

# Submission

## Retirement phase of superannuation

February 2024

A submission in response to the Treasury consultation in respect of the 'Retirement phase of superannuation' Discussion paper (December 2023)

Via email: [Retirement@treasury.gov.au](mailto:Retirement@treasury.gov.au)

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## Preliminary Remarks and Scope of Submission

Given the expansive range of retirement matters to which this Discussion Paper seeks to ascertain considered views, the scope of this submission will be constrained as follows:

- Focus will be directed to addressing, to the extent relevant, the three broad topic areas (and the key consultation questions therein) being:
  - supporting members to navigate retirement income
  - supporting funds to deliver better retirement income strategies
  - making lifetime income products more accessible.
- Matters of adjacent relevancy are to be found in appendices at the rear of this document, and will be referred to as required in the body of the submission, these being:
  - appendix A – risks faced at retirement (and beyond)
  - appendix B – characteristics of APRA-regulated superannuation funds
  - appendix C – a framework for lifetime consumption smoothing
- This submission will not delve into retirement issues as they pertain to Self-Managed Superannuation Funds (SMSFs). This segment of the superannuation sector, currently some \$900 billion across roughly 1.1 million individuals (40 per cent of whom are already in retirement phase with only 5 per cent of these receiving the Age Pension<sup>1</sup>), has greater access to guidance, personal financial advice, and ancillary services relative to members of APRA-regulated superannuation funds such that it need not be the focus of this submission.

It is acknowledged that the principles outlined in the Discussion Paper are not as yet approved by the Government or any relevant Minister of the Crown, nor are they currently legislated. They are conveyed instead primarily to elicit feedback to facilitate the furtherance of retirement income policy development.

One aspect that is legislated, and upon which much of this submission revolves, is the Retirement Income Covenant (hereafter 'RIC') requirement<sup>2</sup>; that requires RSE licensees, from 1 July 2022 onward, to formulate, record, implement, make available and regularly review a retirement income strategy to assist their members in balancing three key goals in retirement. These objectives are:

- to maximise expected retirement income over the period of retirement;
- to manage expected risks to the sustainability and stability over the period of retirement; and
- to have flexible access to expected funds over the period of retirement.

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<sup>1</sup> ATO, Self-Managed Super Funds; a Statistical Overview 2019-20

<sup>2</sup> As now incorporated into the Superannuation Industry (Supervision) Act 1993 (Cth) at sections 52(8A) and 52AA

## Supporting members to navigate retirement income

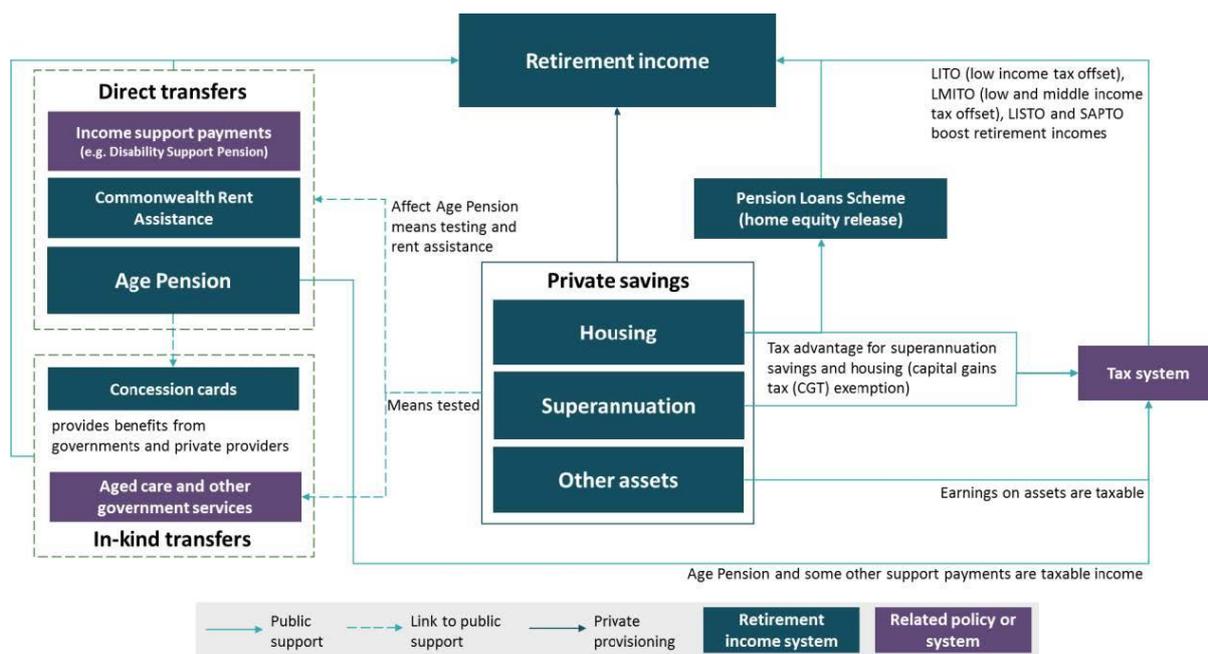
Please provide comments on the issues facing members identified in this section.

In planning for retirement, most retirees must negotiate numerous hurdles; navigating a complex web of interrelated domains, government agencies, transfer payments and a voluminous body of legislation that ties them together. This must be done for a period of retirement, unforecastable with any level of precision, that may vary from a few short years to possibly three decades and beyond.

As the discussion paper rightly notes, “it is inherently challenging to navigate the different parts of the retirement income system, combine multiple income sources, consider the needs of your partner and dependents, and manage the numerous risks and changes in circumstances.”<sup>3</sup>

That complexity was captured in the below schematic provided in the 2019 consultation paper for Treasury’s Retirement Income Review, depicting the numerous sources, and flows, of retirement income for the average retiree, incorporating privately held assets and the interaction of the tax and transfer system<sup>4</sup>.

### KEY RETIREMENT INCOME SYSTEM INTERACTIONS



Source: Treasury, Retirement Income Review – Consultation Paper, Australian Government, November 2019

The schematic above alludes to an insufficiently acknowledged reality of retirement; that in any discussion about the retirement phase of superannuation, it is important to understand the *totality of the financial and non-financial resources* retirees may have with which to support their lifestyles.

Superannuation is an increasingly important component of the retirement income mix, but not necessarily the dominant one for many retiree cohorts (sub-classes) in APRA-regulated super funds,

<sup>3</sup> Treasury, *Retirement phase of superannuation, Discussion paper*, December 2023, p 4.

<sup>4</sup> It should be noted that since the creation of this schematic the LMITO tax offset has ceased effective 30 June 2022 and the Pension Loans Scheme has been renamed the Home Equity Access Scheme (HEAS)

particularly in the profit-for-member sector. This is a key, but under-acknowledged, difference between APRA-regulated funds (particularly the profit-for-member sector) and the SMSF sector.

Depending on the financial and personal circumstances<sup>5</sup> of a particular retiring member, there can be as few as two and as many as five possible sources of retirement income, these being:

- Age Pension
- Superannuation income stream(s)
- Income from non-superannuation financial assets (e.g. rent or dividends)
- Release of some portion of home equity (e.g. reverse mortgage or HEAS)
- Personal exertion income (part-time paid employment)

Leaving aside the two non-financial sources of retirement income (home equity release and employment), the Discussion Paper is therefore right to note that *“retirees could be better supported by information that considers all three pillars of the retirement income system – the Age Pension, superannuation, and savings and investments outside of superannuation. Specifically, how these streams of income might interact and change across the period of their retirement”*<sup>6</sup>.

### The Age Pension

The Age Pension is the key social safety net against old age poverty in Australia, paid to qualifying persons based on a means-tested methodology designed to exclude individuals who have made sufficient self-provision for retirement.

Those born after 1 January 1957 can qualify for the Age Pension upon turning 67.

The rate of Age Pension any one individual may receive is dependent on many factors, due to the operation of the assets and incomes tests, however the maximum rates at present are as follow:

#### AGE PENSION RATES EFFECTIVE 20 SEPTEMBER 2023

Family Situation	Single	Couple (Each)	Couple (Combined)	Couple Each (Illness Separated)
Max Base Rate	\$26,065.00	\$19,648.20	\$39,296.40	\$26,065.00
Max Supplement	\$2,082.60	\$1,570.40	\$3,140.80	\$2,082.60
Energy Supplement	\$366.60	\$275.60	\$551.20	\$366.60
<b>TOTAL</b>	<b>\$28,514.20</b>	<b>\$21,494.20</b>	<b>\$42,988.40</b>	<b>\$28,514.20</b>

Source: Services Australia

There are some 4.5 million individuals of Age Pension age in Australia at present, a number that is expected to roughly double to around 9 million by 2062-63.

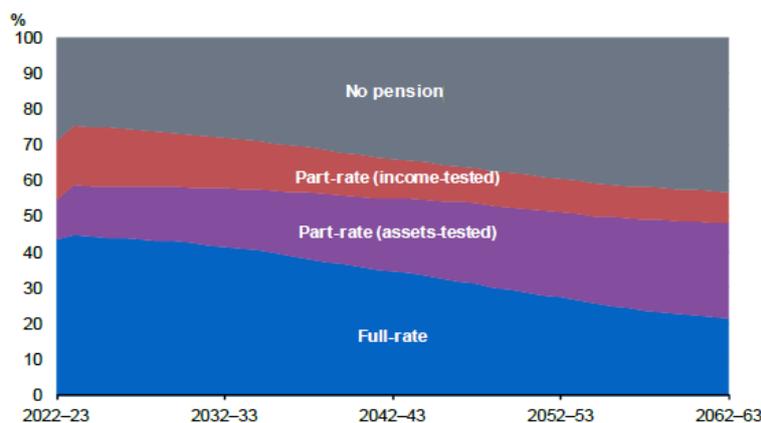
From the perspective of this submission, the key point about the Age Pension is that it is received by nearly 2 in every 3 Australians of eligible age.

