Lifetime Income

Response to

Retirement income covenant

Position paper of 19 July 2021

Julian D Gribble

Cary Helenius

for

Australian Government Treasury

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Lifetime Income

Director, Retirement, Advice and Investment Division
The Treasury
Langton Crescent Parkes ACT 2600
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Via e-mail: superannuation@treasury.gov.au

Response to Retirement income covenant Position paper of 19 July 2021

Dear Director

Thank you for the opportunity to make a submission and comment on the Retirement income covenant Position paper of 19 July 2021.

1 Lifetime Income

Lifetime Income is a boutique consultant that specialises in retirement incomes and their application to services that are relevant to retirees. The directors bring over 70 years of professional actuarial experience and an established interest in providing life-long income streams for retirees efficiently and effectively. We believe that retirement is a multifaceted challenge, both for individual retirees and from a broader social policy perspective. While income is an important enabler of a quality retirement, how that income is best utilised is also important. This is encapsulated by the observation 'if you give money to someone who has (serious) Alzheimer's it is unlikely you are helping them'. Our approach is summarised in the 10 minute overview video posted on the 'Materials' page of our website, www.lifetime-income.com.au.

2 Support direction of covenant

We would like to make it clear that we support the direction of the proposed Retirement Income Covenant (RIC).

Having said that, we also suggest there are some important issues that are not yet explicitly addressed. We do not suggest they will necessarily be easy to address but do believe they need to be 'called out'. If they are not called out and considered, they risk being ignored and whilst that may be a convenient and comfortable approach, that may also be politically expedient, it does not change the reality 'on the ground' for individual retirees who are facing these issues.

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We also understand that, as with any requirement or regulation, establishing the RIC indicates minimum requirements of trustees. There is obviously scope for trustees to do more than this, and it may be that as experience and knowledge develops that more will become expected from trustees.

As the Retirement Income Review highlighted, there are some fundamental core issues that the post retirement superannuation system needs to address. In particular, from a financial perspective, security of income until death. There are some deeply ingrained behavioural and attitudinal challenges to be addressed to improve the rational and efficient use of the system by retirees. We believe that is it important to retain a laser like focus on the core purpose of the superannuation system which is to help retirees provide for themselves in their retirement years. It is therefore part of the broader retirement planning for all retirees, in some way or another, when they retire. It is not appropriate and may be misleading if superannuation, especially its accumulation phase, is considered in isolation and unfortunately there is tendency for this to occur. The fundamental purpose of the superannuation system is not the accumulation phase, but rather, it is the retirement drawdown or pay-out phase.

We also appreciate there are significant industries that are part of the overall superannuation infrastructure, and they naturally have their own vested interests to protect. However, these vested interests should not be allowed to dominate the discussion and narrow or limit the policy setting.

3 Some key themes to address

We would like to highlight some underlying premises which limit the scope of the debates in superannuation, and around retirement incomes.

3.1 Superannuation silo

Often superannuation discussions appear to presume that the sole source of income for retirees should come from their superannuation. This is simply not the case and may never be. Superannuation is founded on the premise that contributors work for pay, and a certain proportion of that pay is compulsorily put into the superannuation system. If pay is low or unpaid work is undertaken (for example, domestic work) those individuals are disadvantaged in accumulating superannuation balances. In addition, the current superannuation system is immature and will not be mature (in the sense of people contributing significant amounts for their full working lives) for approximately another 20 years.

The most recent Intergenerational Report1 also makes it clear the Age Pension will be a key source of funds for retires for the foreseeable future. While the proportion of partial pensions increases though to 2061, the numbers of retirees receiving full or partial Age Pensions increases to nearly 5 million in forty years' time, about 60% of the total retiree population (down from approximately 70% of about 4 million currently).

We support the RIC including recognition of the Age Pension in the advice they provide their fund members.

[1] 2021 Intergenerational Report: Australia over the next 40 years, Australian Treasury, 2021. See https://treasury.gov.au/publication/2021-intergenerational-report

Many retirees have assets outside the superannuation system that may have may be of considerable value, for example ownership of their home. We suggest that these other assets should also be required to be considered by trustees in the development of their retirement income strategies. The Grattan institute[2] emphasises the need to move to a balanced discussion on the sources of funding for retirement and not take a blinkered view that superannuation is only source to be considered.

