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Director
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The Treasury
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Dear Ms Kelly

Consultation: Retirement Income Covenant Position Paper

I recommend that the proposed Covenant should be more directive in requiring trustees to include lifetime income streams (LIS) in the menu that they offer their members. This is because such products offer significant advantages to some members, and there is evidence of reluctance to introduce the products.

Some of the points I am making would be more difficult for others to make it they had to rely on the goodwill of trustees and suppliers to the superannuation industry. While I remain an Adjunct Associate Professor at the University of New South Wales, and am on the Council of the Actuaries Institute, I am enjoying an un-numerated retirement so am not beholden to any vested interests.

My views are based on over 35 years of research and product development in life insurance and superannuation with a particular interest in income streams. My interest goes back to 1985 when, as Chief Actuary of the Prudential Assurance Company of South Africa, I designed and implemented a retail version of a with-profit life annuity. They were also covered in my PhD, entitled "The Design of Retirement Schemes: Possibilities and Imperatives'. It was written to evaluate the retirement policy proposals of the South African Committee of Inquiry[1], which were drafted by the sub-committee that I had chaired. Since 2012, I have been Convenor of the Actuaries Institute's Retirement Income Working Group, which is devoted to the issue.

1 Under-appreciated LIS benefits

There are a few advantages of lifetime income streams that do not always seem to be appreciated, but do depend on appropriate product design.

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[1] Taylor et al (2002) Transforming the present – protecting the future: Report of the Committee of Inquiry into a Comprehensive System of Social Security for South Africa

1.1 Desirable design features

Guaranteed annuities are frequently said to offer poor investments based on the underlying internal rate of return and as unsuitable for people with lower life expectancies. Both these disadvantages can be addressed:

- The regulatory changes that now permit innovative income streams were based on an understanding in government of the advantages of the freedoms to be offered. I think however that it needs to be plainly stated that there is now **no limitation on the investments underlying an investment stream** so that they can potentially provide all the investment options that can be made available to an account based pension (ABP). The consequence is that the decision on investments, and the decision on longevity, can be separated.
- The medical and administrative technology required to tailor premium rates (or longevity credits) to an individual's life expectancy exists and is available in Australia. It has been used successfully in the UK where **enhanced life annuities** apparently make up a third of the market.
  The potential improvement in the lifestyles to those from lower socio-economic groups or in poor health need to be emphasised. Not only are they likely to have lower balances because of their lower incomes or forced earlier retirement, but their mortality risk is higher, as illustrated in the table below.

Life expectancy (1)	Annuity income at 3% interest (2)	Years to 95% probability of survival (3)	Ratio of (3) to (1) (4)
30	4%	44	1.5
20	7%	32	1.6
10	12%	20	2.0

  The table also shows that annuities are more valuable to older people, particularly if their balances have been eroded by poor investment returns or large expenditures.

- **Joint and survivorship annuity** designs directly address the problem that women have lower superannuation balances than men. It is widely accepted that the cost of living for a couple is of the order of 150% of a single (the Age Pension ratio), and so the use of capital can be optimised with a reversionary annuity of 67% after the first death, where only one partner has a superannuation balance. This reduces to 50% if both partners have equal balances. I therefore think the Position Paper is not helpful in suggesting that trustees do not have to consider couples.

1.2 Ways of addressing common objections

The objections to life annuities are based on misunderstandings about their advantages, or of the ways in which the problems can be addressed.

- If people have genuine **bequest motives** it would often make more sense to make specific provisions rather than rely on a benefit that declines with advancing age as capital is being used up. If the intention is to provide capital to children or even grandchildren, the same applies. Life annuities insure families against long lived parents consuming more of the families' capital. Many children would prefer immediate benefits to ease mortgage and child costs, and the parents can then use the capital they expect to consume to purchase an annuity.

- **The need for liquidity** to meet unexpected expenses is not really met by larger ABPs. This need requires a buffer (perhaps from 3 months to 2 years of expenses) that can be used for unexpected expenses and is then built up again by future income.
- The concern that the **money is lost on death** is partly addressed above in the discussion of the bequest motive, and partly by regulation that ensures that product providers are not able to make excessive profits.
- The absence of **trust in product providers** (who include trustees, administrators and insurers) and which includes concerns about their solvency need to be addressed by appropriate regulation. The effectiveness of the regulation needs to be publicised.

2 Under-appreciated resistance by industry

Some of the concerns expressed by trustees to the introduction of innovative income streams are addressed in section 3 of the Actuaries Institute Dialogue[2] of which I was the main author. I draw your attention to appendix 2, which deals with the question of legacy products and the need to pro-actively protect members from opportunistic product providers, which is relevant to the development of more trust in the industry.

