The Frontier Line

Thought leadership and insights from Frontier

Issue 174 | February 2021

Retirement income review

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Frontier's purpose is to empower our clients to advance prosperity for their beneficiaries through knowledge sharing, customisation, technology solutions and an alignment and focus unconstrained by product or manager conflict.

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David joined Frontier in 2015 as a Senior Consultant and leads the Members Solutions Group. He provides investment advice to a range of clients and conducts research in the area of retirement strategy and product development for superannuation funds. Prior to Frontier David spent nineteen years at Mercer in both the UK and Australia. Prior to joining Mercer, David was at Towers Perrin for around six years, working with a number of clients in a consulting and research capacity. David holds a Bachelor of Economics from Macquarie University and is a Fellow of the Institute of Actuaries of Australia.

SUMMARY

Retirement income review report

On 20 November 2020, the Government released the Retirement Income Review final report, which confirms "the Australian retirement income system is effective, sound and its costs are broadly sustainable." However, it found the system is complex and highlighted evidence suggesting there are areas where the system can be improved.

Since the report's release, much of the conversation has centred on the legislated rise in the superannuation guarantee and whether home ownership should be prioritised.

However, the review also considered other important issues aimed at improving the retirement income system. It examined whether Australians once in retirement should be encouraged to draw down on their superannuation balances and use equity in the family home to fund their retirement, rather than rely on increases in compulsory super contributions in the path to securing higher account balances.

In this paper, we summarise the post-retirement considerations of the report. While not making recommendations, the review made some important conclusions:

- reducing complexity would lead to better retirement outcomes for individuals
- retirement income projections, greater use of longevity risk management products and more financial advice and guidance would likely lead to a higher drawdown in retirement
- carefully designed defaults, guidance from superannuation funds, as well as accessible and affordable advice at retirement, would help people get better outcomes in retirement.

The Retirement Income Covenant, delayed due to the pandemic, and Comprehensive Income Products for Retirement, receive much support throughout the report.

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INTRODUCTION

Delivering adequacy in retirement

The Retirement Income Review was commissioned by the Federal Government to investigate the current state of the retirement income system and how it will perform in the future as Australians live longer and the population ages.

The review was recommended by the Productivity Commission in its report Superannuation: Assessing Efficiency and Competitiveness. It was tasked with establishing a fact base of the current retirement income system that will improve understanding of its operation and the outcomes it is delivering for Australians.

The Retirement Income Review took a 'consultative and research-based approach' to identify:

- How the retirement income system supports Australians in retirement.
- The role of each the three pillars (being the Age Pension, compulsory superannuation and voluntary savings) in supporting Australians through retirement.
- Distributional impacts across the population and over time (i.e. how various measures or outcomes manifest differently for different cohorts of retirees).
- The impact of current policy settings on public finances.

In keeping with its terms of reference, the report made no recommendations. However, some of its key observations include:

- The weight of evidence suggests an increase in the superannuation guarantee (SG) rate will result in lower wages growth and would affect living standards in working life.
- More efficient use of savings in retirement can have a bigger impact on improving retirement income than increasing the SG rate.
- Many retirees leave the bulk of the wealth they had at retirement as a bequest. Insufficient attention is given to assist retirees to optimise their retirement income through the efficient use of their savings.
- The review described the family home as an underutilised source to support living standards in retirement. It noted a family home was an asset that could be drawn on in retirement through arrangements such as reverse mortgage schemes.
- About a quarter of retirees who rented privately were in financial stress, primarily because of high housing costs.
- People with very large superannuation balances receive very large tax concessions on their earnings.

Much of the resulting commentary has centred around whether the legislated increases in the SG rate will be revised. This appears set to be a political battleground, with commentators selectively using parts of the review to validate their beliefs[1].

There are many important issues the review investigated, not least the need for an overall objective. We hope the review (and the many other reviews which have taken place) is used to underpin any future legislative changes.

In this paper, we will sidestep the SG discussion and concentrate on the post-retirement superannuation considerations of the review. As the review notes: "a common theme throughout this report is that the focus is on the accumulation phase of the retirement income system and insufficient attention is given to the retirement phase."

[1]See "Stalking horse or fact-minding mission?"