We acknowledge that this may be seen as difficult but believe that retirement and advice relating to it should be approached from a holistic perspective. The fact that something may be seen as difficult is not an excuse or justification to put it in the 'too hard basket' and therefore be ignored. There is a high level of obligation and responsibility on trustees to support members achieve outcomes in their best financial interests and this is entrenched in the recent Your Future, Your Super legislation. Ignoring issues that may impact such outcomes does not meet that objective or responsibility. In the same vein, we also note the current Design and Distribution Obligations promulgated by ASIC in their RG 274 requirements also requires trustees to ensure products offered are 'fit for purpose'. Obviously to assess this the purpose had to be specified.

3.2 Income streams.

There is a very strong focus on the provision of regular income streams for retirees.

We suggest that financial management in retirement is more complex than just receiving regular income streams. Most retirees will incur necessary or optional lump sum payments (for example, for house repairs). Access to funds for these planned or unexpected lump sum payments should also be reflected in retiree's financial planning and ongoing support to ensure that the 'best financial interests of retirees are addressed.

The most recent ABS data[3] (the latest published in May 2020 for 2018-2019, Table 8.1) on uses of lump sum withdrawals. Indicates that almost 50% of retirees have made a lump sum withdrawal (full or partial) from their superannuation. Approximately two thirds of the 3.85 million retirees are reported to have made contributions to their superannuation. This implies that one third of the retiree population have made lump sum withdrawals from their superannuation. Almost 50% of these lump sum withdrawals were applied to work on the paying off or improving homes, purchase of a car, or paying other debts and just under 11% were rolled into another superannuation fund or an annuity.

3.3 Healthy, wealthy, capable and interested.

Discussions around retirement tend to presume that retirees are healthy, wealthy, capable (financially literate) and interested in managing their own affairs in retirement. This is a naturally optimistic view that is hard to gainsay without risking being cast in a negative light.

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[2] 'There's a lot more to retirement incomes than super', Grattan Institute, August 2020. See https://grattan.edu.au/news/theres-a-lot-more-to-retirement-incomes-than-super/

[3] ABS 6238.0, Retirement and Retirement Intentions, Australia, 2018-19, May 2020

It is also a 'comfortable' position to take for those involved in the discussion as they are unlikely to need to personally address declining capacities (although they may have parents or older family members who are). However this approach is very exclusive of those retirees who do not fit all those criteria.

Retirement is typically split into three phases, active, passive, and fragile. Debates typically focus on the active phase with an implied presumption that this will continue indefinitely. This is a false premise. Trustees should consider the impacts of the changing needs of their members and the ways in which they can provide advice to those members as they move past the active phase of retirement and into its later phases.

3.4 Member advice

Trustees, to fulfil their fiduciary obligations to their fund members who do not fulfil all the healthy, wealthy, capable and interested requirements need to step past being passive providers of information and presuming that retirees can and will make an informed and appropriate decisions, and move into more proactive activities, including default options. At this stage it becomes more about trustees providing adequate and 'not bad' advice to support members than about providing the 'best' advice and support at an individual level.

We note that expecting advice to be 'best' may not be a realistic proposition. It is great to aspire to providing 'best' advice, however, in practice circumstance change, both within and without the control of trustees. Hence, there is always the risk that advice that may be considered to be 'best' yesterday is not 'best' today. The word 'best' needs to be put into context with conditional statements such as 'as at the time the advice was provided' and 'based on the information provided by the client/member' and so on. 'Best' can, in practice, is conditional and is not absolute going forward in time.

The above discussion implicitly presumes that retirees have the financial literacy and interest to be able it understand advice and then act appropriately on it when they receive it. While this is laudable objective, we perhaps need to recognise the reality that it is not universally true. This implies trustees should set up mechanisms that are appropriate for those members who have difficulty making appropriate or good financial decisions because they do not have the capacity to do so. Casting them aside on the premise that they have been given information (which they potentially cannot understand) is an abrogation of trustee responsibilities. Member lack of financial literacy and capability/willingness to make significant financial decisions is a practical reality, even if not a pleasant one, that trustees need to actively address.

