Retirement income covenant

Response to exposure draft legislation

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challenger

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Cover Letter

The exposure draft legislation for the retirement income covenant (**RIC**) is a welcome step towards ensuring that the superannuation system works as well for retirees as it does for working Australians. The RIC is one of the remaining recommendations of the Murray Financial System Inquiry and was strongly endorsed by the Government's more recent Retirement Income Review.

The policy underpinning the RIC has been refined over a number of years. It now represents a principles-based reform that aims to help members achieve their retirement income objectives, while preserving choice and flexibility.

The requirement to develop and give effect to a retirement income strategy will encourage trustees to identify a reasonable time horizon for execution of their strategies. It will also ensure trustees have a plan to build their capability and capacity over time. This should result in a deeper market for retirement income products, giving retirees more choice in a competitive environment. The end result should give retirees more confidence to spend their retirement savings to support their quality of life over the period of retirement.

Specifically including inflation risk as part of the retirement income strategy will further strengthen the retirement income covenant. Inflation eats away at the cost of living for a retiree who is drawing their income from a nominal pool of lifetime super savings. Even at a 2.5% pa inflation rate, after 25 years a retiree's savings will have lost 50% of its spending power.

We commend the Government on putting forward a comprehensive piece of critical reform and encourage all members of parliament to support the RIC, for the benefit of Australian retirees now and into the future.

We set out below some suggested improvements to the risk definitions in the explanatory materials and some minor technical amendments to improve the Bill's clarity and readability.

1. Introduction

Challenger is an investment management company focused on providing customers with financial security for a better retirement. We operate three core businesses: Challenger Life Company Limited, which is Australia's leading provider of annuities; a funds management business; and a recently acquired retail bank that offers a range of savings and lending products.

2. Maximising retirement income over the period of retirement

The addition of a time period to the first objective of maximising retirement income is a sensible enhancement to the policy. This will encourage trustees to develop retirement solutions that have as their aim and function the production of income for the period between a member's retirement and death. Because the length of each member's life is not known in advance, some sort of forecast or expectation will have to be used.

However, any forecast or expectation of a fixed period of retirement could underplay longevity risk. Longevity risk should be managed to an uncertain timeframe. If a trustee applies a fixed timeframe for the purpose of the retirement income strategy (up to the 20th percentile of life expectancies or to age 94, to provide two examples) it will not adequately address the longevity risk faced by the retired members in the fund.

As such, and in line with our earlier submission, the preferred approach would be to use a forward-looking estimate of life expectancy of the typical retiree taking up the products offered under the strategy, plus a longer period to protect the 50% of members who will live longer. This estimate should consider expected mortality improvements (as published by the Australian Government Actuary), rather than any shorter period such as the backward-looking estimates from period life tables.

The 'potentially longer' or 'buffer' point is critical. Trustees often avoid the complexity of actual lifespans by using averages (many calculators and tools in use in the industry have a single 'drop-dead' age (often 85) at which everyone must die for the projection to be accurate). This is not conducive to sound member outcomes because a substantial number of retirees, of both genders, will live beyond their life expectancy.

Para 1.33 of the EM raises the 'distribution' of life expectancies but does not make the underlying issue sufficiently clear in our view.

We suggest this amendment to para 1.33:

> '1.33 The 'period of retirement' can differ for different sub-classes of beneficiaries. It is expected that a trustee may wish to consider the retirement patterns of their members when working out the start of that period and consider the distribution of life expectancies of their members in forming views about the end of the period<u>, in order to manage the risk that roughly half of those beneficiaries are likely to live beyond their life expectancy</u>.'

This suggested wording will be effective in cases where the trustee decides that a class or sub-class of beneficiaries is likely to have a shorter than average life expectancy. The same wide distribution of actual lifespans around that lower life expectancy will still occur.

3. Risk definitions in the EM

The draft explanatory memorandum's definition of the risks in paragraphs 1.41-1.43 could be unhelpful in interpreting the legislation in the future. We have identified two issues and have suggested some text for clarification.

