Retirement Income Covenant

Submission from

Household Capital

August 2021

Live Well At Home

Retirement Income Covenant

This submission is from Household Capital, a specialist retirement funding provider that delivers responsible long-term access to home equity to meet the housing and funding needs of an ageing population.

Australians are the wealthiest retirees in the world. While compulsory superannuation is contributing to this wealth, the system is not yet mature, balances at retirement remain modest and for most retirees, the majority of their wealth is still tied up in their home. Retirees may need to access this wealth to plan for long lives at home for 25-30 years in retirement. For many Australians, the question is how to fund their long lives at home with confidence. Few want to downsize or prematurely enter aged care.

Home equity, a key component of the government's third pillar of retirement funding, can be used by older Australians to help improve their retirement. Drawing on home equity can enhance retirement income, provide access to capital and improve retirement housing.

The Retirement Income Review reinforced the importance of the three pillars of retirement funding – the Age Pension, compulsory superannuation, and voluntary savings, including home equity. Utilising this framework presents an opportunity to improve the effectiveness of the super savings pool in terms of delivering retirement income, but also to improve cohesion and coordination between the three pillars as well as confidence to spend to meet retirement needs.

The purpose of the Retirement Income Covenant (the covenant) is to clearly outline the responsibilities of Trustees in terms of developing a retirement strategy; this submission provides a strategic approach for trustees to include all three pillars of retirement funding when assisting members as they reach retirement. This includes the way members can access the three pillars of retirement income to:

- Maximise retirement income
- Manage risks to the sustainability and stability of their retirement income
- Have some flexible access to savings during retirement

Household Capital is in a position to offer super fund trustees the opportunity to provide their members with an additional income stream and access to capital, one that can help members mitigate and manage longevity risk and sequencing risk.

Household Capital response

The challenge for super funds is to support retirees by providing better retirement outcomes. Household Capital has developed a strategic approach that can draw on all three pillars of retirement funding and meet the needs of the vast majority of retired Australian homeowners. Through using such a strategy – and drawing on all three pillars of retirement funding – super fund trustees can operate in the best interests of their members and provide retirement outcomes that support funding, housing, care and community throughout retirement.

A major issue is the growing number of older Australians who are retiring with a mortgage. Paying this out with their super balance does not make economic sense; indeed, it would be a better outcome for retirees to convert a mortgage to a reverse mortgage and grow the super balance to generate a higher level of retirement income. This, we believe, would be in the interests of both members and funds.

Super funds have a key trusted role in delivering new forms of general advice

- Super funds must engage members in the financial guidance on retirement funding as they approach retirement
- The guidance provided by funds should rely on defaults and may need to be supported by prescriptive rules and legislation without expecting the provision of full-service, full-cost advice which would be prohibitive to improved widespread access to advice
- The focus on retirement income among super funds, DSS, the Retirement Income Review and the Retirement Income Covenant should be replaced with a focus on retirement funding which includes access to recurrent income, capital, contingency funding and longevity insurance funding. This approach would also facilitate draw down on capital as well as growth to fund retirement.
- Guidance or advice process to include modelling of retirement outcomes, with reference to the three pillars of retirement income (social security entitlements, super balance and other savings)
- Inadequacies of super alone need to be considered; in many cohorts superannuation represents one third of members' wealth; this particularly effects those Australians closest to retirement (less time in the system), women and those in casualised industries
- Lack of data may make this strategy less effective; however that missing data (partnered status, home ownership), is critical in improving the overall effectiveness of the Retirement Income Framework
- Super funds need to help members mitigate longevity and sequencing risk
- New superannuation and home equity products are required to maximise retirement outcomes.

The Retirement Income Framework should require Trustees to consider adjacent systems

The consultation paper highlights: "*Trustees should also consider any entitlement to the Age Pension…for their members, or cohorts of members in generality*."

This is an important step in helping members and importantly, shifts strategic focus from being product-led to funding source led. Super fund advisers must increase awareness of, and access to, all potential sources of wealth.

- The Retirement Income Covenant should address all forms of funding:
    i. Income and capital needs throughout retirement, rather than a sole focus on income
    ii. Cohesive delivery of all three pillars of retirement funding, not just superannuation
- Basic guidance is essential to meet members' objectives and should include advice on accessing benefits (Age Pension), consuming super savings and how to use private savings, including home equity, most effectively
- Guidance across all three pillars of retirement funding should also consider asset access, diversification, sequencing risk.