<sup>5</sup> Accessing a portion of home equity presupposes home ownership, ideally unencumbered, while generating personal exertion income assumes the physical capacity, workplace skills and capability to be gainfully employed

<sup>6</sup> Treasury, *Retirement phase of superannuation – Discussion Paper*, December 2023, p 11

Thus, by extension, the median retiree of qualifying age is likely to be eligible for the Age Pension, if not at the full rate above, then at a part-rate as depicted in the chart below<sup>7</sup>.

#### PERSONS OF AGE PENION AGE OR OVER, BY PENSION CATEGORY



Note: The increase in 2023-24 is due to the Age Pension eligibility age increasing from 66.5 to 67 years old, which affects the measure of 'person of Age Pension age'.

Source: Treasury.

At some \$43,000 per year for a full pension couple, the Age Pension is the most important source of retirement income for very many older Australians.

Attempts to quantify the lifetime value of the Age Pension for males and females, based on survival probabilities, have previously been undertaken, and suggest that for males it may be north of \$350,000 and for females possibly more than \$400,000<sup>8</sup>.

Given that APRA-regulated funds, and particularly the profit-for-member sector, generally have member demographics that are more likely to qualify for part or full Age Pension at the relevant age, it is extremely important that funds consider the prospective receipt of the Age Pension in their retirement guidance, online tools, the formulation of retirement income strategies and the creation of retirement income products<sup>9</sup>.

#### *Superannuation balances and gender differences*

The superannuation system has been maturing over the past 32 years, with the rate of SG rising slowly to the current 11.5 per cent, reaching the full 12 per cent from 1 July 2025 onwards.

As a mandatory contributory system tied to employment income, combined with the effects of compounding returns over time, super balances are broadly dispersed across the age, gender and income divide.

The most recently compiled data suggests that males in the key retirement planning age cohorts (55 – 64) have median balances between the \$190,000 and \$212,000 range, while for females the median balances range between \$130,000 and \$159,000<sup>10</sup>.

<sup>7</sup> Treasury, *'Intergenerational Report 2023 – Australia's future to 2063'*, Australian Government, 2023

<sup>8</sup> Wood, Justin (2013), 'Examining the Equity Holdings of Australian Superannuation Funds', JASSA Issue 2, 2013 (but it should be noted that such calculations are extremely sensitive to assumptions for benefit indexation and discount rates)

<sup>9</sup> For the characteristics of APRA-regulated super funds as pertains to the retirement phase, see Appendix B

<sup>10</sup> ASFA, *'An update on superannuation account balances'*, November 2023

The data is provided in the table below.

#### SUPERANNUATION BALANCES BY AGE AND GENDER, JUNE 2021

Age	Average Account Balance		Median Account Balance	
	Male	Female	Male	Female
55 – 59	\$316,457	\$236,530	\$191,263	\$130,714
60 – 64	\$402,838	\$318,203	\$211,996	\$158,806
65 - 69	\$453,075	\$403,038	\$213,986	\$201,233
70 – 74	\$509,059	\$451,523	\$216,564	\$212,462
75 +	\$507,556	\$436,865	\$174,179	\$168,973

Source: ASFA

That there is a gender gap as high as 46 per cent in the 55 – 59 age cohort is an issue that should be of significant concern to super funds, particularly those with member demographics skewed to females<sup>11</sup>.

[It should be noted that one reason for the reduction in the gender super gap between ages 55 – 59 and 60 – 64 from 46 per cent to 33 per cent may be a result of pre-retirement planning, where super equalisation (often as part of a withdrawal and spouse re-contribution strategy) is a commonly used strategy.]

APRA-regulated super funds need to be aware of the super gender gap as it applies to their retiring members, and put in place guidance, assistance, and other measures to help ameliorate its impacts on the retirement outcomes of female members<sup>12</sup>.

#### *Housing wealth and non-super assets*

Planning for retirement is most often done at the household level; for people in relationships the respective ages of each partner and the financial resources they collectively hold are relevant to the retirement decision-making process.

It is therefore instructive to understand just what the typical near-retiree household balance sheet looks like, both from an asset and liability perspective, to understand how average households might be placed at the point of retirement.

The below chart depicts the mean and median net worth of Australian households by age band<sup>13</sup>. Focussing on the 55 – 64 cohort, the age range in which most Australians retire, housing wealth

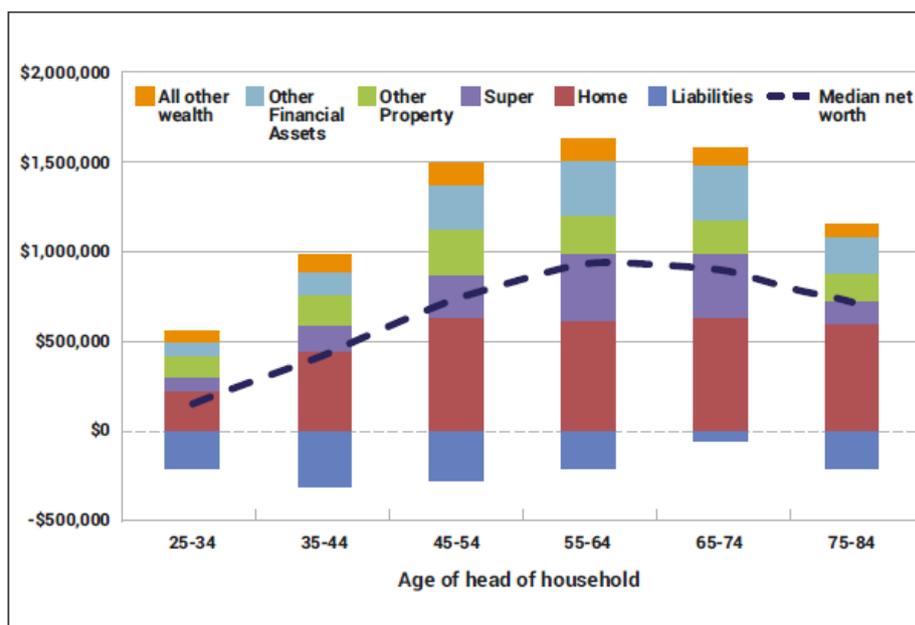
<sup>11</sup> For a more detailed exposition of the super gender gap, see Chemay, H 'The Nouveau Poor- gender pay gap, super inequality stretched in pandemic', September 2021 at <https://michaelwest.com.au/the-nouveau-poor-gender-pay-gap-super-inequality-stretched-in-pandemic/>

<sup>12</sup> Particularly female members who approach retirement unpartnered (see footnote above)

<sup>13</sup> Hennington, J and Boal, A, 'A framework to 'maximise' retirement income', Actuaries Institute, April 2022

(Home) dominates the average household balance sheet, with super and other financial assets broadly in equivalence.

#### MEAN AND MEDIAN NET WORTH OF AUSTRALIAN HOUSEHOLDS BY AGE BAND



Source: Actuaries Institute (based on analysis of ABS Survey of Income and Housing 2017-2018)

This is confirmed in the latest household wealth data from the ABS<sup>14</sup>, where the stock of residential property is valued, in aggregate, at some \$10.3 trillion as compared to total superannuation assets of \$3.6 trillion.

It is noted that financial wealth held outside of both housing and superannuation (primarily equities and deposit-based securities) totalled some \$3.3 trillion, just slightly below the level of aggregate super assets. To the extent held by retiree households, these financial assets might generate a non-trivial amount of retirement income to supplement the Age Pension (where applicable) and superannuation pensions.

<sup>14</sup> ABS, Australian National Accounts, Finance and Wealth (Reference period June 2023)

### *Home ownership and mortgage debt*

Given the dominance of housing wealth in the median Australian household's balance sheet at the point of retirement, it is instructive to delve further into the issue of home ownership and the level of mortgage debt that supports it.

There are two countervailing issues here for super funds to grasp; the general decline in rates of Australian home ownership and, for homeowners, the increase in the level of debt held by mortgagors into their later years.

The reason these issues are so pertinent to retirement planning, and maximising *discretionary* retirement incomes<sup>15</sup>, is that the long-standing retirement policy assumption of home ownership at the point of retirement, unencumbered by debt, is ***no longer a robust basis on which to build retirement solutions*** for most cohorts (broadly those within the 20<sup>th</sup> and 80<sup>th</sup> percentiles).

Turning first to ownership, it is widely acknowledged that rates of home ownership have been in gradual decline over the past four decades. Treasury's latest Intergenerational Report, in its section on trends in the retirement income system, shows the fall in ownership for the key retirement planning cohorts (55 – 59 and 60 – 64) below 80 per cent for the first time since 1981<sup>16</sup>, with the observation that *"these trends present a fiscal risk to Age Pension spending in the future and may impact patterns of how superannuation is drawn down"*.

It is thus to be expected that an increasing percentage of Australians will face their retirement years as renters, either never having become homeowners, or having ceased to be homeowners prior to retirement and not regained a foothold on the property ladder thereafter. Super funds should aim to have strategies in place for renter retirees, as a distinct cohort, to help optimise their discretionary retirement incomes<sup>17</sup>.

For those who are homeowners nearing retirement, the level of mortgage debt carried at the point of retirement becomes a key retirement planning consideration, one in which accrued super balances may play an increasing role mitigating.

ABS data indicates that the aggregate amount of long-term debt, primarily mortgage debt on residential property (both owner-occupied and investment), is currently some \$2.8 trillion.

Research done on mortgage levels across varying age cohorts, based on the 2013-2014 ABS Survey of Income and Housing, shows that in the key retirement planning cohort of 55 – 64, the proportion of homeowners with outstanding mortgages had increased from 14 per cent in 1990 to 47 per cent in 2015<sup>18</sup>.