3.1 Sequencing risk

Paragraph 1.41 of the EM refers to sequencing risk as ***converting assets to income at a disadvantageous time***. This is 'timing' risk, which is important near the start of retirement. Sequencing risk, on the other hand, is the additional risk retirees face when they are drawing regular income in retirement. The impact from the sequence of market returns (up-down v down-up) can rapidly deplete capital under some sequences, while a favourable sequence will see capital continue to grow. The risk comes from drawing fixed amounts of capital from a volatile asset mix where units of capital are trading at different market prices. It is akin to dollar cost averaging, but is negative for the investor, rather than positive.[1]

We suggest this amendment to para 1.41:

[1] See: Challenger Retirement Income Research 'The ABC of sequencing risk' (2012) https://www.challenger.com.au/hidden/The_ABC_of_sequencing_risk.pdf

'1.41 Investment risks include market risk, which is the risk of variable or negative investment returns and sequencing risk, which is the risk ~~of converting assets to income at a disadvantageous time~~ that a beneficiary experiences a disadvantageous sequence of investment returns on their retirement savings as they periodically drawdown on those savings in retirement.'

3.2 Longevity risk

Paragraph 1.43 of the EM misses an important point about longevity risk that is often overlooked. It is the unknown length of life that is the key risk, not just running out of money due to a long life. As the Retirement Income Review noted, many people plan for a long life-expectancy, but when they don't live as long as planned they spend less than they could have (have a lower lifestyle in retirement) and leave a larger than expected balance of savings to future generations.

We recently wrote a paper explaining just how unpredictable actual lifespans are.[2] In fact, the life expectancy concept itself is quite misleading other than when it is applied to large populations. With a large pool of lives, the 'law of large numbers' means that the average length of life in that pool will generally equate closely with life expectancies. Individually, a person has less than a 5% chance of dying in the year of their life expectancy. Put another way, one standard deviation of today's 67-year-old females (around two-thirds of them) will die somewhere between age 82 and 98. Less than 5% of them will die while aged 90 (their mortality-improved life expectancy).

This wide distribution has to be dealt with by the retirement income strategy. The strategy will therefore have to include an explanation of how the trustee proposes to address the fact that a substantial number of retirees, of both genders, will live well beyond their 'life expectancy'. A lifetime income stream will address this, otherwise the trustee is left with nominating an arbitrary age up to which the strategy is designed to operate. Alternatively, the trustee could nominate the proportion of the retiree population that is likely to be covered by the strategy beyond life expectancy (and, correspondingly, the likely proportion that will not be).

We suggest this amendment to paragraph 1.43 of the EM:

'1.43 Longevity risk must also be considered by a trustee. ~~This is~~ Longevity risk has two components: First, the length of a beneficiary's life is not known in advance and is inherently uncertain. Second, the risk that a beneficiary's retirement savings will not extend for ~~the entire life of a beneficiary~~ the whole of that life.'

4. Technical comments

(a) Section 52AA(2)(a) and (c) 'expected'

The proposed wording for sub-section 52AA(a) and 52AA(c) both use the word expected in respect of 'retirement income' in sub-section (a) and 'funds in sub-section (c). We suggest that the words 'existing and' be inserted in both sub-sections before

[2] Challenger Retirement Income Research: 'Longevity: the uncertainty and managing the risks' (2020) https://www.challenger.com.au/-/media/shared/challenger/documents/research/longevity-the-uncertainty-and-managing-the-risks.pdf

the word 'expected'. This will clarify that the requirement does not solely operate in respect of the future, but also the present.

(b) Drafting suggestions on section 52AA(2)

We have highlighted below some suggested amendments to the draft wording of sub-section 52AA(2):

> '(2) The strategy must be for the benefit of beneficiaries of the entity who are retired or who are approaching retirement and must address how the trustee will assist those beneficiaries to achieve and balance the following objectives:
>
> (a) to maximise expected retirement income over the period of retirement;
>
> (b) to manage ~~expected~~ risks to the sustainability and stability of retirement income over the period of retirement of the following kinds:
>
> (i) longevity risk~~s~~;
>
> (ii) investment risks, including the path dependency of investment returns;
>
> (iii) inflation risk~~s~~;
>
> (iv) any other risks to the sustainability and stability of the retirement income that the trustee considers prudent to manage;
>
> (c) to have some flexible access to expected funds over the period of retirement.'

Given that sub-section (2) spells out 'requirements', the failure to comply with which will be taken to be a contravention of a covenant (ie sub-section 52AA(8A)), we think a less open-ended sub-paragraph (iv) might be more appropriate.