Suggestions for improved retirement funding and outcomes include:

- Retirement Funding Covenant communicated and delivered as the three pillars of retirement funding (income plus capital)
- Awareness of consumer protections, options and default positions to provide widespread confidence to draw on retirement wealth
- The introduction a new defaults across all three pillars will be necessary to help retirees understand their options and make informed decisions

- These defaults would need to allow for flexible access to both income and capital throughout retirement to meet the changing circumstances of individual retirees as well as the performance of their assets over time
- One example of a default “rule of thumb” that could be taken up by super funds is a revised retirement asset drawdown default: the 3% + 1% rule –
  3% per annum super + 1% per annum home equity for 30+ years of retirement.

Meeting the challenges of retirement: a new solution

The longevity challenge of retirement

Australians enjoy remarkably long and healthy lives; an average Australian couple aged 65 can expect to be alive together for some 20 years and for the surviving spouse to live into their late 90s. This extended longevity brings both opportunity and challenge for Australian retirees.

The opportunity to enjoy many productive and joyful years together exploring the world and spending important times together and with family. The challenge, knowing how much money is needed to provide for a comfortable retirement.

The housing challenge of retirement

Most older Australians wish to remain at home throughout retirement. Recent retiree research confirms that around 75% of homeowners aged 60+ wish to remain in their own home, leaving just over a quarter intending to downsize.

The recent pandemic experience has challenged the health, finances and confidence of a generation of older Australians. Lockdown has confirmed to many that their family home is the safest place to live throughout retirement.

Carrying a mortgage into retirement impacts both housing and funding security. Repayments eat into cashflow and a failure to meet those repayments can result in default and foreclosure.

The Royal Commission into Aged Care, in combination with the high incidence of COVID mortality and morbidity in aged care facilities, has only reinforced the overwhelming desire to age in place. While many government policies are aimed to support in-home ageing – and in-home ageing is both popular and more cost efficient than institutional aged care – the overall funding of aged housing and aged care by government alone is insurmountable.

Part of the answer must involve recognising the fundamental dual role of the family home in both housing and savings. Another part is to allow retirees to better access to manage their wealth to fund their own retirement.

The funding challenge of retirement

Funds should be required to present, in a simple and standardised format, the three pillars of retirement funding available to each member. Members should be able to consider not only their super balance at retirement, but also their entitlements to the Age Pension entitlement and home equity base. The following example draws on a much used ‘rule of thumb’ and presents an alternative approach.

Traditional approach: 4% drawdown

In the early 1990s, William Bengen was the first to propose that drawing 4% of savings at retirement each year would improve the chances that those savings would last 30 years. Around the world, variations of the 4% rule of thumb have often been used as the “safe withdrawal rate” to ensure pension sustainability.

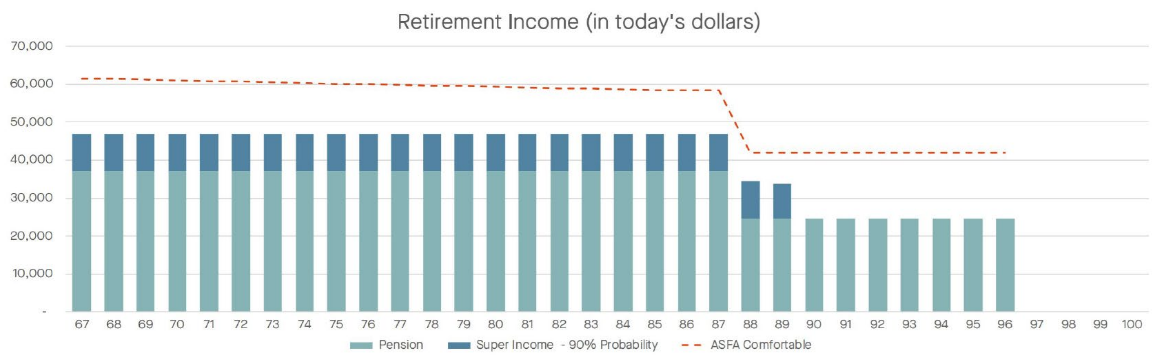
Since then, two major changes have challenged the ability of the 4% rule to generate a sustainable retirement income: longevity has increased significantly over the past 30 years and we are now facing a significantly lower growth environment, with reduced interest rates, lower dividends and market volatility effecting capital appreciation.

