

RETIREMENT PHASE OF SUPERANNUATION: SUBMISSION TO TREASURY DISCUSSION PAPER DECEMBER 2023

BY BRUCE WATSON FIAA GAICD

Introduction

Thank you for providing the opportunity to comment on Treasury's review of the retirement phase of Australia's superannuation system.

The main issues raised in the Discussion Paper are well known and most were addressed thoroughly in the 2014 Financial System Inquiry. That Inquiry, and related work by Treasury and the Australian Government Actuary (AGA), also identified many of the solutions. Unfortunately the process was subsequently sidetracked away from comprehensive solutions into dead-ends such as FOFA and the Covenant, so we've lost a decade of potential progress.

My submission makes three key suggestions responding to three specific questions raised for consultation.

The author

This submission is made by Bruce Watson, a self-employed actuary and company director. I make this submission as an individual.

I worked in the superannuation industry from 1984 to 1994 before moving into the general insurance and personal injury compensation industries, where I have subsequently worked as a consulting actuary, in-house Chief Actuary, Senior Executive and now self-employed consultant. I have not practised as a superannuation specialist for 30 years and I claim no subject matter expertise other than as a member of three public offer superannuation funds. I have no current financial or business connections with any superannuation industry participant or regulator.

Key points

I make the following three key suggestions:

1. Create a meaningful behavioural nudge to retirees by re-expressing the minimum account-based drawdown factors as fractions rather than as percentages, eg 1/25th rather than 4%.
2. Introduce a bundled product, similar to the example in the Discussion Paper Appendix, as a *mandatory default* retirement product for all public offer funds.
3. SMSFs are not superannuation funds; they're personal wealth-creation and wealth-preservation vehicles which take advantage of superannuation tax concessions. Treat them as such, don't bother trying to force them into the frameworks of retirement income policy, but remove any tax advantages they might have over real superannuation funds.

I expand on these three points in the remainder of this submission.

Key point 1: Minimum draw-down rates

Responding to the question "How might funds utilise guidance, nudges, defaults and other actions to assist members into better solutions for their retirement income?" in the section "Supporting members to navigate retirement income".

It is well documented that superannuation funds typically default retired members to the statutory minimum drawdown rates for account based "pensions" and that the vast majority of members stay with the default. My personal experience as a fund member is that this has not changed at all since the introduction of the Covenant. A submission by the AGA to the 2014 Inquiry¹

¹ Australian Government Actuary "Towards More Efficient Retirement Income Products", paper prepared for the Financial System Inquiry December 2014. [AGA 2014]

demonstrated how sub-optimal this strategy is relative to the long-term purpose of the superannuation and retirement income system, and many other studies have affirmed this².

I believe – admittedly with no research to back this up – that expressing the drawdown rate as a percentage of a member’s account balance reinforces an inherent behaviour towards “living on your income” and not touching the capital of your retirement nest egg. I’m sure that almost everyone compares their percentage drawdown rate with the income earning rate on their superannuation balance – the interest rate and/or dividend yield – and that presenting both as a percentage of the account balance strongly encourages this behaviour. Even the Government behaves this way, as seen when they halved the minimum drawdown rates during the GFC and again in COVID times in response to sharp declines in equity values and interest rates: it was seen as undesirable to deplete capital by drawing down more than the income earned.

In fact, the minimum drawdown rates were expressly designed to draw down capital progressively through retirement, “to allow a reasonably level income pattern relative to CPI (that is, in real terms) over a long retirement”³. While the minimum rates are not simply the inverse of life expectancy, they are very closely correlated. For example, life expectancy at ages 60-64 is in the order of 25 years and the minimum drawdown factor of 4% is equal to 1/25th. The percentage factors increase with age because life expectancy decreases, eg by ages 65-74 life expectancy has reduced by approximately five to six years⁴ and the factor reduces to 1/20th or 5%.

I’m convinced that simply re-expressing the drawdown rates as fractions would start a significant behavioural nudge towards acceptance of drawing down capital. To be specific:

Age	Current minimum	Suggested alternative	
		Fraction	Equivalent %-age
60-64	4.0%	1/25	4.0%
65-74	5.0%	1/20	5.0%
75-79	6.0%	1/17	5.9%
80-84	7.0%	1/14	7.1%
85-89	9.0%	1/11	9.1%
90-94	11.0%	1/9	11.1%
95+	14.0%	1/7	14.3%

There wouldn’t need to be any material change at all to the *actual* drawdown rates – 1/25th is still the same amount as 4%, 1/17th is very close to 6% – but the conversation could start shifting retired Australians towards a better understanding of longevity: “my minimum super drawing is 1/20th of my balance because it’s going to provide me with income over the next 20 years”. [This inevitably leads to the question “What if I live longer?”, which is the next key point].