The below chart shows the proportion of homeowners with outstanding mortgage debt across different cohorts derived from this research.

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<sup>15</sup> Discretionary retirement income is used to indicate income that able to be used for consumption other than for shelter, i.e. not used for rent or mortgage payments in retirement.

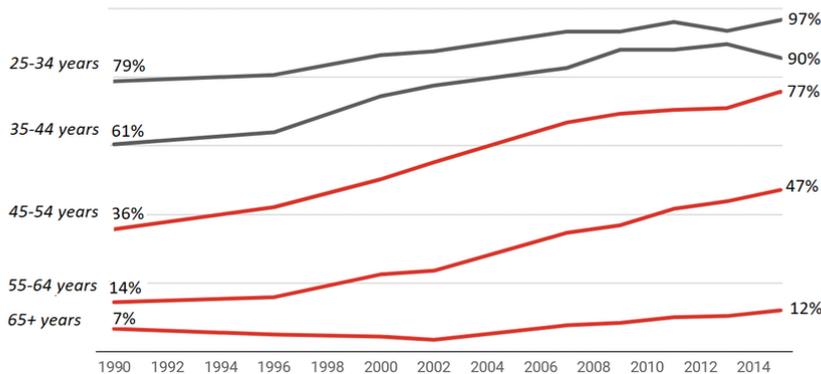
<sup>16</sup> Treasury, *'Intergenerational Report 2023 – Australia's future to 2063'*, Australian Government, p 172

<sup>17</sup> A more detailed exposition of the issue is outlined in Chemay, H *'Falling home ownership: the elephant in the superannuation retirement room'* at <https://michaelwest.com.au/igr-home-ownership-the-elephant-in-the-superannuation-retirement-room/>

<sup>18</sup> Ong ViforJ, R and Wood, J, *'More of us are retiring with mortgage debts. The implications are huge'*, The Conversation, 2019 at <https://theconversation.com/more-of-us-are-retiring-with-mortgage-debts-the-implications-are-huge-115134>

## Proportion of home owners with outstanding mortgages

By age group, 1990 - 2015



Source: Ong ViforJ, R and Woods, G (using ABS Survey of Housing and Income)

Updated data from the latest Survey of Income and Housing suggest that for the 55 – 64 age cohort, the proportion with outstanding mortgages now stands at 54 per cent. Thus, more than one in two people in this group have outstanding mortgage debt nearing or at the point of retirement.

Of the 55 – 64 age cohort with housing debt, the average mortgage debt remaining is now around \$233,000. Juxtaposed against median super balances, the remaining mortgage becomes non-trivial in retirement planning.

There are one of two planning responses to mortgage debt at the point of retirement; either continue servicing it into retirement, or access available financial resources to extinguish it.

There is clear evidence that many members withdraw (commute) at least part of their super at the time of retirement, rather than convert their total accrued super balance into one or more retirement income streams or other income-generating (non-super) investments.

According to HILDA<sup>19</sup> data, the proportion of super withdrawn by early retirees rose for men from 7.2 per cent in the 2011 to 2015 period to 13.4 per cent in the 2015 to 2019 period. For women, the proportion of super spent fell from 13.1 per cent to 10.3 per cent in the same period.

Further, of male retirees who withdrew at least some of their super (for persons who retired between 2015 and 2019) \$108,428, or 43 per cent of the mean super balance of this group, was withdrawn. For women, the relevant figures were \$78,092 and 47 per cent respectively.

Data collected by the ABS in its survey of Retirement and Retirement Intentions<sup>20</sup> broadly aligns with HILDA. For the 2020-2021 year, only 39.3 per cent of those aged between 60 and 64 at the time of retirement did *not* receive a lump sum payment from their super fund. By number of persons, using withdrawn lump sums to extinguish mortgage debt, undertake home improvements or acquire a new dwelling was, at 14.4 per cent (and by a clear margin), the most often cited reason for taking a lump sum.

The interaction between the Age Pension system and the super system, specifically the main residence exemption for the assets test, is likely a relevant consideration for many in deciding

<sup>19</sup> Melbourne Institute of Applied Economics & Social Research, HILDA Selected Findings from Waves 1 to 19

<sup>20</sup> ABS, Retirement and Retirement Intentions, Australia, table 8.1 – Superannuation and lump sum payments (released August 2023)

whether to take a lump sum from their super at the point of retirement, either to extinguish or reduce mortgage debt, or to undertake home improvements.

That being the case, and given over 60 per cent of the 60 – 64 age cohort took a lump sum from their super during 2020-2021, RSE licensees will need to be cognisant of these potential withdrawals on the income generating capacity of prospective remaining super balances<sup>21</sup>, and by extension, on the retirement guidance, assistance and the RIC-based products and solutions they make available to retiring members.

## What actions are industry or other participants in the community taking to address the issues identified in this section?

The comments to date have focussed on retirement planning from an individual's perspective, trying to solve the 'risky, long-horizon, multi-dimensional problem' that is retirement.

As the preceding evidence has shown, the problem is in fact even more complex than the above suggests, because home owning Australians now have another major challenge; paying off a mortgage prior to retirement.

In essence, lifetime consumption smoothing as experienced by working Australians today involves running two multi-decade savings programs in parallel, with the aim of zeroing the balance of one while maximising the balance of the other at the point of retirement.

Taken chronologically, the experience of superannuation starts with the first dollar of contribution, most often in one's late teens to mid-twenties, and thereafter growing the balance through (at a minimum) regular SG contributions combined with the compounding effect of investment returns over time to the point of retirement.

Home ownership involves the obligation of a mortgage, with the aim thereafter to reduce the outstanding principal in accordance with, or ahead of, the amortization schedule, subject to adjustments for property changes (renovations or sale/repurchase)<sup>22</sup>.

The clock starts ticking on the amortization timeframe of the last mortgage prior to retirement (the mortgage on the 'forever' property). Thereafter the complexity resides in whether that mortgage can be discharged through employment-based cashflow (disposable income) prior to retirement, or whether there will be an outstanding mortgage at the point of retirement.

Evidence presented earlier suggests that for 55 – 64-year-olds the odds are now essentially 50/50 on having an outstanding mortgage at the point of retirement, and if so, the outstanding mortgage being circa \$230,000.

These are not matters that super funds should take likely, given that some 60 per cent of retirees appear to be making lump sum withdrawals, with property-based spending (including extinguishing

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<sup>21</sup> The difference between any mortgage outstanding at the point of retirement and the total superannuation balance of the relevant mortgagor household (individual/couple) may be an appropriate proxy for the quantum of super able to be used to create one or more retirement income streams, or the '**Net Pension Generating Super**' (NPGS).

<sup>22</sup> Current data collected by mortgage comparison sites suggest that the average first home loan is now north of \$400,000 while the average refinance/upgrade home loan is somewhere in the vicinity of \$600,000.

mortgages) a key reason cited. This thereafter clearly diminishes the retirement income generating ability of the residual super, which can be considered the Net Pension Generating Super.

*Data – actionable insights count, all else is noise*

Findings from the joint APRA/ASIC thematic review of the RIC suggests that RSE licensees are struggling to understand members’ financial position. Of the factors captured by RSE licensees when determining ‘retirement income’, few capture non-super assets, and where home ownership status was captured, it is not clear whether balances on any corresponding mortgage is similarly captured<sup>23</sup>.

While the thematic review found that all RSE licensees analysed internal data when formulating their retirement income strategies, the depth and quality of the analysis varied. A small number analysed only basic factors such as member accounts by age or balance bands at a point in time.

Such basic analysis does not serve the interests of members and may ultimately impinge on their retirement outcomes. Based on the preceding evidence, the following data should be collected to build a more robust picture of members’ financial position leading up to retirement, and by extension, their retirement income generating capacity<sup>24</sup>:

**IMPORTANT FACTORS IN THE DATA COLLECTION PROCESS**

Factor (data type)	Reason
<b>Balances held in other super accounts</b>	To gain a more accurate assessment of the member’s aggregate super assets at the forecast point of retirement
<b>Partner status</b>	Combined income earning capacity accelerates the rate of household wealth creation
<b>Partner’s super balance(s)</b>	Allows for modelling of prospective combined superannuation at the forecast point of retirement and therefore forecast household retirement income
<b>Financial assets held outside of super (household level)</b>	Given ABS data of non-super household financial assets currently circa \$3 trillion in aggregate, understanding the member’s household position is relevant.
<b>Home ownership status</b>	Unencumbered home ownership alters retirement income needs (reduces cashflow directed to housing) and creates a store of wealth that can be accessed if required (e.g. HEAS).  Conversely, members who are forecast to be renters at the point of, and into, retirement may need differentiated guidance, assistance, and support.
<b>Mortgage outstanding</b>	If “yes” to the above factor, then any mortgage balance is relevant, given the evidence of the quantum of mortgage debt now being carried into the sixties, and the propensity for members to make lump sum withdrawals at the point of retirement to, inter alia, pay down or extinguish such debt.

Much of what has been submitted on home ownership and mortgage debt is somewhat at odds with widely held industry beliefs and assumptions.

The prevailing industry view is that the vast majority of members will reach the point of retirement as unencumbered homeowners, having extinguished their mortgages prior through ‘take-home pay’.

<sup>23</sup> ASIC/APRA ‘Information report – Implementation of the retirement income covenant: Findings from the APRA and ASIC thematic review’, Australian Government, July 2023 p 10

<sup>24</sup> This list is intended to add to and complement Table 2 (Examples of data gaps identified by the RSE licensees) of the joint ASIC/APRA thematic review, p 12

The presumption that follows is that retirees face neither mortgage repayments nor rental obligations in retirement. This is the explicit assumption in the most widely used retirement spending benchmark in the industry<sup>25</sup>.