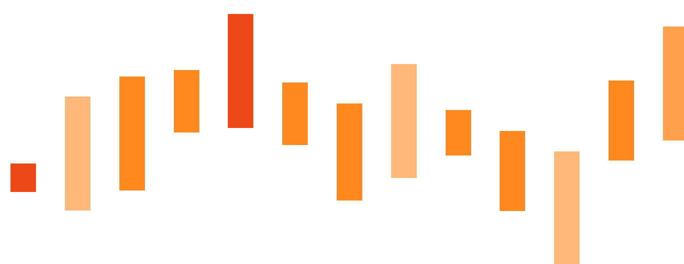
Report findings

The review noted an objective for the retirement system is needed to "anchor the direction of policy settings, help ensure the purpose of the system is understood, and provide a framework for assessing the performance of the system." It suggested the following broad goal: ***"To deliver adequate standards of living in retirement in an equitable, sustainable and cohesive way."***

The report expanded on this statement, fleshing out the concepts of adequacy, equity, sustainability and cohesion. The superannuation-specific issues raised under these concepts include:

- **Adequacy.** The key point emphasised is the system is aimed at maintaining living standards in retirement. It is not directed at building wealth or facilitating estate planning. This involves smoothing consumption over working life and retirement.
- **Equity.** The report noted overall, superannuation tax concessions increase inequity in the retirement income system (as higher-income earners receive greater benefit), while the Age Pension helps partly offset this inequity. Furthermore, inheritances are significant and increase inequity within the generation that receives the bequest. Conversely, income poverty rates of retirees were highest for renters (particularly singles) and early retirees. It found the system did little to address inequities for women and Aboriginal and Torres Strait Islander people.
- **Sustainability.** The cost of the Age Pension is expected to fall over the next 40 years (as a proportion of GDP) but the cost of superannuation tax concession is projected to outweigh this saving. The review raised the idea of extending earnings tax to the retirement phase, helping with sustainability and simplify the system by enabling people to have a single superannuation account for life.
- **Cohesion**. The review believes the system focuses on the accumulation of savings for retirement, but insufficient attention is given to how people can best use their savings to support their living standards in retirement, such as drawing on their superannuation balances or accessing the equity in their homes.

The superannuation system has been subject to constant regulatory change for many years. While many of the changes have been positive, with others it has been less clear how they benefit the overall retirement system. Having a clearly defined and legislated objective will allow a reasoned analysis of some of the more ideological proposals.



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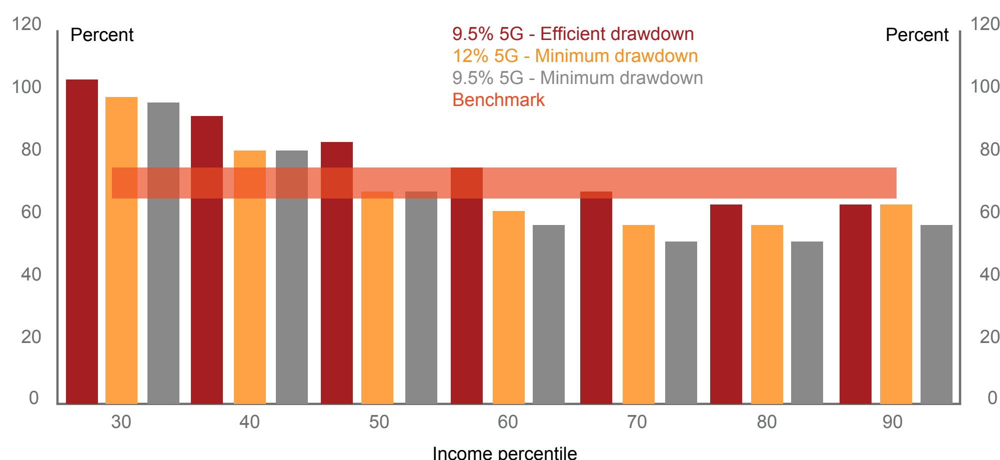
Income drawdown

One of the report's themes is a more optimal retirement income system would involve retirees more effectively drawing on all their assets, including the equity in their home, to fund their standard of living in retirement.

