of information and advice, such as the National Information Centre on Retirement Investments. The sole purpose test restricts the types of advice that can be paid from members' accounts. It is possible, therefore, that some of this broader advice provided by funds would need to be paid for separately.

While the Panel supports the provision of intra-fund advice to choice product members, it does not consider it necessary to mandate this.

Recommendation 7.2

Trustees should be required to offer intra-fund advice proactively to MySuper members as they approach normal retirement age. Over time, advice should be available on as broad a range as possible of the financial issues that members will face in retirement, subject to the requirements of the sole purpose test. In the near term, advice should address investment allocation and alternative retirement products offered within the fund.

5.2 Advice after retirement

Similarly, the Panel considers that trustees should proactively offer intra-fund advice to MySuper members in the retirement phase at periodic intervals (perhaps every five years). Again, while the Panel supports the provision of intra-fund advice to choice members, it does not consider it necessary to mandate this.

Recommendation 7.3

Trustees should offer intra-fund advice proactively to MySuper members in the retirement phase at periodic intervals.

6 ENHANCED TRUSTEE ROLE FOR RETIREMENT PHASE

At the current stage of industry evolution, the Panel considers that the best approach to promoting the interests of super fund members in the retirement phase is to ensure the accountability of trustees, in much the same way as the Panel has recommended for the accumulation phase. Trustees are best placed to understand the particular demographics of their funds' membership bases, to communicate with those members about the risks and options involved, and to mobilise their service providers to deliver the most appropriate retirement products.

The Panel notes that the duties of the trustee in relation to investments has received express legislative attention. The investment strategy covenant and operating standard serves to focus the trustee on its core duty to formulate and give effect to an investment strategy for the fund as a whole that has regard to factors such as risk, diversification, liquidity and the ability to discharge liabilities.[21]

While the breadth of these factors can cover post-retirement concerns, the Panel notes that the risk profile, tax treatment and liquidity needs of those drawing a pension from a superannuation fund are all likely to be different from those of members in the accumulation phase. That is, the notion of a single investment strategy for the fund might not be appropriate once post-retirement assets become substantial.

Accordingly, the Panel believes that the regulatory arrangements should also articulate new and specific duties for MySuper trustees in relation to post-retirement members. A key element of this is to ensure that MySuper trustees are responsible for devising an investment strategy not just for the fund as a whole, but for the assets held on behalf of post-retirement members. This should have regard to the existing factors — risk, diversification, liquidity and the ability to discharge liabilities, as set out in section 52(2)(f) of the SIS Act — plus two new factors — inflation risk and longevity risk. Trustees would work out how they propose to fulfil these new specific duties in the circumstances of their fund's particular characteristics.

Recommendation 7.4

Trustees must devise a separate investment strategy for post-retirement members in MySuper products which has regard to the factors as set out in section 52(2)(f) of the SIS Act as well as inflation and longevity risk.

7 COLLECTIVE PENSION SCHEMES

Collective pension schemes aim, but do not guarantee, to provide a certain level of benefit for employees while limiting employer contributions to a defined contribution. That is, employers pay a fixed contribution which is actuarially determined over time to provide a high likelihood of being able to pay a defined benefit of a certain amount. Ultimately, however, the benefit paid to employees will depend on investment returns. If returns are poorer than expected, the benefit to employees can be reduced and potentially vice versa. This differs from defined benefit schemes where investment risk (upside and downside) falls on the employer.

The Netherlands operates industry-wide collective pension schemes. Under their schemes, benefits are defined as an annuity. In Australia, UniSuper operates an industry-wide hybrid defined contribution/defined benefit scheme for employees of the higher education sector. The design of this scheme provides for a defined benefit payable as a lump sum (which can be subsequently converted to a pension) where employers contribute a fixed 14 per cent of salary and where there is scope for the benefits to be adjusted for significant swings in investment performance.