It would be easy in future to refine these fractions for a more gradual transition of drawdown as people age, if that was a policy preference.

² For example: “...we believe that our paper has identified that the most widely used reference, the statutory minimum drawdown rules, is generally too low to yield anything close to optimal utility. Individuals would be better advised to spend more, especially in the younger years of retirement”. De Ravin et al, “*Spend your decennial age: a rule of thumb for retirement*”, Actuaries Summit, June 2019.

³ AGA 2014, page 10. The relationship with life expectancy is also recognised in Treasury’s report on the *Retirement Income Streams Review*, May 2016.

⁴ *Australian Life Tables 2015-17*, The Treasury, 2019. Male life expectancy at age 60 = 24.02 years, at age 65 = 19.86, at 75 = 12.25. Female life expectancy at age 60 = 26.93, at age 65 = 22.47, at 75 = 14.15.

Key point 2: Default retirement product

Responding to the question: "Of the approaches identified, what should be prioritised and what risks should be considered as policy is developed? What other approaches, if any, should Government consider?" in the section "Making lifetime income products more accessible".

Everybody knows what a superannuation fund looks like in accumulation phase: contributions go into your personal account balance, the account is fully vested, deductions are made for fees and tax, an insurance premium is deducted for death and TPD cover and your balance increases – and sometimes decreases – in line with realised and unrealised investment earnings. But when I started working in superannuation in 1984 super funds looked nothing like this. The current model only became the norm through the innovation of the industry funds which introduced it as the non-negotiable default product for "productivity super" and, later, the Superannuation Guarantee.

My point is that the standard super accumulation account is in fact quite a complex product which involves members accepting some significant risks (principally investment market risk), but it was an innovation which quickly became the universally accepted form of retirement savings in Australia because (a) it was compulsory and, arguably, (b) it was better and fairer for members than the previous products.

Unfortunately the great innovation of the industry funds a generation ago has never been repeated in the development of retirement income products. I believe the decade of inaction since the 2014 Inquiry and the ineffectiveness of the Covenant show it's time again for a mandatory solution from policy-makers. Simply: give Australians a product that works for the vast majority rather than trying the impossible task of delivering financial advice to everyone.

The proposal of a standardised product at page 24ff of the Discussion Paper and in the Appendix is an excellent blueprint for the form of product required. A version of this should be a standard product offered by all public offer superannuation funds. Further, members' accounts should be rolled over into such a product *by default* when they elect to convert to pension phase or when they reach age 65, whichever is earlier, unless they demonstrate they have received professional financial advice to do otherwise (or if their balance is below a minimum viable amount).

There will no doubt be objections to any suggestion of a mandatory default product on grounds such as it's too complex, every person's situation is different, it doesn't factor in home ownership or age pension, etc. I believe the response to this is to recall the successful introduction of compulsory superannuation and the default accumulation product in the 1980s and 1990s, which was subject to similar objections at the time. Also we mustn't ignore the fact that there *is* a default product already – an account based pension drawn down at minimum rates – and we know this is not the product which best meets members' needs in retirement.

The example standardised product

The design in the Appendix gives retirees clarity and certainty: "When I retire I'm looking forward to 25 years of active life and I know how much income we'll have to live on during those 25 years. If I die during those 25 years I haven't forfeited my super to some evil insurance company. And if I happen to live longer there's the protection of an income for the rest of my life, separate from the age pension." This is excellent⁵.

If I may make a few observations on the detail:

The "Income Account" (ABP income stream):

- The default drawdown should simply be an equal amount over the period until annuity age (the deferral period). Eg, if you start at age 65 and the default annuity age is 90, then

⁵ Or to quote respected academics Qiao and Sherris: "the ideal post retirement income provides consumption income with both longevity insurance and inflation indexation". *"Managing Systematic Mortality Risk With Group Self-Pooling and Annuitization Schemes"*, The Journal of Risk and Insurance, 2013, Vol. 80, No. 4, pp949-974

income in year one is 1/25th of the starting balance, income in year two is 1/24th of the balance at the start of year two, etc.

- There's a valid argument that the income should actually start higher and decline over time, in line with typical retirement spending patterns and with means-tested age pensions⁶. Perhaps this should be a standardised option.
- If a member wants to draw a higher amount and/or a one-off lump sum, the fund must be required to demonstrate what that will do to their income for the remaining term.
- Default investment should aim for inflation protection so that income remains broadly constant in real terms over the income period. This is broadly in line with current "capital stable" type investment products. Other investment strategies can be offered as options.