Evidence presented in this submission shows this to be a shaky assumption on which to now develop retirement income strategies. 20 per cent of members at the point of retirement today may not be homeowners, a trend that is only accelerating. Of the 80 per cent who are at present, half are likely to have a non-trivial level of mortgage debt still outstanding.

RSE licensees that fail to understand these developing dynamics, and fail to adjust their RIC programs accordingly, may inadvertently misguide relevant members in respect of their prospective retirement outcomes.

A simple example illustrates the problem:

*Michael is a 55 year old member of ABC Super Fund. His partner, Eliza, is a 48 year old member of XYZ Super Fund. Neither have any other superannuation interests.*

*Michael and Eliza own a house valued at \$2.1 million. Against that they have an outstanding mortgage of \$580,000, which they pay at the scheduled monthly mortgage repayment. At that rate the mortgage is set to extinguish when Michael turns 72.*

*ABC Super Fund has allocated Michael to a sub-class of members, based on his income, occupation, partnered status and forecast super balance at the point of retirement, as part of its RIC program. The Fund does not collect information on, nor does it make an assumption of, the mortgage debt of its members.*

*Based on the modelling for this sub-class, ABC Fund forecasts Michael's accrued super to age 65. Michael's fund informs him that he should receive a stable and sustainable income of \$39,000 per year in retirement, and continues to do so in every annual statement thereafter.*

*Michael gets to age 62 and decides to retire. He withdraws \$230,000 of his accrued \$650,000 in the ABC Super Fund to extinguish the mortgage. He then inquires of ABC Fund as to the income its RIC sub-class retirement income product will generate for his retirement. He is informed that, given the lower starting balance, the best estimate of a stable and sustainable income is now \$25,200 per year. Michael feels let down by his fund.*

If this were to occur, it would be a significant unintended consequence of the otherwise pro-consumer RIC reforms.

#### *Framing effects, nudges, and presumptive guidance*

One of the more established behavioural biases in finance is the concept of 'framing', of being influenced into a mode of thinking or action based on the way in which information is presented.

In the retirement planning domain, one of the most entrenched, and most difficult to shift, frames is that of the 'pot of gold' concept; of superannuation as the process of creating a sufficiently large pool of financial capital such that a desired level of income can be generated in perpetuity, without the capital base being diminished<sup>26</sup>.

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<sup>25</sup> The ASFA Retirement Standards (Comfortable and Modest)

<sup>26</sup> The capital base is often only considered in nominal terms however, with no requisite adjustment made for the fall in purchasing power because of inflation. This is sometimes referred to as the money illusion.

Part of the reason for the ubiquity of this frame in Australia is due to our Defined Contribution (Accumulation) biased super system.

Contrast that with Defined Benefit (DB) schemes, where the focus is the end income benefit, and the differences in member perspective is significant.

This difference is best summarised by Nobel prize winning economist Professor Robert C Merton as follows:

*“A DB scheme is designed and managed to provide members with an income in retirement. And because this motivation filters right through the scheme, members think of their benefit in terms of income. Ask DB members what their pensions are worth and they will reply with an income figure – ‘two thirds of my final salary’, for example.*

*DC language is different. Asset value is the metric; its growth the priority. Everything flows from this. Members are taught to understand their appetite for investment risk and to be wary of volatility in asset values rather than volatility in income. Members’ annual statements highlight their investment returns and account values. Ask DC members what their super is worth and you are likely to hear a cash amount and perhaps a lament to the value lost to the global financial crisis<sup>27</sup>.”*

After 32 years of DC-biased framing in Australia, it is hugely entrenched and will require a concerted effort to shift this collective thinking on the part of super industry participants and members alike.

One way to do so is to think of retirement planning as a mere continuation of a lifelong process of **consumption smoothing**. In a consumption framework, cashflow is what counts and its sources are secondary to their quantum, stability and sustainability.

All that matters is that there is sufficient cash inflow, from relevant sources, to match the cash outflows that are required based on personal circumstances, preferences, and needs.

The Age Pension is possibly the best such example of a resource delivering a considerable level of consumption smoothing. In its absence, many retirees would experience a significant deterioration in their retirement lifestyles. Yet few, if any, Age Pensioners would think of this benefit in terms of a ‘pot of gold’.

A more detailed discussion of lifetime consumption smoothing, and its relevance to the super sector, is provided in Appendix C.

Another difficulty with Australia’s retirement phase of super arises due to the presumptive guidance many members mistakenly adopt when selecting retirement income products. The most common being the selection of the minimum draw down rate on account-based pensions.

This would appear to be a combination of presumptive guidance on the part of the member (‘this is what the super fund believes I should draw’) and a measure of self-insurance of longevity risk.

The issue of longevity risk management will be addressed later in this submission, but for now it is sufficient to say that nudging members to take more than the minimum required under the SIS Regulations is not easy, even when robust modelling suggests this as the best way to maximise a member’s lifetime retirement income.<sup>28</sup>

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<sup>27</sup> Merton, Robert C in ‘Next Generation Retirement Planning’, Dimensional Managed DC publication.

<sup>28</sup> The author of this submission led the design of a novel ABP-based retirement product, released in July 2014, with an initial minimum drawdown of 7 per cent of the purchase price. Members appreciated the product’s

### *Finding the sweet spot between ‘the cohort of one’ and just one cohort*

The joint ASIC/APRA thematic review in 2023 found that RSE licensees were undertaking some level of segmentation of their members into sub-classes.

There was however a wide dispersion in the number of sub-classes found, from 2 to more than 30, with 3 sub-classes found to be the most common<sup>29</sup>.

There are two factors that might account for this divergence.

First, it may be a function of the internal data capabilities and resources of different RSE licensees. Funds with less advanced capabilities will invariably find it more difficult to be more granular in the insights they can parse from their internal member data, leaving aside any capability to collect, analyse and draw inferences from external data sources.

Sector dynamics also play a part in the divergence, with for-profit RSE licensees more likely to either have more granular member data (courtesy of the advice channel from which much of their membership originates) or to have more retiree members receiving personal financial advice from a qualified financial adviser.

This is essentially the ‘cohort of one’ approach, where members are having their personal and financial circumstances reflected in the guidance, advice and retirement income strategies implemented.

In respect of profit-for-member RSE licensees, the cohort of one approach is infeasible, but neither should there be one cohort (or possibly two or three).

Given the differences outlined in preceding paragraphs just in terms of gender and home ownership, let alone the myriad of other possible factors (occupation type, physical and mental health, family history of longevity for example) it is possible that greater granularity might be beneficial.

One such approach may be to divide members of similar age cohorts across quintiles by expected total household wealth, incorporating estimates for the key components of housing wealth (and associated debt), superannuation assets held with other RSE licensees and non-superannuation financial assets.

This approach would be consistent with segmentation based essentially on forecast total net household wealth at the point of retirement, across the five cohorts, to which estimates of the level of Age Pension, if any, could then be overlaid to estimate the level of income from all sources in retirement.

Each member would be allocated to a quintile, and members might move between quintiles over time as their relative circumstances change (i.e. a change in net household wealth relative to their peer group or quintile).

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many other features (bucketing + automatic annual rebalancing), but were disinclined to draw at the suggested income level, preferring instead to commence their pension incomes at the SISR minimum. The product was modified after launch to allow members to commence at their aged-based legislative minimums.

<sup>29</sup> ASIC/APRA Retirement Income Covenant thematic review, 2023 at p 13

Of the approaches identified, what should be prioritised and what risks should be considered as policy is developed? What other approaches, if any, should the Government consider?

Of the approaches identified, facilitating the secure, accurate and timely movement of relevant member data between data sources and RSE licensees holds the greatest potential to shift the complexity of retirement planning from members to their super funds, and in so doing accelerate the implementation of the RIC obligations.

This is because super funds cannot be expected to perform complex retirement forecasting, even at the sub-class or cohort level, without the benefit of timely and relevant member data.

To date the Consumer Data Right has only been implemented in a select number of industries, notably banking and energy retailers. While it is scheduled to be expanded to non-bank financial institutions and thereafter to select insurance services, a superannuation version of 'Open Banking' ought to be pursued by the industry as a high priority.

Consider the ability of a member to authorise the sharing of data as between his/her bank or financial institution and his/her super fund, restricted for privacy purposes purely to mortgage accounts. The insights gleaned from understanding the interplay between the member's super balance (a key wealth asset) and mortgage debt (the key wealth liability for most consumers) over time would allow for a fundamentally more rigorous approach to retirement preparedness.

Were such an arrangement in place for the disappointed Michael in the earlier example, his retirement planning could have been different. At the very least, the fund might have been able to warn him of the trade-offs involved between debt and retirement income optimisation.

Given the small prospect of an 'Open Super' in the near future, the quickest wins in terms of priorities would be for super funds to enhance retirement income solutions by, inter alia, enhancing drawdown profiles optimised for sub-classes, and further developing retirement-centric portfolio optimisation, rebalancing and withdrawal prioritisation techniques.

These facets, broadly of an internal investment and operational nature, can more readily be enhanced without the need for extensive data projects involving external counterparties.

## Supporting funds to deliver better retirement income strategies

In addressing this section, the following statements from the Discussion Paper are taken as self-evident and indisputable<sup>30</sup>:

*“Funds need to provide well-rounded products that are appropriate for the complex risks and decisions members face, and that balance all three of the retirement income covenant objectives.”*

*“The market for retirement income products will work best when it is competitive, comparable, and transparent.”*

*“Members are best served if they can readily compare products and switch providers to one that meet their needs.”*

For evidence of the consumer benefits of standardisation, simplification, and product comparability in the superannuation sector, one only need look to MySuper, a fundamental change to the accumulation phase of super that has now reached its 10-year milestone.