It seems a narrow perspective to presume, as the position paper seems to, that members will, or should, get advice from financial planners or some other third party regarding their retirement plans. The current reality, given the state of the financial planning industry is that there is neither the capacity nor competence for this to be a realistic objective, certainly in the short term. This implies that, pragmatically, and from a broader social policy perspective, that alternative convenient and cost effective options need to be explored. The minimum criteria should be that the advice is 'not bad'. That ensures that clearly adverse outcomes are avoided, providing member protection.

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This suggests that trustees need to consider providing relatively generic default advice, perhaps based on a few individual parameters and indications of desired directions forward, on general paths forward for retirees. That is, provide default paths forward that may not be individually tailored, but are relatively safe and do not lead to adverse outcomes. We recognise this is differs to 'best' and individual advice, but also recognise that this 'not bad' advice may protect and benefit may retirees who may otherwise get no advice.

3.5 The financial focus of retirement is on wealth management.

The current approach to retirement is all about 'wealth creation' during the 'accumulate' phase, with an aim of producing a regular 'indexed' income in retirement. The approach has been relatively successful in Australia in delivering accumulated lump sum benefits. However, in the decumulation phase there has not been a holistic, comprehensive solution that provides lifetime financial security combined with lifetime access to the services required to deliver the needs and wants of retirees as they move from the active phase of retirement into the 'passive and frail' phases.

This is a paradigm shift when considering retirees needs throughout the entire retirement period and perhaps applies even more strongly in the over 80s context. A different and wider set of risks apply after retirement than before it. This suggest that different approaches and techniques may be needed to manage these new risks. In particular, it suggests that an accumulation perspective may become inappropriate and narrow in retirement. This applies to both retirees and their advisors. It is not clear the need for this change in perspective is widely appreciated.

The challenge is to manage the regular (and perhaps some additional irregular) payments from a retiree's funds in contrast to accumulating funds for future use. We have noted earlier the issue of sequencing risk. This risk is only relevant after retirement starts. However, it can be material in adverse investment conditions.

As retirees age, the time horizon in which adverse investment outcomes can be redressed shortens. This risk may be compounded as retirees move into the passive phase of retirement as they may also have reduced capacity to make the relevant financial decisions. A common response of those nearing retirement to the possibility of inadequate funding is along the lines of 'I will go out and get some work'. We suggest that in reality this 'plan' has a decreasing likelihood of success for active retirees and may be close to impossible for passive retirees (and that is before diminished capabilities are considered). These reductions in remaining lifetime and capacity are also risks that are only relevant after retirement starts.

We also note that we are not advocating automatically taking a conservative investment strategy on retirement. A benefit of a conservative strategy should be reduced volatility in outcomes. This can provide comfort and increase the ability to plan into the future with confidence. However, it contains an aspect of (investment) risk avoidance though adopting a conservative approach. It may not address matters like inflation protection in the future. The reason sequencing risk may be a major concern is that the size of the funds a retiree manages are largest in the years immediately following retirement. A changing balance between growth and security may be most appropriate over the retirement period. This highlights the wealth management aspect of retirement. We acknowledge that if the challenge is taken as minimising downside effects for retirees who are not receiving advice, then the benefits of a 'set and forget' conservative post retirement strategy may be enhanced.

3.6 Longevity

We are all also aware of the need to manage longevity, both in terms of the uncertain time period before the death of an individual retiree and the ongoing mortality improvement that continues to be experienced across all retirees. Even if mortality improvement slows (and there is some recent evidence suggesting this may be the case, particularly in the developed countries, including Australia) or ceases, the key risk for the individual retirees is not knowing when they we will die is a major challenge. Individuals are either alive or dead, and statistical measures such as averages and average expected lifetimes are not directly relevant. Statistical measures are valuable when managing groups, but less so to the individuals in that group. As we discuss later, longevity can only be efficiently managed by pooling. This risk is only relevant after retirement starts.

These risks also pose serious challenges for those managing retirement funds on behalf of retirees. Often these people are in a trustee or fiduciary position (either formally or informally) and charged with protecting the interests of the retirees. In case where they need to make decisions and set policy on behalf of retirees, they need to balance competing risks and act on the overall best interests of the group retirees. This can be challenging and may carry the risk of action or litigation by individual retirees (or more likely their beneficiaries or other relatives) who may feel their individual interests have not been 'properly' addressed. This risk may be exacerbated by the likelihood that such concerns only arise after the event when options for remedial action, if warranted, become limited. While this risk also needs to be managed in the accumulation phase, it is heightened in the decumulation phase.

