

Retirement phase of superannuation

Mercer's response to the Discussion
Paper

9 February 2024

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Section 1

Mercer's recommendations

Major recommendations

Mercer recommends that:

- following the objective of superannuation passing Parliament, a broad campaign commences to reframe superannuation from being a lump sum “nest egg” to its primary purpose of being the provision of income for life. (section 2)
- a new framework be established for the provision of retirement income. This framework would:
 - enable the provision of relevant information and guidance to members without this being treated as personal financial advice, and
 - require a proportion of members benefits to be taken in the form of an income stream.

For example, from a certain date in the future, and with appropriate transition arrangements, retirees supported with relevant information and guidance be required to convert at least 50% of their retirement benefit into permitted retirement income products that provide regular income payments for most of an individual's lifetime. These permitted products would include:

- Lifetime pensions, including both guaranteed, pooled and market-linked products, immediate and deferred annuities, and defined benefit pensions
- Term annuities for a period of at least 15 years (these could be guaranteed, or market-linked)
- Restricted account-based pensions, where the annual drawdown is between the current minimum rate and double that rate (section 4)

Supporting information and guidance may include:

- assisting members determine their eligibility for the Age Pension
- provide details on permitted retirement income products
- suggest to members two or three retirement offerings (e.g., different combinations of products or different drawdown rates) which provide different outcomes for the future, taking into account income from superannuation and the Age Pension. (section 7)

Supporting recommendations

Mercer recommends that

- the current tax on the superannuation balance remaining on the death of a member be abolished. (section 4)
- benefit projections, expressed as both a future income and a future lump sum, expressed in current dollars, be a required component in the vast majority of annual statements provided to members of defined contribution plans and to retirees in market-related products. (section 7)
- superannuation funds can provide guidance and nudges to retiring and retired members without it being considered personal financial advice. (section 7)
- with the consent of the individual and their partner (where appropriate), financial advisers and superannuation funds providing advice, are able to access their eligibility for the Age Pension directly from Centrelink data. (section 7)
- the sole purpose test be revised significantly to enable superannuation funds to provide nudges or defaults, charge fees for financial advice, provide guidance and advice relating to the broader issues of retirement, and to provide services to ageing individuals. (section 10)
- the introduction of a standardised product disclosure framework for retirement income products does not proceed as the underlying characteristics of these products are fundamentally different. However, to assist members in their understanding, some standardised definitions, and the requirement to include a worked example in the product disclosure statement be introduced. (section 10)
- the introduction of any performance test in the retirement phase does not proceed (section 10). Instead, we propose and have set out an approach to measure the effectiveness of a fund's retirement strategy. (section 13)
- A framework for retirement income, as suggested above, is introduced. This would mean a standardised product is not required. (section 12)

Section 2

Introduction

Mercer welcomes the opportunity to respond to the Discussion Paper released by The Treasury on 4 December 2023 entitled “Retirement phase of superannuation”. This is a really important topic for many Australians, including both current and future retirees. We agree that a holistic approach is needed to ensure a complete understanding of the many issues, both within and beyond the superannuation system, that affect Australian retirees.

What is the fundamental issue?

The Discussion Paper identifies several shortcomings in the current system including:

- A lack of choice in products available in retirement
- A reluctance by retirees to draw down their superannuation savings
- That retirees are not maximising the benefit of their superannuation
- A low take up of lifetime income products by members
- A lack of urgency amongst RSE licensees in embracing the retirement income covenant

Whilst these observations can be broadly accepted from an historical perspective, it should be noted that new retirement income products are regularly coming onto the market and that many RSE licensees are now giving the retirement income covenant a much greater focus.

The Discussion Paper also notes that as superannuation balances continue to increase, superannuation benefits will become even more important for Australian retirees. We agree. Hence this consultation process is critical to help Australians “make the most out of their superannuation in retirement.”

To achieve this long term outcome, Mercer believes that we should commence with the re-framing of superannuation within the community and not concentrate on the design of particular or standardised products. This process has begun with the retirement income covenant and the objective of superannuation (currently before Parliament). But these subtle changes have not affected or been understood by average Australians.

We therefore need to change the messaging about superannuation. A few examples of the current arrangements highlight the inherent problem.

- The annual member statement shows the member’s current balance and past transactions, similar to a bank account. There is no requirement to look towards retirement or focus on a future income stream.
- The default superannuation product is known as MySuper. That implies it is my money and not to be shared with anybody else.
- The accumulation phase provides members with many choices – choice of investment, choice of fund, choice of insurance. This is very different from the traditional defined benefit scheme where members had no choices. Given the existing choices in the accumulation years, most members assume that similar choices will be available in retirement.
- Self-managed superannuation funds extend this freedom with individuals running their own superannuation fund.

The Government's response to the Quality of Advice Review indicates an increasing role of superannuation funds in providing financial guidance and advice to their members. Mercer supports this direction as such advice can greatly assist an individual's understanding of superannuation as they approach and throughout retirement. However, the reframing of the role of superannuation needs to go beyond fund members.

Mercer therefore recommends that following the objective of superannuation passing parliament, a broad campaign commence immediately to reframe superannuation from being a lump sum "nest egg" at retirement to its primary purpose being the provision of income throughout retirement.

The outcome of this campaign, together with any related legislation, will require a co-ordinated effort between government, regulators, the superannuation industry, financial advisers, and the media to ensure that there is a very clear and consistent pathway and messaging to maximise the outcomes for all Australian retirees.

It is critical that government and regulators create an environment, with an appropriate framework, principles and rules, to ensure that all those involved in superannuation understand the long term purpose of superannuation. Without such broad community acceptance, there is limited value in proposing detailed rules or products.