2.1 Industry is conflicted because of lost advisor income

Section 5.2 of the Dialogue mentions evidence from the UK that advisors steer their clients away from annuities:

> *Receiving professional advice appears to reduce the likelihood of choosing an annuity over a drawdown arrangement by 70% to 75% – the impact being higher for those larger balances. ... A potential explanation is the income they and their employers expect to receive for future advice from those who choose drawdown arrangements.*

The suggestion that advisors face conflicting interest is confirmed by recent Australian research.[3] This clearly applies to their employers – who serve trustees as product providers and possible gatekeepers to new members.

2.2 Decision makers cannot envisage being poor

My experience of trustees and their advisors in the retirement industry is that their financial circumstances often render them unable to see the needs of those who would benefit from

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[2] Retirement Income Working Group (2020) "Developing the Retirement Income Framework" https://www.adviservoice.com.au/wp-content/uploads/2020/07/Dialogue-Paper-Retirement-Income-Framework-July-9.pdf

[3] See p 24 and 26 of Teagan Altschwager and Jody Evans (2021) Providing advice for retirement; a financial adviser perspective, University of Melbourne. https://mbs.edu/-/media/PDF/Research/Providing%20advice%20for%20retirement_%20%20a%20financial%20adviser%20perspective

using their accumulated capital for retirement spending. I have lost count of the number of times I have been told that dividend streams on your equity investments are adequate to live on in retirement. Given that investment arguments are irrelevant (section 1.1 above), such people ignore the possible increase in made possible by spending capital appropriately – because they are satisfied by not spending capital. One can point out that the modelling by the RiceWarner referred to in note 9 of the Position Paper suggests that spending could increase by 50% if all the money going to bequests was spent.

This apparent myopia is further illustrated by suggestions from industry that amounts of as much as $100,000 are relatively trivial and not worth converting into an income stream. For someone on the Age Pension, $100,000 is four times their annual expenditure. Putting aside a year's expenses (about $25,000) for contingencies, the other $75,000 could allow for a 25% percent or more increase in spending.

It seems to me that this myopia goes some way to explain the paradox that an industry that is otherwise very ready to innovate, fails to provide better products for poorer people. The fact that innovations in microfinance have been led by not-for-profit organizations, but have been followed to some degree by the industry, further bears this out.

2.3 Abuse of cost-to-income ratios

This myopia is confounded by another common misconception, which is to use the cost to income ratio (CTI) as an organizational objective.[4] Products and services offered to poorer people invariably cost more, but can be profitable when appropriately designed and costed. Those who focus excessively on costs savings can also undermine the provision of services and products to poorer people.

2.4 Evidence from South Africa

I would recommend that Treasury consider the South African experience in their introduction of their "Annuity Strategy", which was introduced at the same time as their MySuper equivalent in 2017.[5] This was necessary given that annuities are compulsory for some retirement funds.

A contact in South Africa has told me that the "annuity strategy" has not led to an increase in the sales of lifetime income streams. The comment was: "Many funds have focused on the tick-box exercise of:

- having a strategy in place (which could even mean only living annuities (income drawdown));

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[4] These have been included in the financial objectives of the banks for some years. NAB remains an offender in that it is a key performance indicator in its 2021Half Year Results. https://www.nab.com.au/content/dam/nab/documents/reports/corporate/2021-half-year-results-announcement.pdf

[5] Relevant documents and legislation can be found at: http://www.treasury.gov.za/publications/RetirementReform/Default.aspx

- and having “retirement benefit counselling” (which could mean a very short written document, as opposed to “counselling”)."

My recent experience in actually applying for a benefit from a South African fund was that I was not given any indication that a lifetime product was available. This was clearly not intended by their government. The Media Statement by the National Treasury[6] said that “it was decided that funds should first require the active participation of members, who should indicate beforehand, which type of annuity (e.g. life or living annuity) should be paid.” This intention has effectively been subverted by fund inaction.

It seems quite possible that the proposed covenant will be similarly subverted.

3 Obtaining more information from members

I am convinced that the industry (and the Position Paper) has greatly underestimated the possibilities of obtaining the data necessary to offer a reasonably tailored solution to every members approaching retirement.

If you want a financial benefit from anyone, you have to provide detailed information. Superannuation is quite easy comparatively: the Unisuper form, to which I have access, is 4 pages long if you just want a lump sum; about 6 if you want an account based pension. The mortgage we applied for last year went over 11 pages. "The Age Pension application form has 95 questions and is 25 pages long. In addition, there is an Income and Assets form with another 59 questions and 18 pages".[7] The details required for credit cards and insurance are all lengthy. If people want benefits, they will, and already do, provide the necessary information.