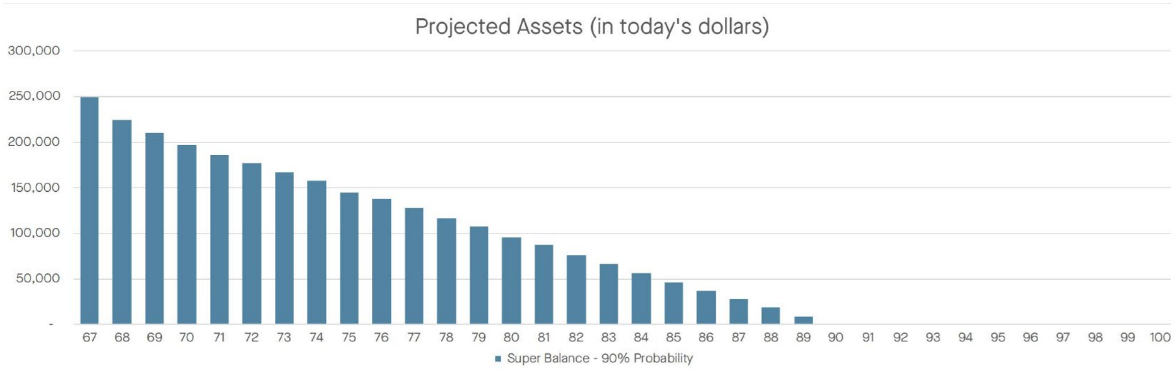
Combined, these two major challenges reduce the probability that retirees can be successful in making their retirement savings last over 30 years. Retirees now need to find ways to generate income for longer from lower investment returns.

Let’s take the case of a retired couple, both 67 years of age with $250,000 in superannuation and owners of a $750,000 home trying to fund their retirement. The new reality of the long term, low growth outlook they face is: 5% pa returns on superannuation growth, 0.75% pa paid in fees to manage their investments and 6% pa investment volatility.

House price growth is 3% long term, with 3.5% estimated volatility of house prices and 5% pa home equity access cost. Long-term inflation is 3%. How can they navigate the next 30 years?

Scenario 1 – Drawing 4% a year of super in a low growth environment provides only 20 years of an inadequate income with the surviving partner living without any super.





Clearly the 4% rule doesn’t go the distance and the couple’s retirement savings run out well before their expected longevity. But the biggest problem with the 4% rule was that it focused on sustainability and does not address retirement funding adequacy.

In this 4% drawdown example, the couple were forced to live on a retirement income consistently well below the ASFA “comfortable” standard, and the surviving partner lived on the pension alone for the last seven years.

The 4% drawdown rule generates little flexibility to maintain a quality lifestyle, manage unanticipated expenses like healthcare and in-home care, or even to fund and enjoy extended longevity.

The Australian retirement funding conundrum: drawing on all three pillars

Jane Hume, Australian federal Assistant Minister for Superannuation, Financial Services and Financial Technology last year stated:

> *"The third pillar, or voluntary savings, is incredibly important to the retirement security of Australians. For many, as we know, the family home is possibly the most significant form of voluntary savings that retirees have historically had, because retirees have historically had a very high level of home ownership compared to other countries than Australia. However, the family home is not actually considered a part of a person's retirement income."*

The solution to this conundrum is arguably simple: access some of the home equity to improve retirees' lifestyles. Australians, however, have no widespread experience of responsible, long-term access to home equity as part of wealth management and retirement funding. Quite simply, our system has not provided universal access to all three pillars of the retirement funding system.

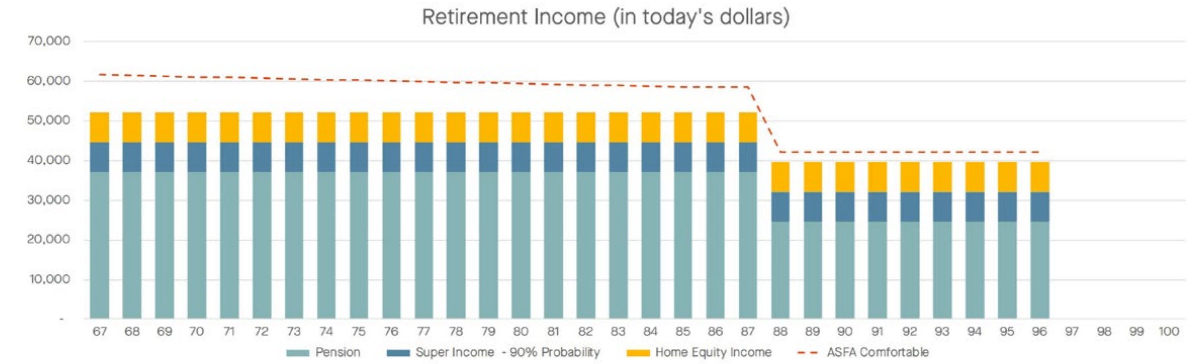
The preceding challenge notwithstanding, there is hope on the horizon in new forms of home equity access that allow borrowers to release modest amounts of home equity on an ongoing basis, as well as provide flexible access to anticipate financial contingencies throughout retirement.

A new approach: 3+1% drawdown

Australian retirees are among the wealthiest in the world, with median wealth number per household over the age of 65 years an eye popping $1,400,000 AUD. But in most cases, around $1m of that wealth is stored in the home where the couple want to stay throughout their retirement.