Evidence provided to the review indicates that retirees tend to hold on to their assets and leave significant bequests, even though surveys suggest people do not prioritise leaving a bequest. If people drew down more on their assets, they could have a higher standard of living in retirement. Alternatively, they need not have saved as much as they did for retirement and could have had a higher standard of living during their working years. Some retirees do consume more of their assets in retirement than others. According to the review, non-home owner age pensioners consume their assets faster than other households, and people with low balances draw down their superannuation at a much higher rate than those with larger balances. Chart 1 from the review report demonstrates the importance of efficient use of savings in retirement. According to the review's analysis, if the SG rate remained at 9.5% and people made more efficient use of their retirement savings, many would have higher replacement rates (the benchmark in Chart 1) than they would have with the SG at 12% and drawing down their balances at the legislated minimum rate. The 'efficient drawdown' product used by the review in their analysis is a longevity protection product, which is summarised in the attachment.

Chart 1: Projected replacement rates by SG rate and drawdown strategy



Source: Retirement Income Review final report.

Factors that contribute to low drawdown of assets in retirement include:

- complexity and little guidance on how to maximise retirement incomes
- reluctance to consume funds that are called 'investments', 'savings' or 'nest eggs'
- adopting the minimum drawdown rates required for a superannuation pension account
- concern about possible future health and aged care costs
- concern about outliving savings.

Not mentioned by the review, there is also concern the Age Pension may be reduced in the future.

Some measures raised in submissions to the review to help people use their retirement savings more effectively include:

- funds providing regular estimates of an individual's retirement savings being expressed in terms of an income stream rather than balance at retirement
- educating people that their health and aged care costs are heavily subsidised by the government
- emphasising the age pension provides a safety net for people who outlive their savings or when the value of their retirement savings falls significantly
- amending the minimum drawdown rates so income is delivered when people are more likely to consume it, namely earlier in their retirement rather than the current drawdown rates, which are highest at ages 85-90
- at retirement, guiding people towards products that deliver an income stream and provide protection against market fluctuations and outliving savings.

For over a decade, it has been recognised that more attention needs to be placed on the retirement phase of superannuation. The minimum drawdown rates are anchoring members to low income. Funds need to be developing products which meet the needs of those members who wish to prioritise higher income in retirement.

Complexity

Another of the review's main points is that the retirement income system is complex and hard to navigate. This complexity, combined with a lack of assistance, guidance or advice, and low financial literacy makes it hard for people to make well-informed choices about their retirement income.

The report noted the pre-retirement phase of the retirement income system has substantial compulsion and defaults, and as a result, people do not have to make decisions about their superannuation contributions. A downside of defaults is that people fail to engage with their superannuation. The Productivity Commission suggested default settings be set to encourage people to make active choices, but also to protect those who do not.

The retirement phase is more complex than the pre-retirement phase, but little guidance is available to help people choose their retirement income products.

To address this, submissions to the review suggested:

- advancing the Comprehensive Income Products for Retirement concept and making available regulated, simple and safe retirement products
- developing the proposed Retirement Income Covenant under which superannuation trustees would be required to develop a retirement income strategy, and provide guidance to help retirees choose a retirement income product
- introducing defaults, and while recognising the difficulty of designing an optimal default given people's circumstances vary, making pre-selected or 'soft' default products available
- limiting options offered, such as the UK approach where every defined contribution pension has only four investment pathways.

People need advice and assistance to make better informed decisions. But the advice has to be sound. Assessments by regulators and the Hayne Royal Commission, identified weaknesses and misconduct in financial advice.

Superannuation funds are uniquely placed to provide advice and guidance because members have to contact their fund to open a retirement income product. But funds are restricted in what they can consider when providing intra-fund advice. Changes would need to be made to the regulatory framework to facilitate funds providing more guidance at retirement. Automated or digital advice could be more accessible and affordable. The take-up of such advice is currently low, with people lacking trust in this form of advice and thinking it should be free.

There may also be a role for the Government to provide comparison tools to help consumers compare products.

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Guided choice and innovative retirement income products

Compared to the pre-retirement phase, the retirement phase involves more complex decisions. However, it has no default arrangements. In the absence of a strategy designed for consumers, account-based pensions at minimum draw down rates are effectively acting as a default strategy for all retirees.