The default fund landscape was vastly different prior to the introduction of MySuper, and not necessarily to the consumer’s benefit.

In an industry reliant on future promises, where tangible evidence of ‘value for money’ is simple not ascertainable by the average person, strong policy intervention is often needed to ensure that industry players do not take unfair advantage of consumers.

10 years on from the introduction of MySuper, the enhanced regime has tangibly improved member outcomes in the accumulation phase, and stands as an example of what may now be possible in the decumulation phase of superannuation.

As noted in the Discussion Paper, MySuper also provided the impetus for a number of consumer-centric initiatives, including the YourSuper online comparison tool, and the Your Future Your Super (YFYS) annual performance test undertaken by APRA across MySuper and, more recently, trustee-directed (accumulation) products.

There is thus no logical reason why the same approach to product comparability and assessment could not be, in time, implemented in the retirement income space.

As the Discussion Paper notes, some of these initiatives were slated for implementation, but have been paused pending industry feedback and ongoing discussion.

The technical paper produced by the Australian Government Actuary in 2018 to create a workable ‘retirement income risk measure’ is one such example<sup>31</sup>. The development of an ‘income variation risk’, one that measures the difference between the income received and that expected by a benchmark, is technical in nature, but conceptually sound.

Quantification of retirement income risk is one thing. Communication of it to a lay audience in terms that are easily understandable and actionable, another thing altogether.

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<sup>30</sup> Treasury, ‘Retirement phase of superannuation – Discussion paper’, Australian Government, p 17

<sup>31</sup> Australian Government Actuary (AGA), *Retirement Income Risk Measure – AGA Technical Paper*, AGA, Australian Government, 2018 p 4

For that reason, as between the three opportunities outlined in the Discussion Paper to support retirement income product disclosure, these being:

- Development of a standard risk measure that could assess the relative risk of retirement income products to a fall in income from year to year;
- Establishing scorecard approaches that demonstrate how products balance the three retirement income covenant objectives or other metrics; and
- Retirement income strategies compared via the combination of a broad qualitative checklist to assess fund activities undertaken to deliver on good member outcomes, as well as quantitative modelling where potential member outcomes are simulated and assessed against the covenant objectives

the standard risk measure appears the one most likely to be applicable as a risk communication tool to members, specifically the creation of a relative risk measure and the graphical representation of it (the 7 point scale developed by the AGA) either via a linear approach (page 14 of the AGA technical paper) or a non-linear approach (page 15).

Conversely, in respect of internal research and development (and testing) of various combinations of products (say account-based pensions mixed with some type of annuitisation), the approaches adopted by Bell, Khemka and Warren in their June 2023 'Thought Piece'<sup>32</sup> is worthy of further consideration.

RSE licensees cannot contract out of their obligations under sections 52(8A) and 52AA of the Superannuation Industry (Supervision) Act 1993. There is a requirement to do the work to understand their membership base better, segment them appropriately, create and test retirement income products and combinations thereof in different solutions for different segments, with the goal of optimising member retirement outcomes, based on the three objectives of the RIC for income maximisation, risk management and capital flexibility.

If this should mean one approach to internal retirement product R&D and a different one to member communications, that, in and of itself, should not be seen as a barrier to innovation.

To the end consumer (member) however, the key questions are as follows:

- How much income will this solution deliver me?
- How might this income change over time?
- If there is a longevity component, what might that income look like by itself once the flexible component(s) are exhausted (in present value terms)?
- How much will it cost me to buy and hold this income solution?
- How will it interact with the Age Pension and my other sources of retirement cashflow (non-super investments, HEAS or possible part-time work)?
- What happens if I want to cease holding this solution and acquire a different one?
- What happens to any residual benefits within the solution in the event of my death?

RSE licensees should be able to provide concrete answers to the above in respect of their retirement income strategies already in existence and those in development.

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<sup>32</sup> Bell, D, Khemka, G, and Warren, G, 'How to Approach Quantitative Assessment of Retirement Income Strategies', The Conexus Institute, June 2023

## Making lifetime income products more accessible

Prior to providing responses to those specifically elicited in the discussion paper, it is helpful to first ensure clarity on the issues to be considered. Risk management concepts are difficult to both convey and grasp, especially risks associated with life expectancy, so the below are some thoughts on the matter.

The RIC obligation articulates a need for RSE licensees to manage expected risks to the sustainability and stability of the expected retirement income of pension beneficiaries<sup>33</sup> (in addition to the obligation to help maximise expected retirement income and provide flexible access).

Further, the range of risks trustees are required to help manage are explicitly included in SISA section 52AA(2)(b) as including longevity risks, investment risks, inflation risks and ‘any other risks to the sustainability and stability of the retirement income’.

A comprehensive list of risks faced by retirees is provided in Appendix A, including investment risk and inflation risk, however it is worth being very clear about what exactly longevity risk is for the purposes of this submission.

Given this discussion pertains to risks in the financial domain, my definition of longevity risk as it applies to retirement is as follows:

*The risk of living beyond one’s actuarial life expectancy, and in so doing exhausting one’s **private financial resources** before one’s death, consequently experiencing a fall in living standards **below that which is desired**.*

The key aspects of this definition include living beyond what was expected and by doing so exhausting one’s **private** financial resources.

Importantly, one needs to experience a **fall in living standards below the desired level at that point in time** (not necessarily the living standard at the commencement of retirement).

The reason this is important is that all qualifying Australians already have access to a government-funded, longevity risk insured, income stream: the Age Pension.

### *The ‘Automatic Stabiliser’ of Retirement Income*

The Age Pension is, in essence, a means-tested, cost-of-living-adjusted lifetime annuity<sup>34</sup>, with the guarantee of lifetime income backed by the Commonwealth Government’s balance sheet.

For those who have not been able to save sufficiently for retirement, the full Age Pension acts as a minimum retirement income safety net, a lower bound below which one’s living standard cannot fall. That income continues, so long as the qualifying criteria remain met, for life.

Due to the operation of the assets and incomes test, those who have taken reasonable steps towards self-provision may receive part Age Pension, the amount means tested and thus variable, acting effectively as a retirement income automatic stabiliser. When private financial resources fall

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<sup>33</sup> Superannuation Industry (Supervision) Act 1993 (Cth) section 52AA(2)(b)

<sup>34</sup> The cost-of-living adjustment occurring through the higher of male AWE, CPI and the PBCLI

(through market movements or capital consumption), the part Age Pension amount rises, and vice versa.

What then is the 'value' of this government provided 'lifetime annuity'?

A 2013 article<sup>35</sup> in a finance journal attempted to quantify this benefit. The author sought to place an estimate on the present value of the full Age Pension for a single female, single male or a couple, based on survival probabilities. His findings appear below:

Present value<sup>36</sup> of the full Age Pension

Age	Female	Male	Couple	Couple (per person)
69	\$293,000	\$346,000	\$542,000	\$271,000
75	\$268,000	\$226,000	\$424,000	\$212,000
81	\$152,000	\$181,000	\$292,000	\$146,000
85	\$132,000	\$113,000	\$219,000	\$109,000

Thus a 69-year-old male receiving the full Age Pension in 2013 would have received a benefit over his life expectancy equivalent to \$346,000 in 2013 dollars.

These results help explain why retirees so keenly seek to access the Age Pension, even if only partially. The figures above represent a 'private capital equivalent' that would need to have been saved to recreate the cash-flow benefit that the Age Pension would have provided in 2013.

In essence then, what we are now dealing with are two questions:

1. why might some Australians choose to insure a portion of their private savings, i.e. some of their accrued super at the point of retirement, to create a private market equivalent of the Age Pension?; and
2. for those who chose to do so, how might this be facilitated in a way that is efficient, equitable and 'actuarially fair', such that a market for these lifetime income products might grow over time?

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<sup>35</sup> Wood, Justin (2013), 'Examining the Equity Holdings of Australian Superannuation Funds', JASSA Issue 2, 2013.

<sup>36</sup> Calculations use ABS Life Tables Australia 2009–11, age pension payments at March 2013, a real interest rate of 1.5 per cent p.a. and an assumed real growth in the age pension of 1.6 per cent p.a.

Please provide any comment on the barriers in the supply and demand for lifetime income products.

The barriers to the creation of a thriving market for lifetime income products is best understood by focusing mostly on the demand side.

Solve the demand issues and there will be appetite amongst providers to create solutions to meet it, thus resolving the so-called 'annuity puzzle'.

#### *Demand-side issues*

Australia is something of a unique market for lifetime annuities, as there appears to be a particularly strong behavioural bias against annuitizing as a means of managing longevity risk.

Given the ubiquity of the Age Pension, individuals are generally unwilling to use their own capital to purchase commercial lifetime annuities, judging these products not to be 'value for money'. Yet these very same individuals will aim to optimise the amount of Age Pension (a government lifetime annuity) they receive in retirement.

The Age Pension table above provides a clue as to why this might be the case. The typical retiree is making a subjective assessment that:

- The Age Pension is a better way to deal with longevity risk than a commercial lifetime annuity;
- The Age Pension 'costs' nothing in comparison to the private savings required to create the same cash-flow benefit; and
- The value placed, **at the point of retirement**, on accessibility of capital and the bequest motive is greater than the value placed on the sustainability and stability of income in one's later years.

The Retirement Income Covenant legislation concedes as much, with the explanatory materials for the legislation noting that:

*"The Age Pension provides a minimum amount of investment, inflation and longevity risk management. Depending on the beneficiary's circumstances, the Age Pension **may be sufficient without additional** sources of investment, inflation and longevity risk protection<sup>37</sup>." [Author's emphasis]*

Recalling the longevity risk definition used earlier that held it to be the risk of living beyond one's actuarial life expectancy and by doing so exhausting one's private financial resources.