3.7 Over 80s

In our 2018 paper[4] we examined the over 80's market for retirement income products and support.

A key finding was that morbidity has a strong influence on retirees and thus on the support they should receive from trustees to meet the 'best financial interests' and other potential covenant criteria.

In terms of morbidity, we established that over 50% of the over 80s population suffer from some level of cognitive impairment. We also reported figures from the ABS that indicate that many more older people suffer from physical impairments, including:

[4] Gribble J and Helenius C, '*Retirement: A new frontier for the over 80s market*', International Congress of Actuaries, Berlin, May 2018. Full paper available on request.

- 1.8 million, just over half, of Australians aged 65 and over have a disability, compared to one in eight (12.5 %) aged under 65
- Almost 40% of those aged over 65 need some form of assistance with everyday activities (almost half of the women and a third of the males)
- At age 85, more than 80%, 8 out 10, people needed assistance compared to less than 30%, 3 out 10, people aged 60-69

The healthy, wealthy, interested and capable paradigm does not hold for many retirees aged 80 and over. For the over 80s we need to confront the impact of declining physical health and intellectual decline. We are not suggesting that all retirees over 80 will suffer material declines that will adversely affect their quality of life, but many will.

There is therefore an important role for a 'fiduciary' to act on behalf of the retiree to ensure the program of services is delivered to the retiree when they are not capable of organising and implementing their own care. To allow the fiduciary to act in the interests of the retiree in their passive and frail stages, it requires that when the retiree is in the active phase of retirement, they make the decisions over their preferred long-term retirement arrangements through a 'living will'. The fiduciary then becomes responsible for acting out those wishes in a similar fashion to an executor of a deceased estate.

3.8 Retirement Income Strategy principles.

The May 2018 Retirement Income Covenant Position Paper: Stage one of the Retirement Income Framework stated (Page 4):

> *[Covenant Principle] 1. Retirement income strategy*
>
> *Trustees should assist members to meet their retirement income objectives throughout retirement by developing a retirement income strategy for members.*
>
> This was amplified:
>
> ...
>
> *Requiring all superannuation trustees to develop a retirement income strategy will help to ensure appropriate, high-quality products are developed and offered to retirees. This should expand individuals' choice of retirement income products and improve their standard of living in retirement.*
>
> *The covenant would outline specific factors trustees need to take into account when developing a retirement income strategy. Importantly, the strategy should focus on the collective needs of members. ... the strategy should primarily focus on delivering retirement income solutions that are appropriate for members as a whole or for large cohorts of members. Specifically, trustees would need to consider the following factors when designing their retirement income strategy, with the strategy optimising the retirement outcome for members (given trade-offs between the factors):*
>
> - *maximising income for life for members;*

> • *the potential life spans of members and the costs and benefits of managing longevity risk for members as a whole;*
> • *managing risks that affect the stability of income, including inflation;*
> • *providing members with access to capital;*
> • *member needs and preferences for the factors above;*
> • *the costs and benefits to members of developing a CIPR in-house compared with offering a CIPR developed and managed by a third party or a combination of both in-house and a third party;*
> • *expected member eligibility for the Age Pension; and*
> • *whether and how cognitive decline may affect outcomes.*

The inclusion of these factors would ensure consistency by trustees and improve member outcomes by requiring all trustees to consider a minimum number of common factors. If required, further guidance for trustees would be provided through regulation.

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Trustees should also consider how the potential cognitive decline of members may influence the member's ability to make optimal decisions regarding the drawdown of income during retirement.

The current position paper talks about introducing a Retirement Income Covenant, but then backs away and does not propose what it may be. The closest it gets is on page 4, in the context of a broader retirement income framework, where it is stated:

The retirement income covenant will require trustees to develop a retirement incomes strategy.

So a tool for fulfilling the RIC is specified, but the covenant itself is not. focus is then on retirement income strategies, which are summarised in Box 1:

Box 1: Proposed retirement income strategy principles

Trustees are required to formulate, review regularly, and give effect to a retirement income strategy for the retired members of their fund, and the members of their fund approaching retirement.