In complex situations, people get choice overload and disengage or rely on shortcuts to help them make decisions, instead of assessing the options to make the best decision. People tend to:

- rely on heuristics (rules of thumb) and pick options they understand
- stick with what they know
- stick with the default option
- follow others
- procrastinate, disengage or avoid making the decision
- be prone to misleading advice

At retirement, in the face of complexity, people fall back on defaults, even if these defaults were not designed for the purpose people use them. For example, many people rely on 'easy' options such as selecting an account-based pension and withdrawing at minimum drawdown rates, or withdrawing their superannuation and placing it in a bank account.

Submissions to the review proposed a guided choice framework at retirement (offered by superannuation funds) could simplify the experience for many. It could create pathways for people to choose between, or a reference point from which they can compare different retirement strategies. It could also be accompanied by financial advice or guidance. The literature suggests guided choice frameworks can 'nudge' people where there is uncertainty around the best course of action to help them make a decision. The UK, for example, will assist disengaged consumers by mandating four investment pathways that every defined contribution pension provider must offer when someone reaches age 55.

Superannuation funds are well placed to provide both guidance and financial advice at retirement because members have to contact their fund to start accessing their savings. Arguably, if it comes to pass that retirement income is the core purpose of superannuation, funds have a responsibility to provide this guidance. However, the regulatory framework does not make it easy for funds to provide such guidance. Anecdotal evidence suggests some funds are reticent to provide guidance to people at retirement as there is legal ambiguity over what is and what is not financial advice.

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The review concludes giving funds the confidence to provide limited and targeted guidance to members without needing to comply with the legal obligations associated with financial advice would likely improve people's retirement outcomes.

The benefits associated with drawing down more retirement savings and higher standards of living in retirement, coupled with effective regulation, would likely outweigh any potential impact from conflicts of interest.

Stakeholders have indicated an improved range of products is needed to align with people's consumption patterns in retirement and provide longevity risk protection for those who need it. Products are needed that provide a reasonably stable income, flexibility to withdraw a lump sum, and longevity risk management if necessary. Retirees find it difficult to combine a portfolio of available products that provide both flexibility and longevity risk management (including the Age Pension).

To address these issues, some stakeholders have called for simple regulated products suitable for most people and satisfy minimum requirements (akin to MySuper products) to be developed for the retirement phase. Given these products would be standardised and regulated, funds and financial advisers could potentially provide guidance on these products outside of the financial advice framework.

The Government has consulted on creating a framework for Comprehensive Income Products for Retirement (CIPR) that would meet minimum standards and provide income higher than an account-based pension drawn down at minimum rates, alongside flexibility and longevity risk management.

Research shows people would take up CIPRs that combine income, risk management (e.g. longevity risk management) and flexibility (e.g. to access a lump sum) if these products were offered. A 2017 experiment by the Behavioural Economics Team of the Australian Government on the take up of Comprehensive Income Products for Retirement found: 'On average members were around 50% willing to choose the CIPR if it were offered to them in the future. Given the lack of product diversity (94% of retirement assets in Australia are currently allocated to ABPs) and the fact that CIPRs are a new product, this level of interest is encouraging and suggests CIPRs may do well (in terms of customer take up) in the market.'

More recent research suggests while people are interested in annuity products, they find the process of choosing between specific products too difficult (Orford Initiative, 2020). This suggests there may be a role for guidance and financial advice in encouraging people to make more use of annuities.

In recent years, the Government has removed some of the barriers to people taking up products that manage longevity risk:

- In 2017, the Government passed legislation to allow eligible longevity risk management products to receive the tax exemption on earnings in the retirement phase.
- In 2019, the Age Pension means testing rules were created for pooled lifetime income streams to clarify their means testing treatment.

The Retirement Income Covenant is also designed to encourage take up of products that manage longevity risk by requiring superannuation funds to consider whether they should develop and offer a CIPR.

It is important for retirees to receive some assistance is choosing the right retirement solution for their circumstances. A default/primary offering will play a part for many. For other members, advice will be the solution. Cost effective advice and regulatory certainty will help funds develop their solutions to meet members' needs.

