6 August 2021

Director
Retirement, Advice, and Investment Division
The Treasury
Langton Cres
PARKES ACT 2600

Email: superannuation@treasury.gov.au

Dear Sir/Madam,

CONSULTATION RESPONSE: GIVING EFFECT TO THE RETIREMENT INCOME COVENANT

About Optimum Pensions

Optimum Pensions have designed a lifetime income stream that superannuation funds can easily white label to provide members with longevity protection whilst at the same time still offering investment choice. We have partnered with Hannover Re and Generation Life to bring this product to market in Spring 2021. We are in discussions with several major superannuation funds who are waiting for further clarity from Treasury.

Optimum Pensions supports the Government's introduction of the Retirement Income Covenant and believes this will assist superannuation funds to develop or utilise better retirement solutions for their members.

We note that while the position paper refers to longevity products, there is no explicit requirement for trustees to include longevity products in retirement strategies.

We have limited our submission to focus on three key issues on which we would encourage Treasury to take a proactive stance. These issues need to be appropriately addressed if trustees are to achieve the Core Obligation under the proposed covenant. Appendix 1 of the position paper summarises this core obligation as:

> *"Formulate, review regularly and give effect to a retirement income strategy for their members, assisting members to balance three key retirement income objectives:*
> - *maximising retirement income*
> - *managing risks to stability and sustainability of income*
> - *having some flexible access to savings in retirement"*

The first point we make is that Retirement Strategies must be built (and measured) to last for much longer than ***average life expectancy*** and the use of longevity products will be essential in tackling this

The second is that strategies should focus on **what retirement looks like *after* the member has reached Age Pension Age**. This is because most Australians will need considerable cashflow flexibility as they transition into retirement, but the picture becomes much more stable once they, and their spouse, reach Age Pension Age.

The third is that the Government should not only put a timeframe of the development of the funds' retirement income strategies, but also a timeframe that covers the "giving effect" to the strategy.

We consider that these issues are of major importance and that our comments assist with drafting the legislation and/or the guidance that supports the Covenant. It is of paramount importance for trustees to use products that pool or insure longevity risk in order to deliver the Government's and the country's objective of providing the best possible living standards in retirement. The need for longevity products to lift retirement income has been clearly stated in all the government's work since the Financial System Inquiry. We include various references below.

There is a risk that if longevity products aren't mandatory in retirement strategies, then trustees will tend to focus on averages – which mask the risks each individual member faces – and trustees will continue to conclude that 100% allocation to account-based products is a satisfactory retirement strategy. I.e. despite this being at odds with all the research and despite this practice leading to Australians being excessively frugal in order to manage the fact their individual lifespans are unknown and have a standard deviation of 8 years. There is also a risk that without providing a timeframe for funds to implement the strategy (eg a maximum of 2 years form the date the legislation is passed), it could be many years before funds decide to do more than develop the strategy.

Longevity Products must be a mandatory part of improving retirement incomes

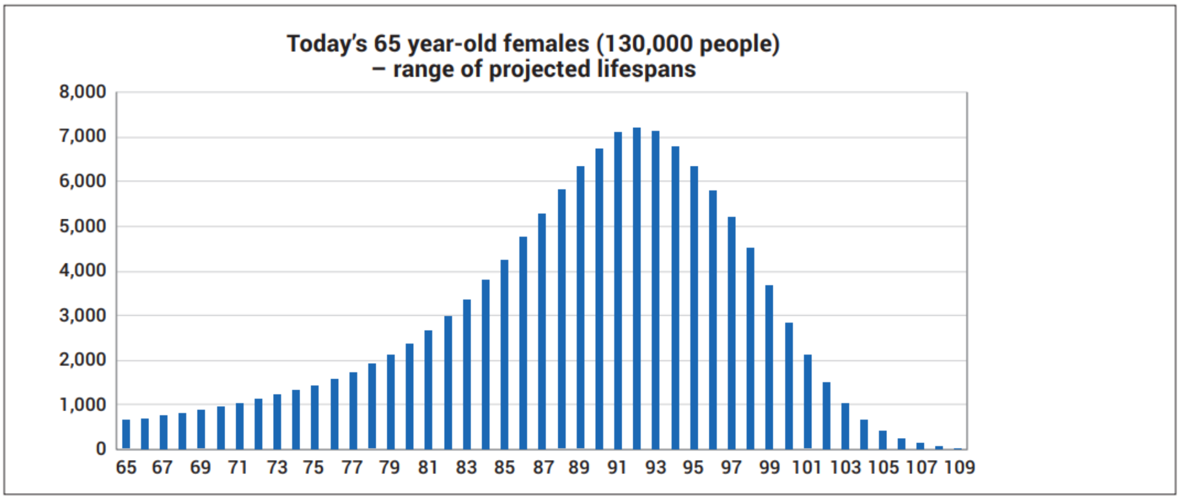
Only a lifetime income stream (with a guarantee that there will be an income for life) can precisely achieve the objective of turning superannuation into 'income for retirement' - without either leaving a residual bequest or running out. This is because nobody knows how long they will live. A person's lifespan could end next week (they could get hit by a bus) or it can continue to the end of the life tables at age 109.