The "Rainy Day Account" (Capital Reserve):

- While I see the attraction of this to meet members' *perceived* needs, in practice the same outcome is achieved by allowing one-off drawdowns from the ABP account.
- Having a separate Rainy Day account probably works against the retirement income policy objective so there should be a maximum amount which can be placed into any such account, perhaps no more than 10% of the initial balance on commencing the product.
- The argument could also be made that such an account is not really providing retirement income so it should not be exempt from income tax on its earnings.

"Long Life Insurance" (the Deferred income stream):

- I fully support a pooled deferred income stream as the best form of longevity insurance⁷. Immediate annuities are unlikely ever to become widely accepted in the context of our ABP-based system, even if they're pooled or partially underwritten by government (as floated on page 24 of the Discussion Paper).
- I also agree with the proposal that investment of the supporting assets be "balanced", at least until approaching the annuity age, to enhance the value of the annuity.
- Purchase by a regular "premium" seems better than an up-front amount. Members are accustomed to purchasing insurance by regular premium deductions from their accumulation accounts. In effect the member is progressively buying "units" of lifetime annuity and can track the (growing) amount of their projected annuity income over the time until it commences.
 - The alternative of allocating, say, 15% to 20% of the initial super balance to purchase the deferred annuity up front would produce a better annuity outcome but is likely to meet resistance from members. This could perhaps be modified by guaranteeing a return of a proportion of the initial purchase price (starting at 100% and decreasing over time) in the event of death during the deferral period.
 - I agree that commutation should not be allowed, neither during the deferral period nor after the annuity has commenced.
- The proposal for Commonwealth Government pooling and reinsurance of longevity risk is interesting but questionable. I would have thought the largest superannuation funds have the scale to self-insure this risk on an equitable basis between age cohorts⁸, while smaller funds should be able to reinsure commercially. It's hard to see why taxpayers should finance something which ought to be the core business of these financial giants.

⁶ See for example the Actuaries Institute submission to Treasury on CIPRs in July 2017.

⁷ As did the AGA's analysis in 2014, for example.

⁸ This is a familiar area of work for the life insurance actuarial profession. There is also a body of recent academic work on the topic, for example: the Qiao and Sherris paper cited above; also Butt, Khemka and Warren: "Optimal strategies for retirees in Australia with realistic risk transfer", ANU, 28 January 2021

Key point 3: SMSFs

Responding to the question: "Are there barriers to improving how SMSF trustees achieve these objectives, and what role can government or industry play to improve these outcomes?" in the section "Supporting members to navigate retirement income".

I have never been a SMSF member or trustee. But having read widely on the subject and read the views of many SMSF members in industry forums, I have become convinced that Government should not worry about bringing them into the fold of retirement income policy.

If SMSF members wish to enjoy the benefits of Government initiatives for retirement, eg any pooling or underwriting of longevity risk, it is simple for them to transfer their SMSF fund into a public offer fund at the time they convert to pension mode.

Otherwise, Government should treat SMSFs for what they really are: vehicles for creating and preserving personal wealth which take advantage of superannuation tax concessions. SMSF members are typically both member and trustee, placing them in a very different position to other superannuation funds. Policy should focus on ensuring SMSFs comply with relevant obligations and do not enjoy any inappropriate advantages over other super fund members.

In that respect, I suggest Treasury investigate the tax treatment of capital gains in SMSFs. Tax policy is that members of super funds pay tax on their investment earnings while in accumulation phase and no tax when in pension phase. However I believe this does not always apply to capital gains in an SMSF: my understanding is that if an SMSF member holds an asset for, say, 30 years while in accumulation phase then converts to pension phase and subsequently sells that asset, the entire capital gain accrued over 30+ years is completely tax free. I don't believe this concession is available to members of public offer super funds (which I believe accrue notional CGT in the valuation of their assets for daily unit pricing) nor even for individual taxpayers (any net capital gain above the tax-free threshold would become assessable at marginal tax rates). My understanding may not be correct – I'm not a practitioner in this field – but if it is, this is an inequitable loophole which should be closed eg by taxing the SMSF's total capital gain at the time of sale on a pro-rata basis (taxable accumulation years : non-taxable pension years) for the period the asset was held.

Thank you again for an excellent Discussion Paper and for allowing the opportunity for public comment on this important matter. I would be happy to explain or expand on my suggestions if required.

Yours sincerely

Bruce Watson
Sydney
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