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The final word

The last two decades have seen a plethora of reports into the superannuation industry, including the Henry, Cooper, Murray and Hayne inquiries. The Retirement Income Review is the latest, and it is comforting it found the Australian retirement income system to be effective, sound and its costs are broadly sustainable.

However, the review found that the system can be improved. We hope that the review is used as intended – a fact base to inform public policy. In the words of the review chairman, Michael Callaghan, ***"the problem we've had in the debate is, to date, people make assertions without looking at the evidence."***

As a first step, Frontier urges the government to legislate an objective for the retirement system, something they agreed to in 2015. As the review notes: ***"an agreed objective is needed to anchor the direction of policy settings, help ensure the purpose of the system is understood, and provide a framework for assessing the performance of the system."*** The report also found a more efficient use of savings in retirement would do more for people's lifestyles in retirement than hiking the guarantee. For this to happen, regulatory certainty is required, and it is pleasing to note the review's support of the retirement income covenant and the CIPR concept.

For its part, the industry needs to progress with developing products which meet the varying needs of retirees – particularly those who prioritise income or risk management.

Want to learn more?

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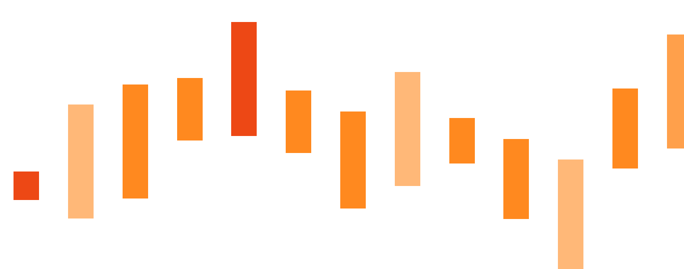

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Attachment: Longevity protection product

The modelling assumed retirees dedicate a small proportion of their balance at retirement (2060 in the central case) to purchase a longevity protection product. These products are more efficient for managing the risk of retirees outliving their savings than other strategies, like slowly drawing down assets (Chart 2). It was assumed individuals allocate five per cent of their superannuation balance at retirement to the purchase of a longevity protection product. The product used in the modelling for the review was a deferred pooled annuity product, such as a deferred group self annuity. The model did not incorporate more complex features of these products, such as withdrawal options, death benefits or co-morbidity for couples.

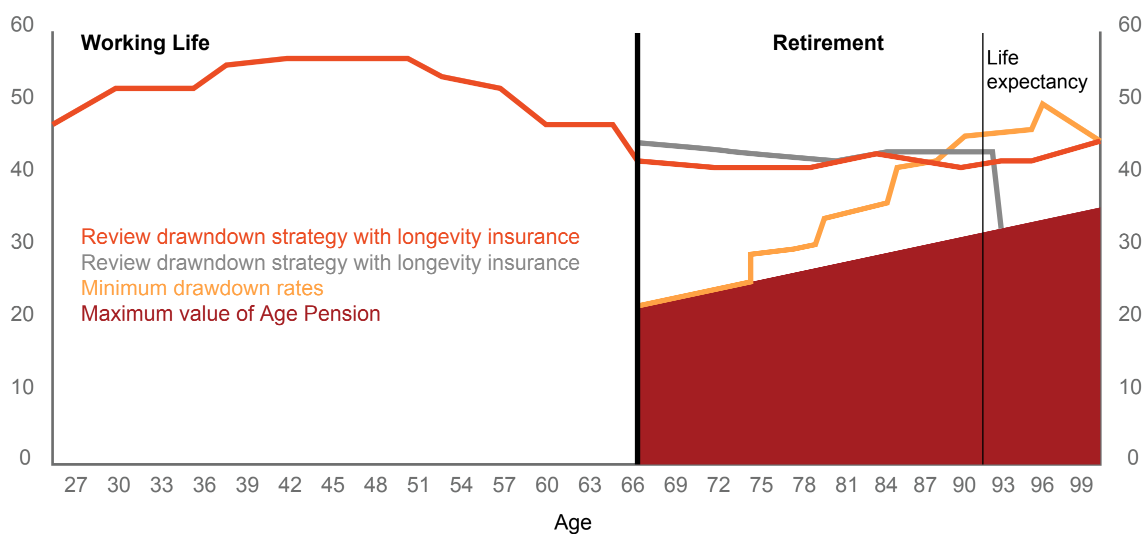
Product payments and pricing

The longevity product commences CPI indexed payments from age 92. The product was assumed to have investment returns of 6.2 per cent before fees and taxes. Investment fees were assumed to be 2.5 per cent per year, which are significantly higher than the 0.85 per cent variable investment fees assumed for funds invested in a typical superannuation account. Net earnings for the longevity product (3.7 per cent) were conservatively assumed to be lower than money invested in a typical fund (5.35 per cent).