"Life expectancy" is not a prediction of how long people live, it is the average, with a standard deviation of around 8 years around this average[1]. It is not possible for an individual to convert their superannuation into retirement income that exactly covers their lifespan without using a longevity product.

[1] https://www.actuaries.digital/2020/08/12/standard-deviation-around-life-expectancy-is-eight-years-what-this-means-for-retirees/

Chart 1 shows the projected lifespans for Australia's current population of 130,000 females who are age 65. It shows the total number of individuals who are projected to die at each age. Each individual does not know where they will be on this range.

Chart 1: Projected lifespans of Australia's current 130,000 females who are aged 65[2]



Healthy retirees tend to live longer than the average. 'Red flag warnings' can ensure that people who aren't suited to a longevity product (e.g. people with life threatening illnesses) know not to use them.

There are three obvious ways that a superannuation fund can offer a longevity product:

- Develop their own product,
- Use a "white label" product", or
- Refer members to other providers.

Investment solutions alone cannot deliver the goal of making the retirement phase of superannuation more efficient.

The Retirement Incomes Review made this explicitly clear as demonstrated by the following references:

- "**Without longevity protection, concern about running out of savings may contribute to retirees undertaking costly strategies to protect against the risk of running out of money, including drawing down the minimum from their superannuation assets and lowering their potential retirement living standards**". Page 197.

[2] https://actuaries.asn.au/Library/Miscellaneous/2020/RNLifeExpectancy.pdf

- The Retirement Income Review's modelling assumed that people confidently draw their ABP to zero by age 92 but said "**It is also assumed that they will not leave bequests and will purchase a longevity product at retirement that provides them with income from age 92**" (page 36) and "**The modelling assumed retirees dedicate a small proportion of their balance 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 6A-26
- "**Higher incomes can be achieved by allocating more to a longevity product**." Page 533

These observations have been consistently made in previous government reviews. The Financial System Inquiry Final Report stated that "**Greater use of products that pool longevity risk could significantly increase retirement incomes**" (page 123). Modelling by the Australian Government Actuary for the Financial System Inquiry showed that retirement income for a male on average weekly earnings could increase by 15% - 30% through use of products that include longevity protection[3]. These figures echo our own modelling, using an investment linked annuity.

The FSI also said "**An enduring income stream would give retirees the confidence to spend in retirement, which would help to sustain economic growth as the population ages and reduce the extent to which longevity risk falls on the taxpayer**". Page 91.

Importantly, the use of any drawdown rules or investment strategies for retirement can always be improved upon further (i.e. maximised) by also pooling or insuring longevity risk.

The income from any strategy can be improved if benefits that would otherwise be payable on death are instead used to pay higher incomes to members while they are alive.

Longevity Insurance

Where funds decide to offer their own guaranteed longevity product, or a white label solution, they will need to obtain an insurance policy. Funds are not permitted to self-insure, so it is essential that the provision of longevity insurance is recognised as a viable option. The SIS Act covenant Section 52 subsection (7) states:

> *"Insurance covenants*
>
> *(7) The covenants referred to in subsection (1) include the following covenants by each trustee of the entity:*
>
> *(a) to formulate, review regularly and give effect to an insurance strategy for the benefit of beneficiaries of the entity that includes provisions addressing each of the following matters:*
>
> *(i) the kinds of insurance that are to be offered to, or acquired for the benefit of, beneficiaries;*

[3] Financial System Inquiry Final Report page 123.

(ii) the level, or levels, of insurance cover to be offered to, or acquired for the benefit of, beneficiaries;

(iii) the basis for the decision to offer or acquire insurance of those kinds, with cover at that level or levels, having regard to the demographic composition of the beneficiaries of the entity;

(iv) the method by which the insurer is, or the insurers are, to be determined;

(b) to consider the cost to all beneficiaries of offering or acquiring insurance of a particular kind, or at a particular level;

(c) to only offer or acquire insurance of a particular kind, or at a particular level, if the cost of the insurance does not inappropriately erode the retirement income of beneficiaries;

(d) to do everything that is reasonable to pursue an insurance claim for the benefit of a beneficiary, if the claim has a reasonable prospect of success."