How much information is required? For a person about to retire: whether partnered; homeowner status; and a reasonable approximation of other assets and liabilities. The data asked for in calculator prototype[8] that I was involved in developing would be equivalent to a couple of pages – even if future earnings and children were still at home. Our calculator shows it can be done very easily on-line and can lead to a recommendation as to spending and saving. (We add another screen for investment risk - but that is more complex and probably not necessary for MySuper members/those not paying for advice.)

Our calculator does not address longevity products, but that does not have to be too complicated. Bateman and colleagues[9] showed not only that it was not difficult, but that well

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http://www.treasury.gov.za/comm_media/press/2017/2017082501%20Media%20Statement%20Minister%20issues%20final%20Retirement%20Funds%20Default%20Regulations%20to%20improve%20member%20outcomes.pdf

7 https://nationalseniors.com.au/members/our-generation/winter-2020/the-age-pension-application-nightmare.

8 https://draftfinplancalc.com

9 Bateman H, Eckert C, Iskhakov F, Louviere J, Satchell S, Thorp S. Default and naive diversification heuristics in annuity choice. *Australian Journal of Management*. 2017; 42(1):32-57. doi:10.1177/0312896215617225

over 90% of the people they surveyed made an allocation to life annuities. (Their research provides further indirect evidence that people are currently being steered away from annuities by the structure of the industry.)

Collecting the data in this way would necessitate a 2 stage process. The first would be a request for the additional information, which could be provided anonymously on-line or in written form to the administrators, who would then provide a tailored quotation to the member. The quotation could give a recommendation or offer a few options. The member would then apply for the benefit giving evidence that they had received the tailored quotation. If it was considered necessary for privacy purposes this could also be anonymised, although this seems unnecessarily precious to me.

For those accustomed to on-line interactions, this would be easy and unremarkable. There is however some concern that a significant number of people would find such an application process difficult. Such people may rely on brokers to navigate the paperwork required by financial institutions, or on Centrelink offices to complete the "nightmare" that is Age Pension applications, but there is currently no equivalent support for superannuation fund members.

Warren and Bell[10] suggest that up to 1.2 million accounts and $175bn in balances, but concede that some of this will be held by people with over the $1.6m cap. Further analysis of shows that this is likely to explain than half of the $175bn.[11] It appears likely of the order of $100bn is held by people who are not taking advantages of the tax concessions of moving into retirement phase. In the absence of further information, one should assume that such people are disengaged either through disinterest or confusion and need help in completing a simple four page document to obtain even a lump sum benefit.

4 Recommendations for the Covenant

These facts and arguments point to the conclusion that the proposed Covenant should provide for some compulsion for trustees to offer tailored solutions that include LISs. If it does not, there is a significant risk that many members will be offered less than optimal solutions for some years. Given that over a quarter of a million Australians are retiring each year I suggest that it is a matter of urgency that they have access to the best advice and products that are available. Those owners of the 1.6 million accounts with total balances of $485bn that have already retired also deserve access to better advice and products.

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[10] https://theconexusinstitute.org.au/wp-content/uploads/2021/08/Ensuring-all-retirees-find-a-suitable-retirement-solution-August-2021-1.pdf

[11] APRA's Annual Superannuation Bulletin (Table 7c, d and 8a) can be used to calculate that $175bn of the $518bn held for people over 65 is in accumulation accounts with funds with more than 4 members. Some of this will be held by people with over the $1.6m cap, but only $81bn of the $518bn is held in accounts of over $1 million, it appears likely that the majority of the $175 bn is held by people who are not taking advantages of the tax advantages of moving to retirement.

4.1 Additional requirements in the Covenant

In order to achieve this, I recommend that the Covenant should include the requirement for trustees to immediately provide members with information about their options to choose products that offer protection against longevity, investment and inflation risks and to access to advice appropriate to their circumstances. It should not be necessary for funds to provide the products or advice themselves; reference to other providers would be adequate. This would I believe provoke a greater sense of urgency in the industry to meet needs that are currently unmet.

It might also be desirable to provide, in the Covenant, for trustees to ask members for sufficient information about themselves to be able to provide a quotation for appropriate LIS products without infringing on financial advice legislation. The precise nature of such a "safe harbour" could probably be worked out after ASIC's consultation next year.

The Covenant should also provide that trustees have an obligation to ensure that all members are able to access their benefits. It should be clear that this includes provision of access to assistance in completing the necessary forms if people are currently unable to do so.

4.2 Best interests of members

It may be objected that this is a new requirement that will mean that funds will lose funds under management to those funds and insurers that have developed more appropriate products and advice, I suggest, however, that this requirement is already implicit in the requirement for trustees to act in the best interests of their members, and that the failure to address these questions have already potentially disadvantaged the four million Australians who have already retired.

I would be happy to discuss and potentially expand on the issues that I have raised in this submission.

Yours sincerely

Anthony Asher