This then is the crux of the annuity puzzle; for very many retirees, the automatic stabiliser of the Age Pension may be a sufficient annuitized 'safety net' level of consumption, particularly in the later (passive and frail) stages of retirement.

Then there is the problem of the median prospective level of income generated by a lifetime income stream commenced from super.

Data presented earlier indicates that at present, the median super balance for a 60 – 64 year old retiree is around \$190,000 at present (averaged between the genders). Assuming a 20 per cent

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<sup>37</sup> Treasury Laws Amendment (Measures for a later sitting) Bill 2021: Retirement Income Covenant explanatory materials at para 1.44

allocation to a lifetime income stream component, that equates to a purchase price of \$38,000. What might the resultant income stream be? And how might it compare to the current single full Age Pension of \$28,514 per year at present?

Therein lies the problem. At present, lifetime income streams are most effectively utilised as part of the retirement income mix for wealthier cohorts, particularly those who do not qualify for the Age Pension.

If you have no foreseeable access to the Age Pension during your expected retirement years, and you have sufficient capital to make your lifetime annuity component a non-trivial part of your total retirement income, purchasing such an income product makes a lot more financial sense.

Particularly if you fear a fall in your living standards below your preferred threshold (floor level) of retirement consumption, due to outliving your other financial resources.

It is unsurprising then that lifetime income products have found their strongest demand thus far in the higher end advised segment, and by extension, the retail super funds who serve their advisers (see discussion in Appendix B).

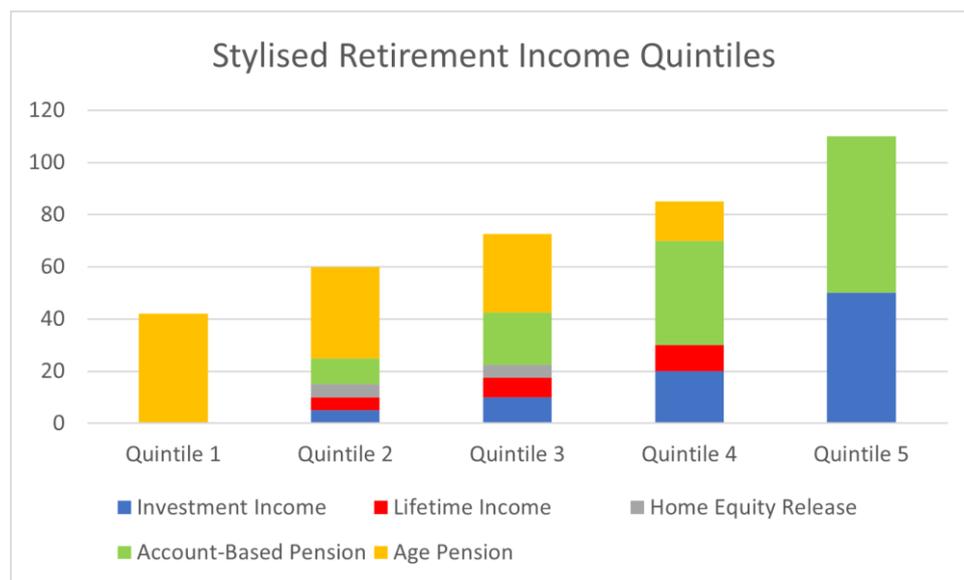
It is in essence a 'barbell' issue, with either end of the wealth spectrum being catered to:

- Low wealth retirees have access to the full Age Pension for their longevity risk management;
- Higher wealth retirees can choose to purchase lifetime income products to manage theirs.

The dilemma in developing a viable market for lifetime income products is in the 'messy middle' cohorts (roughly between the 20<sup>th</sup> and 80<sup>th</sup> percentiles)<sup>38</sup>.

Conceptually, the longevity risk dilemma can be considered with reference to retirement income quintiles. The below is a stylised chart that seeks to depict the layering of income solutions that different cohorts may typically use.

#### HYPOTHETICAL SOURCES OF RETIREMENT INCOME BY WEALTH QUINTILE



<sup>38</sup> For an excellent overview of the middle cohorts dilemma, see Appendix A – *Understanding the 'middle Australia' cohort* in Hennington, J and Boal, A, 'A Framework to 'Maximise' Retirement Income', Actuaries Institute, April 2022 p 26

Quintile 1 captures retirees with the lowest 20 per cent of retirement incomes. These are depicted as relying solely on the Age Pension for their retirement income<sup>39</sup>.

Quintile 5 retirees are full self-funded and will remain so for the duration of their retirements. Retirees here may be generating investment income surplus to retirement consumption requirements and have sufficient capital reserves to call upon to support lifestyle preferences well past actuarial life expectancies. Retirees here may therefore be disinclined to purchase lifetime income products, preferring instead to manage their own account-based pensions via their Self-Managed Super Funds.

The problem the super sector faces are with quintiles 2, 3 and 4. These are the 'messy middle' from a RIC, and specifically longevity risk management, perspective.

These three quintiles will likely have a larger mix of retirement income sources, including some Age Pension, depending on individual circumstances. The level of longevity risk insurance thus varies accordingly.

The challenge the sector has, particularly super funds with smaller retiree pools, memberships with greater socio-economic variability and lower super balances at retirement is to blend an appropriate (yet meaningful) level of private longevity risk protection (the lifetime income component of their retirement income strategies) with the longevity risk protection built into the Age Pension.

That will be no trivial task.

It is therefore relevant that the RIC legislation makes the point that:

*"A trustee has discretion to determine if their beneficiaries need assistance managing investment, inflation and longevity risks, and how trustees provide that assistance. In exercising their discretion, a trustee needs to consider each of the risks in turn."*<sup>40</sup>

### *Supply-side issues*

On the supply side of the equation, the Discussion Paper is right to note the relatively small addressable market for lifetime income products in Australia, leaving aside the quirks presented by the Age Pension.

All risk management solutions that are probability based require enough participants for the law of large numbers to apply with authority. Absent that, the variance between actual outcomes and expected outcomes may make pricing, and managing, a pool of risks problematic.

Therein lies part of the dilemma with the lifetime annuity market. Either through an insufficient understanding of the likelihood of living past one's actuarial life expectancy or a reliance on the Age Pension as the longevity risk management product of choice, Australians have not embraced privately insuring against 'living too long'.

At its core, longevity risk insurance requires a sufficiently large pool of lives such that mortality credits, provided by the short-lived, can be directed to the long-lived in an actuarially and commercially sound manner over an extended (multiple decade) time horizon.

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<sup>39</sup> This may not be the case in reality, but for the purposes of illustration is taken to be so.

<sup>40</sup> Treasury Laws Amendment (Measures for a later sitting) Bill 2021: Retirement Income Covenant explanatory materials at 1.40

## What policy approaches should be taken to support use of lifetime income products to address the risks to retirement income? What risks should be considered?

On the assumption that a thriving lifetime income product market would be a societal good (allowing more retirees to consume at higher levels in retirement than would otherwise be the case), there are certain policy measures that might assist its development.

Firstly, as alluded to earlier, the problem of small pools of insured lives will continue to be a barrier to the growth of lifetime income products.

Thus the option outlined in the Discussion Paper to have Government facilitate pooling as between smaller funds, such that these funds could be allowed to pool mortality credits with each other is one that warrants serious consideration.

The other option of having Government intervene in the pricing of longevity risk through a reinsurance facility, or the issuance of longevity bonds, is to be welcomed. The ability for providers to offset or hedge longevity risk on their balance sheets should provide a supply-side impetus, given that this should lower the effective cost of capital for providers.

It should be noted that other countries, Brazil in particular, are starting to look toward longevity bonds as a means of providing a natural hedge to the long-term liabilities that lifetime annuity providers take on in providing lifetime income products. Some of the developments in this space point to possible avenues for the maturation of the Australian longevity risk market<sup>41</sup>.

In addition to the above, Government has a role to play in establishing, or regulating, 'actuarially fair' risk pricing in the sector, to overcome the twin problems of adverse selection and pools containing actuarially disadvantaged socio-economic lives (for example indigenous members, or heavy blue-collar members being included in a largely white collar professional pool of lives).

## What action are funds taking to better manage longevity risk, and what role do funds see guaranteed income products (e.g. annuities, pooled products) playing in the future?

Longevity risk is not a new risk to the super sector. On the profit-for-member fund side, some of the oldest funds in Australia, many that predate the introduction of SG in 1992, have a provenance of managing defined benefit assets, many such schemes involving lifetime defined benefit pensions for retiring members. Prior to 1992, Australia's superannuation sector was dominated by such funds, with defined contribution (accumulation) funds in the minority by assets.

On the retail fund side, some of Australia's largest financial institutions built their businesses on the sale and management of life insurance products, with term and lifetime annuities being a significant part of their operations until the removal of the Age Pension asset test exemption for the full purchase price.

Thus the issue is one of reviving a market that has been in a state of slumber for some 20 years.

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<sup>41</sup> See for example Merton, R and Muralidhar, A, '*SeLFIES: A New Pension Bond and Currency for Retirement*', 2020

The challenges of building longevity protection into their retirement income products and solutions will be most keenly felt in the profit-for-member sector, particularly at by small to medium sized funds.

As alluded to in the Discussion Paper, these funds generally do not have sufficiently large and diversified pools of retiree members from which to apply probabilistic longevity risk management, even where they have the internal skills and resources to do so.

Despite their small stature, smaller funds are not beyond innovation. Some of the more innovative retirement income solutions of the past decade have come from funds that might now be considered 'sub scale' by APRA.