Under these schemes, periods of higher investment returns can result in surpluses which can be drawn down in periods of below-normal returns. In the event of sustained high returns, some or all of the surplus can be returned to members as higher benefits. In the event of sustained lower returns, benefits to members would need to be reduced. Accordingly, it is critical that members are aware of the scheme design and the potential risks that they bear. Nevertheless, the ability to pool risk over time can result in a higher level of certainty than a normal defined contribution scheme.

These schemes are likely to be more attractive where the expected benefits exceed the standard SG defined contribution rate. If the employer contributions of a collective pension scheme and a standard scheme are the same, then the expected returns to members are likely to be similar. For this reason, it seems appropriate that policy neither encourage nor discourage collective pension schemes. This seems to be the general result of the current regulatory rules so no change is suggested.

ENDNOTES

1 See section 62 of the SIS Act.
2 AustralianSuper 2010, Review of AustralianSuper's default investment option, February 2010, <www.australiansuper.com/resources.ashx/FormsAndPublications/855/File/BEFA48A6AE3EE0310A49D9B391B750CB/Default_option_update_26_Feb_2010%5B1%5D.pdf>
3 Australian Bureau of Statistics 2009, Trends in superannuation coverage, 25 March 2009 (4101.0) <www.abs.gov.au>
4 Rice Warner 2008, 'Superannuation Fee Report 2008', December 2008, <www.ricewarner.com>
5 Intergenerational report (2010), 'Australia to 2050: Future Challenges', Publications of the Commonwealth of Australia, January 2010.
6 Lim-Applegate, H, McLean, P, Lindenmayer, P & Wallace, B 2005, Part rate pensioners: characteristics and changes, Australian Government, Canberra.
7 Australian Bureau of Statistics 2009, Employment Arrangements, Retirement and Superannuation Australia, April to July 2007, 2 June 2009 (6361.0.55.004) <www.abs.gov.au>
8 Challenger, Submission no. 196, p 12. Both scenarios take the age pension into account.
9 For example, ASFA, Submission no. 320, p 6; IFSA, Submission no. 382, p 24; Tower Watson, Submission no. 367, p 2; FPA, Submission no. 329, p 14; IAA, Submission no. 332, p 9.
10 For example, ING's 'Money for Life', <www.ing.com.au/moneyforlife> ; AXA North's 'North Guarantee' www.north.axa.com.au; Macquarie Bank's 'Macquarie Lifetime Income Guarantee' <www.macquarie.com.au>
11 Department of the Treasury (Treasury) 2009, Australia's future tax system: Report to the Treasurer– Part 2 Detailed analysis, vol. 1, December 2009, Treasury.
12 Part 1A of the SIS Regulations.
13 Department of the Treasury (Treasury) 2009, Australia's future tax system: Report to the Treasurer Part 2 Detailed analysis, vol. 1, December 2009, Treasury.
14 For example, PriceWaterhouseCoopers, Submission no. 356, p 8; SPAA, Submission no. 400, p 16.
15 Rice Warner 2008, 'Superannuation Fee Report 2008', December 2008, <www.ricewarner.com>
16 Chant West, A pension – the 'must have' accessory for the modern super fund, 8 October 2008, <www.chantwest.com.au>
17 Rice Warner 2008, 'Superannuation Fee Report 2008', December 2008, <www.ricewarner.com>
18 For example, ASFA, Submission no. 320, p 7; NICRI, Submission no. 389, p 6; AIST, Submission no. 380, p 18; Professional Financial Solutions, Submission no. 399, p 2; SPAA, Submission no. 400, p 7; Rice Warner, Submission no. 404, p 14.
19 For example, NICRI, Submission no. 389, p 3; PriceWaterhouseCoopers, Submission no. 356, p 9; Greg Hurford, Submission no. 241, p 2.
20 For example, SPAA, Submission no. 400, p 7; Super Compliance Services, Submission no. 364, p 9.
21 See sections 52(2)(f) of the SIS Act and regulation 4.09 of the SIS Regulations.