The strategy can be formulated for:
- *all members in generality, or*
- *cohorts of members in generality, as identified by the trustee*

The strategy should outline how the trustee intends to assist their members to achieve the following objectives:
- *maximise their retirement income (taking into account the Age Pension and any other relevant income support payments identified by the trustee paid under the Social Security Act 1991 or the Veterans Entitlements Act 1986)*
- *manage risks to the sustainability and stability of their income*
- *have some flexible access to savings during retirement*

Where these objectives compete, the strategy should identify how trustees intend to assist their members to balance these objectives and whether the trustee's intended assistance is likely to increase or decrease the retirement incomes of their members.

Comparing Box 1 to the outline from the 2018 position paper above shows a considerable lowering and narrowing of objectives. This regrettable and should be reviewed.

We acknowledge that some of the measures that have been dropped may have been difficult to implement, however that does not detract from the need for them. Rather it means that some creative thinking and development needs to be applied so that trustees do more than apply minimum standards in instances where they are supposed to be providing the 'best financial advice' to their members. The gap between "minimum" and "good" (let alone "best") is material and there is a moral obligation on superannuation trustees to bridge it.

The most important omission is the dropping of the last point in the 2018 position paper: '*whether and how cognitive decline may affect outcomes*'. There is no doubt that cognitive impairment of various level and from various sources, is rising as the population ages. The ABS reports[5] that the leading cause of death for females and the second leading cause of deaths for female in 2019 was dementia (including Alzheimer's). As we have noted above, about 50% of the population suffer some level of cognitive impairment by the time they reach the age of 80. Physical impairments have reached even higher levels at these ages.

This 'inconvenient truth' should be acknowledged and reintroduced into the obligations of trustees to support the increasing challenges experienced as a rapidly increasing number of their members reach these higher ages and face these challenges in the future. We acknowledge that this may imply trustees need to apply a higher level of care and duty,

[5] 'Causes of Death, Australia' (Reference period 2019), ABS, October 2020.

including proactive steps to support members with cognitive and physical decline than they may have done in the past.

4 Assets to support income streams

There is also a need for appropriate assets to be available to support retirement and consequential investment objectives.

We have already noted the need to change the approach for retirement from wealth accumulation to wealth management for the rest of the retiree's life.

A key component of wealth management is access to assets that are liquid, stable and have cash flows that match, as closely as practically possible, the cash flows of the expected payments. This reduces investment risk for the provider of the payments and provides increased security for the recipient.

We therefore suggest that the Australian government considers the opportunity to enhance the depth of Australian fixed interest market by issuing bonds with maturities covering the period 2031 to 2051 and possibly longer. That is, have securities maturing in each of the years over the next 10 to 30 years, and possibly beyond. Australia currently does not have substantial depth in its bond market for maturities beyond 10 years with considerable gaps in the maturity profile of government issued fixed interest securities.

We propose that serial bonds which bundle a number of long dated zero coupon bonds (with sequential annual maturities) will provide a payment pattern that matches income retiree needs. The use of serial bonds is well established in a number of countries, including the US. Such bonds would reduce the mismatch risk between more traditional bond payment patterns and the decumulation cash flow expected by retirees by better matching assets and liabilities. They would provide an asset class that is appropriate and 'fit for purpose' to support the decumulation phase of superannuation, and support retirement income streams more broadly, by matching of funds with income liabilities for retirees.

Based on the work we completed to support the Institute of Actuaries submission to Treasury[6] in March 2021 on this topic, we estimate that the demand from the retirement sector could be of the order of $50 billion. We also note that these "Retirement Bonds" would reduce the asset-liability mismatch in retirement income stream products and therefore are likely to improve the robustness and resilience of assets supporting retirement income products

[6] *'Long Dated Fixed interest Opportunity'*, submission to Australian Treasury by Institute of Actuaries of Australia, 25 March 2021. See https://www.actuaries.asn.au/Library/Submissions/2021/AISubmission20210325.pdf

5 Next steps

We would welcome the opportunity to discuss our views with you.

Please let us know if this would be of interest to you. We can be contacted by email at jules.gribble@lifetime-income.com.au and cary.helenius@lifetime-income.com.au.

Yours sincerely,

Cary Helenius, Actuary

Jules Gribble, Actuary