It does not specify whether this is group life or longevity insurance and, therefore, should apply to both forms of insurance. Otherwise the Government would need to include an amendment to ensure that funds are able to provide longevity products to support the proposed Retirement Income Covenant.

Calculations to support Retirement Income Strategies must be fit for purpose

Trustees should not be permitted to use models that focus only on income to life expectancy, or 'survival-weight' cashflows[4], when developing and assessing retirement income strategies and products. Such models ignore the uncertainty each individual retiree faces and the resultant behavioural impacts from them not knowing their own length of lifespan.

If a model or metric assumes a fixed age of death (based on the average) then this hides risk and creates a major disconnect between what superannuation trustees think is in their members best interests and what those individual members know they face in reality.

This practice will lead to inappropriate retirement income strategies to be developed that do not meet the core obligations of the proposed covenant.

Retirees need their trustees to plan based on them having a longer lifespan than averages

We strongly recommend this requirement be included as a Core Obligation as an explicit requirement.

A simple analogy is that building a retirement strategy based on averages is like building a door that is only high enough for a person of average height to walk through. Half of people will have to duck or bump their head!

[4] Survival weighting cashflows means weighting each year's cashflow by the percentage of members who will live to that age. This technique is only appropriate for schemes where risk is actually pooled, not for individuals who all plan as separate economic entities.

With innovative retirement income products that pool risk, funding a planning horizon that is longer than average does not need to come at the expense of high income. Quite the opposite. The use of longevity products gives retirees the ability and confidence to turn their whole balance into retirement income.

The metric to assess and maximise 'Retirement Income over retirement' needs careful design

The following logic is critical when designing any metric to assess or to maximise income from a retirement strategy for any cohort of members:

- Clearly, individuals will require a better than a 50/50 chance their retirement income will last as long as they live, and they can maintain the best possible lifestyle. (We acknowledge that the Age Pension will continue but it may not achieve the replacement ratio that they want or could afford with their own longevity product).
- The objective most individuals have is to be confident their retirement income is able to last to a higher age than average, e.g. to the age they can be, say, 75% or 95% confident it will cover them[5]. Actuarially, this means planning to around age 100, or more for healthier retirees[6].
- A metric for assessing retirement strategies which focusses only on retirement income to average life expectancy equates to giving members a 50/50 chance they will receive that outcome
- A metric that only looks at retirement income up to life expectancy does not therefore align with what members need. Therefore, it carries a risk of showing the wrong strategies as being satisfactory.
- Focussing only on outcomes up to average life expectancy hides risk and hides the scenarios that retirees fear and drive retiree behaviour – the risk of outliving their savings.

We recommend that any metric or assessment of a retirement strategy should focus on total income up to age 100. The metric should **not** be reduced by the probability of living to each future age (as that technique is only appropriate for schemes where risk is <u>actually</u> pooled, not for individuals who each plan as separate economic entities).

Using a metric that focuses on income up to age 100 will not, as some may fear, result in excessively low incomes in retirement. On the contrary, using the right innovative longevity products can provide the required confidence *without* having to be frugal.

Most members enter retirement as part of a couple. It is important to consider that many (if not most) members will be planning their retirement to cover both their lifespans (i.e. to cover the longer lifespan of two people). Joint life calculations are always longer than either of their individual

[5] This is supported by studies of Centrelink data as referenced by the Retirement Incomes Review. It is also evidenced by users of Optimum Pensions Lifespan calculator https://www.optimumpensions.com.au/lifespan-calculator/

[6] The Importance of Accurate Life Expectancy Calculations in Retirement Advice, Actuaries Institute Retirement Incomes Working Group, RNLifeExpectancy.pdf (actuaries.asn.au) Page 5. This is consistent with inputs and results under Optimum Pensions Lifespan calculator.

lifespans[7]. It is also important to ensure that allowance is made for Australia's increasing life expectancies, and that people with good superannuation balances are likely to be healthier than average.

Optimum Pension can provide quantitative data from over 2,000 retiree households to assist in selecting a suitable age if requested. Our research takes health status and lifestyle into account as well as the age of both spouses in each couple.

Having retirement strategies that last up to age 100 will align more with retirees' preferences and demonstrated behaviours. This will drive forward both the benefits of, and need for, longevity products in achieving the objectives of Australia's Retirement Incomes Framework.