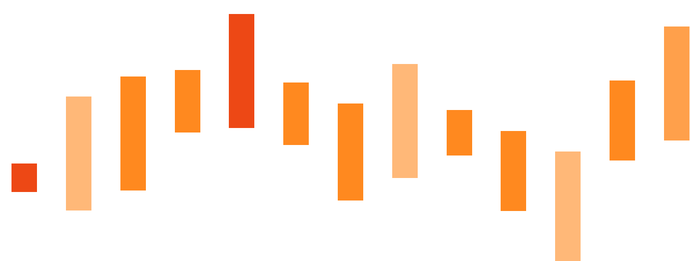
Underlying mortality rates for retirees in 2060 were calculated by the Australian Government Actuary and accounted for increases in life expectancy. Mortality rates for women were used in all models to be conservative compared to gender specific mortality rates. Mortality rates for women are lower than for men, and therefore result in lower mortality credits.

The product is subject to Age Pension means testing in accordance with current means test rules for lifetime income streams.

Chart 2: Projected disposable income by longevity product, median earner



Note: Values are in 2019/20 dollars, deflated using the review's mixed deflator. Source: Cameo modelling undertaken for the review.



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Longevity product sensitivity analysis

The longevity product type used by the review was a simple hypothetical product to provide longevity protection and facilitate the draw down of superannuation assets. This product is one of many longevity products that could provide retirement income and longevity protection. To ensure its appropriateness, analysis compared this longevity product type to other possible retirement products, including:

- a deferred group self annuity beginning at age 85, with 5 per cent of superannuation balance at retirement to purchase the product, and 95 per cent allocated to an account based pension.
- a group self annuity beginning at 67, with 40 per cent of superannuation balance at retirement to purchase the product, and 60 per cent allocated to an account based pension.
- 100 per cent allocation of assets at retirement to a group self annuity beginning at 67.

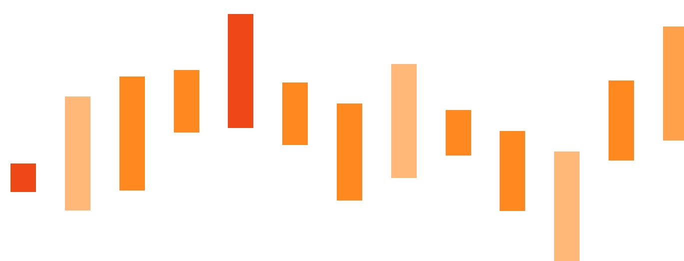
The review's retirement income portfolio tends to give lower incomes than similar products (Table 1). Non deferred products provide slightly higher replacement rates and retirement outcomes, as they pay out mortality credits for longer. However, higher incomes come at the cost of reduced capital flexibility. The review's central case assumption represents one way to balance longevity protection, high retirement incomes and capital flexibility.

Table 1: Projected median earner retirement outcomes, different annuity products

Longevity product (asset split)	Replacement rate (per cent)	Average annual retirement income ($)
Review portfolio — account based pension and deferred group self annuity (DGSA) beginning age 92 (95/5 split)	87	42,100
Account based pension and DGSA beginning age 85 (95/5 split)	89	43,100
Fund format Account based pension and group self annuity (60/40 split)*	90	43,600
Group self annuity (0/100 split)*	91	44,000

Note: Products are hypothetical and used only for the basis of estimating retirement outcome differences. Values are in 2019 20 dollars, deflated using the review's mixed deflator and rounded to the nearest $100. *Group self annuities in these scenarios are not deferred, and commence at retirement. Non deferred products are assumed to have investment fees of 0.85 per cent consistent with review central case retirement phase specifications. Source: Cameo modelling undertaken for the review.

Source: Retirement Income Review final report



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