Instead of the old 4% drawdown rule of thumb, to get through retirement with confidence, Australian retirees should use a 3+1% drawdown rule: 3% of the value of your investments at retirement per year plus 1% of the value of your home equity per year.

Scenario 2 – Drawing 3% a year of super and 1% of home equity in a low growth environment provides lifelong and adequate income with additional available access to capital.



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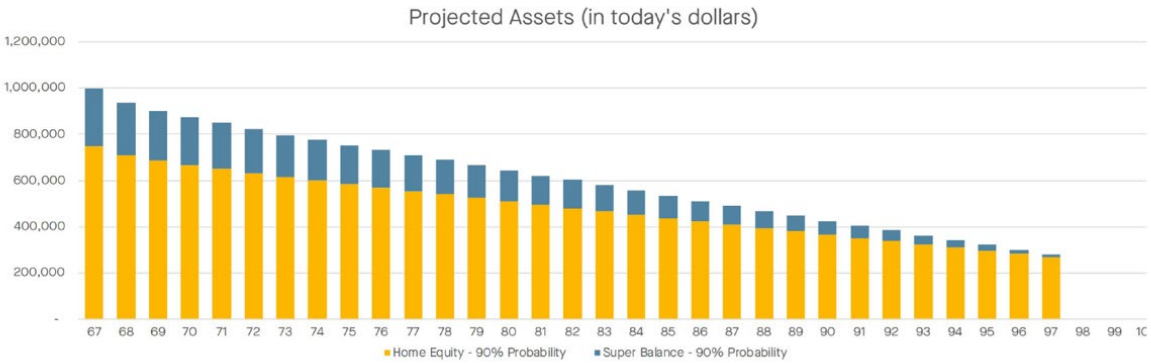

Adding an additional 1% per annum draw down from home equity, our couple could begin to achieve a retirement income that is both sustainable over more than 30 years and adequate relative to comfortable lifestyle standards.

Using a 3+1% retirement drawdown approach also provides our couple with the flexibility to draw additional funds along the way to meet a range of needs, including:

- to renovate or modify the home to make it safe and comfortable for retirement
- to fund large purchases, such as a new car or furniture
- to meet unexpected expenses
- to pay significant medical or dental expenses
- to fund in-home or aged care services
- to give to their children and grandchildren before they die.

Conclusions: the path to a sustainable, adequate and balanced retirement funding system

The 3+1% rule of thumb has several major implications for Australian retirement funding:

- 3+1% provides a sustainable, adequate retirement funding plan for the majority of Australian retirees, not just those with $1m in super
- 3+1% would improve retirement outcomes, lifestyles, and wellbeing
- 3+1% helps Australian retirees drawn on all three pillars of retirement funding flexibly throughout retirement to meet their own retirement funding needs
- 3+1% harnesses the value of the family home for both retirement housing and funding
- 3+1% diversifies retirees' sources of retirement funding and improves the probability they will successfully fund their full longevity
- 3+1% preserves significant savings for retirees to be the bank of mum and dad and to bequeath to the next generation without unduly depleting available retirement funding
- 3+1% supports age-appropriate housing for in-home ageing at all stages of retirement for couples and surviving partners
- 3+1% maintains a significant reserve of value to fund in-home care and residential aged care
- 3+1% would boost retiree consumption and provide a long-term stimulus to the local economy
- 3+1% brings $1trillion of retirees' savings to bear on funding their own retirement without including the home in the assets test for the pension or imposing a death tax to recoup the costs of aged care services.

Concluding remarks

The Retirement Income Covenant will require super funds to know their members as required under ASIC's Design and Distribution Obligations (DDO), which come into force in October 2021, as well as APRA’s Regulatory Guidance 515. These requirements should necessitate funds knowing whether members are homeowners. Gathering important information is an important aspect of developing a three pillar retirement income solution.

Importantly, it’s all about engagement first and product second.

The reality is that the majority of members do not currently have adequate retirement funding in superannuation, and this will remain the case for many years. Certain cohorts, including women and casual or gig economy workers, have been – and continue to be – disadvantaged.

Indeed, many retirees would be well advised to pursue a strategy of growth in their lump sum asset if they are able. Despite this, Australian retiree homeowners have accumulated sufficient assets and entitlements across all three pillars to adequately fund retirement.

The introduction of a simple default pathway as a post-retirement base option for super fund members, including each of the three pillars, is integral to achieving adequate and flexible access to savings. This base option can underpin more nuanced strategies, ones that would be dependent on each member’s appetite for advice (and ability to pay) and the asset mix of each.

The opportunity exists for Household Capital to work with super funds toward a mutual growth goal; for a significantly higher number of super fund members to achieve retirement funding adequacy and to ensure each member is best positioned to achieve their retirement goals.