Cohorts for older retirees (i.e. after they reach Age Pension Age)

The development of the right retirement strategies for cohorts for members in the lead up to their retirement is difficult for superannuation funds. Funds only have limited data about members and very little or no data on their spouse. For example, funds will not know about home ownership, private savings or income, the age of a spouse and their superannuation entitlements. It is expected that surveying members will be of limited success. This means that assigning members to cohorts will be relying on limited data.

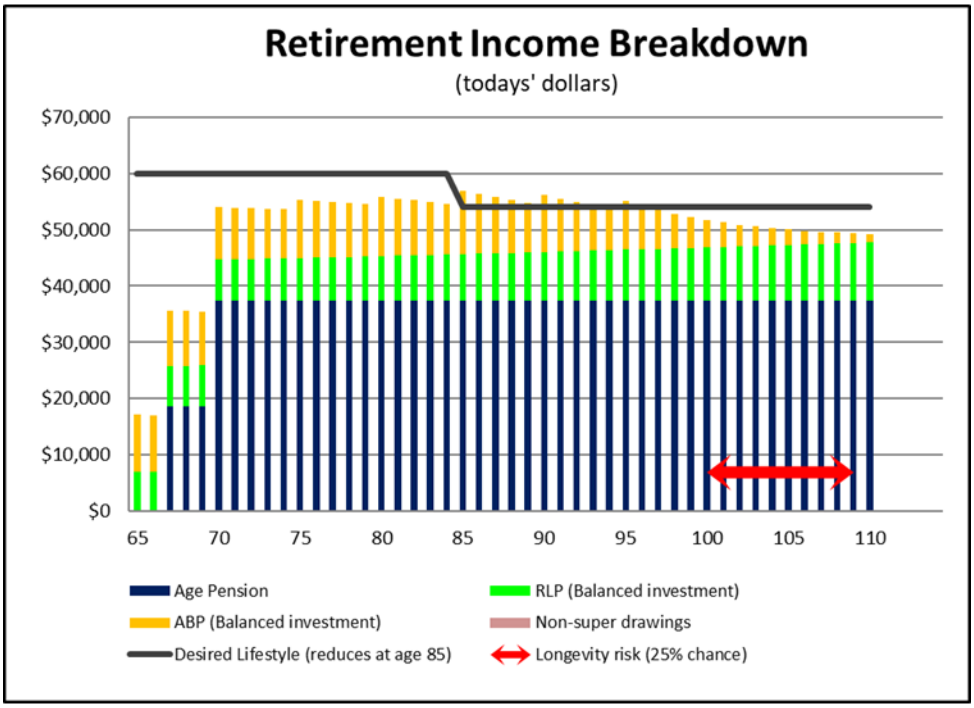
The cashflow patterns for households who haven't reached their Age Pension Age can vary dramatically as they transition into retirement. For example, the age and assessable assets of a member's spouse has a major impact on that household's retirement cashflow picture. See the sample chart below. A reduced Age Pension applies for the household until the spouse reaches their own respective Age Pension age. These type issues are compounded further if the spouse has a high superannuation balance or other assets or income (including part time work) that push them above the means testing thresholds.

For younger retirees, it would be more appropriate to develop a menu of strategies that suit a variety of members' characteristics and allow each member to see which of these would provide the best fit for their personal situation.

Chart 2 is for a male aged 65 and female aged 62 with $350,000 in super and $50,000 non-super. Cashflow scenarios like this are not uncommon at all for many (if not most) Australians. A fund would need significant data about the member's household to design any meaningful strategy that can take total income into account and apply this to cohorts prior to Age Pension Age.

[7] https://www.mylifespanserver.com.au/resources/pdf/OptimumPensions_LifespanCalculator_CouplesPlanning.pdf

Chart 2: Typical example cashflow picture for a couple entering retirement



However, once a retiree reaches Age Pension Age, their retirement strategy becomes simpler as their cashflows stabilise and can be estimated more easily.

For older age groups, it is much easier to segment retirees and assign them to appropriate 'flagship' retirement solutions. Less individual data is required. Most of the 'transitional' cashflow issues (that are unknown to the superannuation fund) start to stabilize. Data about home ownership, couple status and other assessable assets are still important.

Income projections and calculators

We strongly encourage Treasury to also proceed with the work done as part of the 2018 Retirement Income Disclosures Consultation.

Please do not hesitate to contact me should you wish to discuss any part of this submission or to request further information.

Yours sincerely

Peter Rowe
General Manager