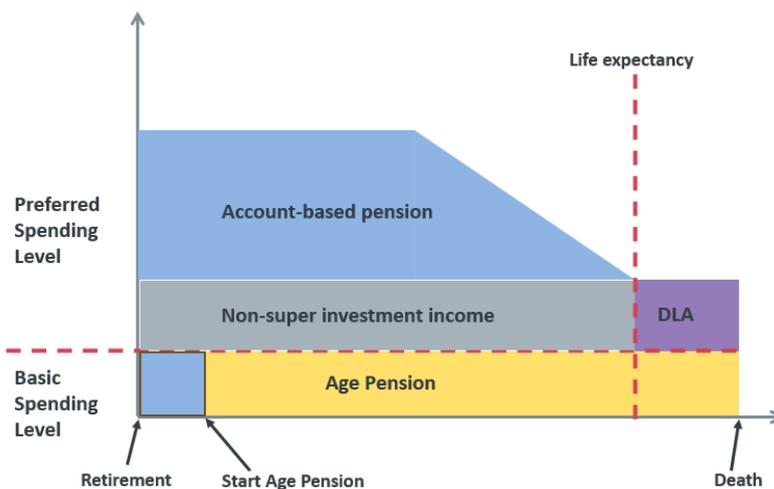
Funds have addressed investment, sequencing, and longevity risk in differing ways, but often the unifying idea is the concept of member retirement income 'layering'; of retirement funding being an exercise in managing more than one source of income.

A stylised depiction of how income layering might work for a fund with a higher balance demographic is provided below.

Here the fund's trustee recognises that this particular sub-class of beneficiaries is likely to qualify for some level of Age Pension at age 67. The expectation is that the average member of this sub-class will retire at 65.

The solution involves the commencement of an account-based pension at age 65, drawn at a higher level until age 67, whereby it reverts to a lower annual payment, diminishing toward life expectancy. A level of non-super investment income is also considered likely for this sub-class, again extinguishing around life expectancy.

Longevity risk is explicitly hedged using a deferred lifetime annuity (DLA), with this income stream commencing (if needed) at the point of life expectancy and continuing thereafter until death, in concert with the Age Pension.



The above is provided purely for illustrative purposes only, to show what might be possible in dealing with the 'messy middle' annuitisation problem in Australia.

### Would an industry-standardised product(s) assist funds to develop and offer lifetime income products to their members?

There is precedent, in MySuper, for the creation of standardised parameters in a retirement income solution that incorporates an element of longevity risk hedging.

Whilst the super industry was reticent at the start of MySuper, there is clear and unequivocal evidence that, a decade later, the benefits to member outcomes have outweighed the costs of funds creating MySuper products.

There is no reason why a standardised retirement income product should not similarly shift the dial. In large part, the need for membership retention would be a sufficiently large inducement for funds to ensure that they have at least one standardised retirement income solution. In this way competition can form the basis for industry-wide transformation.

### What features should a standardised product include?

The example 'bundled retirement product' depicted in the Discussion Paper (at page 28) has the primary features that one would expect in a reasonable standardised retirement income product, including some withdrawal flexibility (via a capital reserve component), an account-based pension component and a deferred lifetime income stream.

In many ways, the stylised income layering solution on the preceding page is of the same overall ambition.

### Should there be a path to more easily transition members to a standardised product?

The pathway to full and final retirement are many and varied. The existence of Transition to Retirement (TTR) pensions attests to this fact.

Transitioning members to a standardised product should be made as seamless as possible, but no more, in the sense that commutations and rollbacks may be more problematic where these products have a lifetime income product that has been activated (and past any cool-off period).

For this reason alone, amongst a host of other such as sharper pricing, use of deferred lifetime annuities in standardised products would make a lot of sense.

### Should superannuation funds be required to offer a standardised retirement product, similar to MySuper for accumulation?

Funds should be required to offer such a product, but there should be no compulsion on the part of the member to acquire it. These products should serve as a 'base model', from which consumers might choose to adopt an alternative approach, in similar fashion to the MySuper regime.

### How should a product vary for individual circumstances of the member?

This is the key concern. Many funds have highly heterogeneous pools of beneficiaries. It is unlikely that any one standardised product will suit the needs of all sub-classes of beneficiaries in a fund.

The account-based pension component is likely to provide the greatest degree of flexibility (portfolio construction, glidepaths, time segmentation (bucketing), withdrawal prioritisation, rebalance optimisation). Even so, it may be difficult to cater to the needs and preferences of a diverse membership within the framework of a standardised retirement income product.

## Concluding comments

It is for good reason that retirement planning is often considered the hardest problem in finance.

It is an optimisation problem involving multiple variables, many of which are resistant to forecasting, conducted over a horizon that might span potentially four decades of working life and then three plus decades beyond it.

Part of the problem is systemic. Australia moved away from a defined-benefit biased system with the introduction of Super Guarantee in 1992. Thereafter the goal for the then-nascent DC sector was to grow as fast as possible: maximising contribution inflows (SG, salary sacrifice, spouse super co-contribution, small business CGT exemption, downsizer) became the main game.

Creating robust retirement solutions to allow members a dignified retirement was not the focus. The lessons of Australia's DB heritage were somehow lost in the rush to growth.

Now, after a near three-decade hiatus, the industry is re-engaging with its original purpose; to deliver income in retirement to replace, to the extent possible, that which is lost when an individual ceases permanently to be connected to the workforce. The Retirement Income Covenant is a fundamental enabler of that re-engagement.

But, as the Discussion Paper puts it:

*“While industry is moving in the right direction, there is still a long way to go. Superannuation funds need to do more to understand their members’ retirement needs, set a vision for their members’ retirement outcomes, and provide well-rounded retirement products. There is a role for government and regulators in creating an environment that supports these changes.”*

The sector is closer to the start than the end on this journey of rediscovery, bringing some of that DB thinking of old into our DC-centric superannuation environment.

The ‘pot of gold’ framing may still hold sway in most quarters but for those who understand superannuation's true calling, income is the outcome that truly matters<sup>42</sup>.

The sooner the industry embraces this fundamental reality, the better.

In the interim, operationalising the legislative requirements of the Retirement Income Covenant is as good a start as any.

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<sup>42</sup> The author sincerely hopes the Superannuation (Objective) Bill 2023, currently in the Upper House of Parliament, will be passed into law soon.

## Appendix A – Risks faced at retirement (and beyond)

The discussion paper emphasises a select number of risks to retirement income, these being **investment** risk, **longevity** risk and **inflation** risk. For completeness, the below represents a more detailed set of risks that members face at the point of, and into, retirement:

- **Investment risk:** Members don't know what their final retirement benefit will be, subject as it is to the vagaries of financial markets, over which the member has no control. Likewise, investment returns play an outsized part in maintaining purchasing power through retirement, and periods of poor investment returns can severely impact on living standards in retirement.
- **Sequencing risk:** Where an account-based pension product is utilised with non-trivial exposure to investment risk, a member's account balance (and by extension, pension income) is 'path dependent' on the sequence of returns achieved by the product, both at retirement and into the early years of retirement. A poor early sequence of returns can accelerate the time to capital exhaustion beyond that which might have been expected.
- **Inflation risk:** Expenditure in retirement is subject to inflation broadly in the same way as it is prior to retirement, although the composition of the average retiree's consumption basket may differ to that of someone still in the workforce. Any increase in the retirement cost of living, if not accompanied by an equivalent increase in retirement cashflow, results in a loss of purchasing power and thus a decline in one's retirement standard of living.
- **Longevity risk:** The risk of living beyond one's actuarial life expectancy, and in so doing exhausting one's private financial resources before one's death, consequently experiencing a fall in living standards below that which is desired.
- Longevity risk complicates the budgetary process, often resulting in members drawing less than an optimal pension (where account-based pensions are used) to self-insure against prematurely exhausting their capital base.
- **Management & agency risk:** Members cannot know before the fact whether their particular super fund will perform well relative to its peers and investment objectives.
- **Budgetary risk:** Expenditure patterns can vary considerably during the active, passive and frail stages of retirement. As each individual might move through these stages differently, budgeting for expenditure needed across an entire retirement is a considerable challenge.
- **Counterparty risk:** Financial products may be utilised that have an element of counterparty risk. Lifetime annuities are one such example. Whilst strong prudential regulation can mitigate this risk, it can never fully remove it.
- **Liquidity risk:** Retirees may require rapid access to lump sums of capital at short notice to meet unplanned expenditure. This risk arises where there is a liquidity mismatch between the assets backing a retiree's pension product and their cash requirements.
- **Legislative risk:** A member's retirement experience is likely to span multiple decades, during which it is possible that legislative changes may occur that might impact on their financial circumstances. Whilst some disadvantageous changes may be 'grandfathered' and their impact thus mitigated, legislative risk still represents a long-term risk to retirees, particularly changes related to taxation of income streams and final estates, social security rules impacting the Age Pension and ancillary benefits, and senior's health and aged care related legislation.

## Appendix B – Characteristics of APRA-regulated superannuation funds

The superannuation sector has undergone a tremendous amount of change over the past decade, from the introduction of MySuper in 2014, to the outcomes of the Financial System Inquiry, the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (Hayne RC), the Retirement Income Review, the Levy Advice Review, the annual performance test and the Retirement Income Covenant, the subject of this submission.

Throughout this period, but especially since 2019, the pace of consolidation in super has accelerated, as fund merger activity spiked in the wake of the Hayne RC findings.

For an outline of where the sector now finds itself, it is instructive to review the most recent APRA fund-level data analysed by Conexus Institute in its recently released ‘State of super 2024’ report<sup>43</sup>:

Conexus Institute sample data of the APRA-regulated super sector covered some 65 RSE licensees that collectively had net assets of \$2.18 trillion at June 2023, some 60 per cent of total system assets at the time. SMSFs collectively accounted for \$876 billion, or 24 per cent, of total system assets<sup>44</sup>.

The sample of funds comprised some 22.15 million member accounts at 30 June, with the 10 largest funds by membership accounting for 16.26 million accounts, or some 73 per cent of accounts.

The challenges in dealing with the retirement phase of superannuation become apparent when variations between industry funds, public sector funds and corporate funds on the one hand (collectively referred to hereafter as profit-for-member funds) and for-profit funds (hereafter referred to as retail funds) are studied.

While profit-to-member funds dominate retail funds in terms of overall assets (at \$1.55 trillion v \$686 billion) and total accounts (72 per cent v 28 per cent), when it comes to the retirement phase, the results essentially invert. Profit-for-member funds collectively hold only 14 per cent of their total assets in pension accounts, less than half the 30 per cent held by retail funds.

Collectively, the top 50 funds by pension assets had 1.45 million pension accounts summing to \$386 billion at June 2023, excluding the defined-benefit biased Commonwealth Superannuation Corporation (CSC). Tellingly, as compared to the accumulation phase of super, retail funds dominate the retirement phase, with six of the top 10 funds by value of pension accounts.

Why might this be the case? It is essentially a historical artefact, and a function of the differing business models and distribution strategies that have evolved in the two sectors.

Profit-for-member funds have traditionally evolved, and grown, from servicing distinct groups of members based on employment relationships or industry sectors<sup>45</sup>. Being a ‘default fund’ under an award enables access to mandated contributions made under SG, which allows for low-cost scaling of member accounts, but skews overall membership toward younger, lower balance individuals who may be decades away from retirement.

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<sup>43</sup> Bell, D and Warren, G, Conexus Institute, ‘State of super 2024 – Industry insights based on APRA’s annual fund-level data released for FY 2023’, January 2024

<sup>44</sup> Non-APRA regulated funds and timing issues account for the balance of system assets

<sup>45</sup> It should be noted that most profit-for-member funds have now devolved from this sector-centric membership approach and are public offer funds, making membership available to the general public.

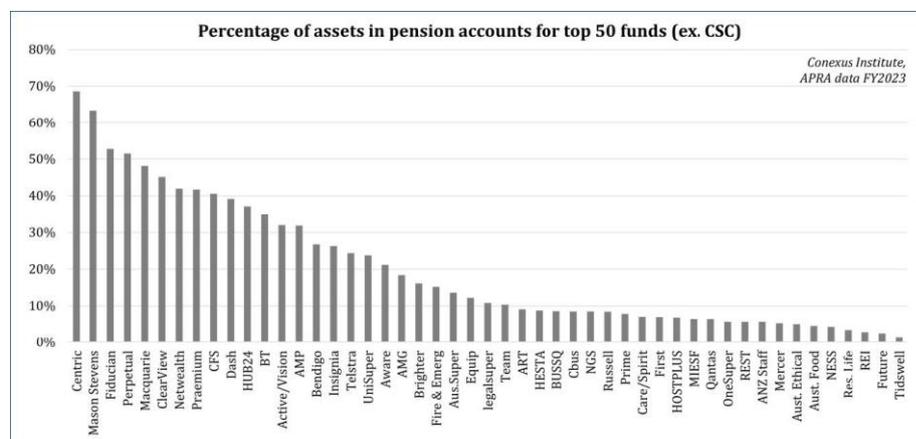
By contrast, retail funds (or more accurately super platforms) have traditionally distributed their services through financial advisers. As advice is most often sought closer to retirement for individuals with more complex needs (proxied by higher income/net worth), advised clients tend to have larger superannuation balances on average, and be closer to (or in) retirement.

To illustrate the difference, the largest APRA-regulated super fund at present, the profit-for-member AustralianSuper, had at June 2023 some 3.26 million member accounts, of which 3.16 million were in accumulation mode and only 98,000 were in pension mode (a pension account rate of 3 per cent).

By contrast, the (retail) super fund with the largest pension footprint, Insignia Financial, had 1.86 million member accounts, of which 235,000 were in pension mode (some 12.6 per cent), a rate over 4 times that of AustralianSuper.

Insignia Financial’s pension assets (\$47.36 billion) account for 26.3 per cent of its total assets while for AustralianSuper the corresponding values are \$40.69 billion and 13.6 per cent.

The chart below depicts this dispersion, with retail funds dominating the retirement market.



Source: The Conexus Institute

In embracing the requirements of the RIC, retail funds, with a history of engaging at the first instance with older, wealthier, and higher accumulation balance members closer to the point of retirement, may have an advantage borne of two factors.

Firstly, greater experience in creating and operating pension products and, secondly, the greater likelihood their retired members will be receiving personal financial advice via the financial adviser connected to the member’s account.

Profit-for-member funds, by contrast, are relative newcomers to the decumulation space at scale, and as such their business planning, systems thinking, resourcing and skillsets may be in the process of evolving toward being more retirement-centric. When it comes to the retirement phase profit-for-member funds are, in short, a work-in-progress.

The authors of the report also make the point that creating quality RIC-based solutions may involve a level of cross-subsidisation, of retired members by accumulation members, that profit-for-member trustees may have to negotiate<sup>46</sup>.

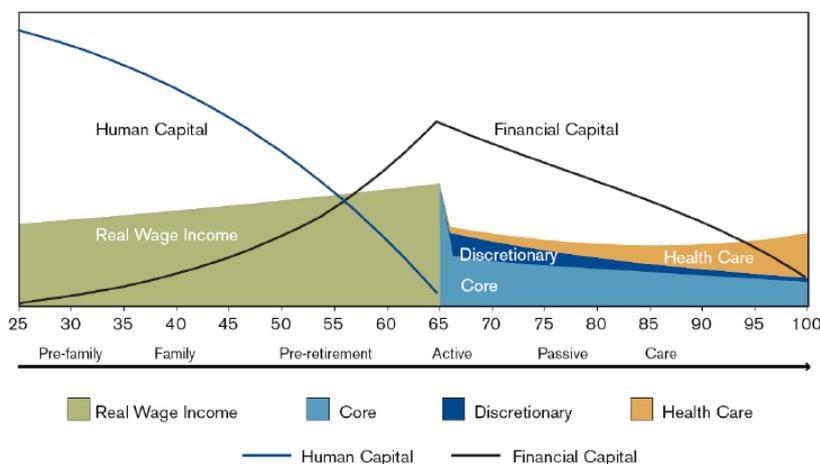
<sup>46</sup> Bell, D and Warren, G, [Cross-subsidisation challenge may hinder RIC progress - Investment Magazine](#)

## Appendix C – A framework for lifetime consumption smoothing

Since the late 1960s a rich body of academic research has developed as to how individuals earn, spend, save and make provision for their later years. This body of work has come to be broadly known as the Lifecycle Theory of Finance. A central tenant of this theory is that individuals save (and make provision for their retirement years) to *smooth optimal consumption levels* over their expected lifetimes.

A key element of lifecycle theory is the concept of human capital. In mathematical terms it is the present value of an individual’s future earnings. In practical terms it is the ‘store of earnings potential’ that can be traded in the employment market for income, some of which can be saved to build financial capital. The conversion of human capital into financial capital is what allows for future consumption when human capital is exhausted (i.e. in full and final retirement), with living expenses thereafter met from financial capital (income and draw-downs). A model of this financial lifecycle, as created by global pension consultant Milliman, is provided below:

### A SCHEMATIC OF THE FINANCIAL LIFECYCLE



Source: Milliman – A Framework for Lifecycle Investing

Retirement systems exist as an acknowledgement of, and a response to, the diminution of human capital over time such that, in modern developed economies, it is the expectation that most people will outlive their willingness or ability to exchange their labour for income, electing instead to remove their services from the labour market and thus ‘retire’.

Underpinning retirement income policy is thus a notion of *consumption smoothing*; of individuals under-consuming during their working years, setting aside a portion of their income from personal exertion, either voluntarily or by compulsion, to help fund consumption in their retirement years.

In a consumption smoothing framework, the aim is to have a level of income in retirement that bears some relationship to one’s pre-retirement income. Indeed, this is the assumption used in the RIR, insofar as the modelling of income adequacy was based upon a suggested replacement rate of income of 65 – 75 per cent of one’s pre-retirement equivalent. This is thought to be an appropriate rate of replacement income for most Australians (i.e. those that are not at the extremes of income distribution pre-retirement).

Consideration of consumption smoothing has relevance to any discussion of the objective of the superannuation system because, from a household economic efficiency point of view, getting the

balance right between the ‘delayed gratification’ implicit in deferring consumption today and enjoying higher levels of consumption in retirement (than would be the case without retirement savings) has ramifications at the broader macroeconomic level.

Saving for retirement necessarily lowers one’s consumption capability during one’s working years (and thus arguable one’s working-life living standard). The trade-off is a presumably higher consumption capability (and living standard) in one’s retirement.

To the extent that individuals accrue superannuation assets and, once in retirement, under-consume these assets, either by design or due to insufficient knowledge or confidence to ‘spend down’, it tests the premise of consumption smoothing as the rationale for a properly functioning retirement income system and brings into consideration other possible motives, such as bequests.

In a system such as operates in Australia, the preferential tax treatment accorded to superannuation contributions and earnings exists to incentivise both compulsory and voluntary contributions, on the premise that these are preserved until needed for retirement (unless accessed prior in one of the limited available circumstances).

The cost of these tax concessions is not inconsequential, with the latest IGR forecasting the combined earnings tax and contributions tax concessions to continue growing steadily over the 40-year forecast period, increasing from 1.9 per cent of GDP in 2022-23 to 2.4 per cent in 2062-63<sup>47</sup>. The cost of these concessions is projected to overtake Age Pension expenditure in the 2040s.

It is therefore vital that RSE licensees take their obligations under the Retirement Income Covenant to try optimising their members’ retirement outcomes such that individuals have the highest, smoothest lifetime consumption paths (subject to reasonable consideration of individual preferences as to bequest motives).

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<sup>47</sup> Treasury IGR 2023, at page 171