Notwithstanding our recommendation for the immediate need to reframe the community's understanding of superannuation, this submission also presents a major system recommendation to change the framework for retirement benefits and provide a much stronger income focus without the need to introduce new products. This submission also makes several additional recommendations to support our two major recommendations. Mercer believes that the implementation of these recommendations would significantly improve the outcomes for Australian retirees for decades to come.

Structure of the submission

This submission begins in Section 3 with some initial observations to set the scene to discuss the retirement phase in Australia. Section 4 outlines Mercer's major recommendation for the long-term which is designed to reform the direction of retirement benefits provided by superannuation.

The rest of the submission is in the same broad order as the Discussion Paper; namely supporting members, supporting funds, and considering lifetime income products. However, we spend more time on considering the members' perspectives as any discussion on the retirement phase must have a member or individual-centric focus.

With this in mind, Section 5 considers the many uncertainties facing Australian retirees before we outline some of their desires and wishes. Section 6 presents some data on the actual behaviour of retirees before Section 7 discusses a range of ideas and recommendations to provide additional support to fund members. Of course, the Australian system is not the only pension system in the world that is tackling the retirement phase. Hence, in Section 8 we consider the evidence and principles arising from the best ranking pension systems in the 2023 Mercer CFA Institute Global Pension Index before Section 9 analyses a range of retirement income products using a novel risk-return approach from the retirees' perspective.

Section 10 then considers how superannuation funds can better support members to deliver improved retirement outcomes while Sections 11 and 12 discuss lifetime income products and standardised products respectively.

Who is Mercer?

Mercer believes in building brighter futures by redefining the world of work, reshaping retirement and investment outcomes, and unlocking real health and well-being. Mercer's approximately 25,000 employees are based in 43 countries and the firm operates in 130 countries. Mercer is a business of Marsh McLennan (NYSE: MMC), the world's leading professional services firm in the areas of risk, strategy and people, with 85,000 colleagues and annual revenue of over \$20 billion. Through its market-leading businesses including Marsh, Guy Carpenter, Mercer and Oliver Wyman, Marsh McLennan helps clients navigate an increasingly dynamic and complex environment.

Naturally, we would be very happy to discuss any of these comments as the Government and Treasury carefully consider these matters.

A handwritten signature in black ink, appearing to read 'Dr David Knox'.

Dr David Knox AM
Senior Partner

Section 3

Some initial observations

There is much discussion about the need for the availability of longevity products to retirees to protect them from the risk of outliving their savings. However, the need for longevity protection varies considerable between retirees. For example,

- Retirees with modest financial assets are likely to rely significantly on the Age Pension for most of their retirement income. As the Age Pension represents an indexed pension provided by the Government, there is little reason for most of these retirees to purchase an annuity. As a recent American paper noted:

“if a retiree, receives a substantial portion of her income through a Social Security annuity, it stands to reason that her remaining financial portfolio should include substantial exposure to risk equities”.¹

- Similarly, retirees with significant superannuation balances (say, more than \$1 million) are likely to have sufficient financial assets to last them for their lifetime, without the need for longevity products.

Hence, Mercer does not support the concept that longevity protection should be a required component of any future framework for the provision of retirement income.

As Section 8 presents, many of the leading pension systems have requirements relating to the retirement phase. However, there is a range of approaches with some systems giving retirees considerable flexibility, which recognises the substantial heterogeneity amongst the retired population in respect of their financial needs, health status, life expectancy, household makeup and expectations. It is also noted that some of these leading systems have no requirements in respect of longevity products.

Section 9 highlights this heterogeneity by assessing a range of retirement income products in terms of value and the variation of the annual income. It is not surprising that the “best” product varies according to the size of the individual’s superannuation benefit. There is no single product that provides the best outcome for all retirees.

It is therefore essential that this heterogeneity is recognised in the development of any future retirement income framework. Considerable flexibility is required in the system to ensure that all retirees receive the best outcome for their personal situation.

Due to this heterogeneity and the need for flexibility, we believe the primary focus should be to develop a framework and guidance to members as opposed to a focus on product. Where members can be provided with the relevant information and guidance, this will enable them to make better use of their retirement savings and will naturally lead to the provision of appropriate products to meet these needs i.e., an information and guidance lead rather than a product push.

¹ Horneff V., Maurer R., and Mitchell O. S. (2023), Fixed and Variable Annuities in Defined Contribution Plans: Optimal Retirement Portfolios Taking Social Security into Account, Pension Research Council Working Paper 2023-01.

Section 4

Mercer's system recommendation

Both the retirement income covenant and the objective of superannuation (currently before Parliament) indicate a strong focus on the provision of income throughout retirement. Yet the current arrangements within Australia's superannuation system provide Australian retirees with full flexibility, permitting retirees to take their superannuation in any format from 100% lump sum to 100% lifetime annuity. As noted in Section 8, this extreme flexibility is not permitted in most of the leading pension systems around the world. Without some form of compulsion, it is unlikely that the current outcome will change. Similarly, without more guidance for individuals, the current situation presents a challenging environment for retirees to make the most of their retirement savings.

Therefore, Mercer recommends that a new framework be established for the provision of retirement income. This framework would:

- enable the provision of relevant information and guidance to members without this being treated as personal financial advice, and
- require a proportion of members benefits to be taken in the form of an income stream.

For example, from a certain date in the future, and with appropriate transition arrangements, retirees supported with relevant information and guidance, be required to convert at least 50% of their retirement benefit into permitted retirement income products that provide regular income payments for most of an individual's lifetime.

These permitted annuity or pension products could include:

- Lifetime pensions, including guaranteed, pooled, and market-linked products, immediate and deferred annuities, as well as defined benefit pensions
- Term annuities for a period of at least 15 years² (these could be guaranteed or market-linked³)
- Restricted account-based pensions⁴, where the regular drawdowns must be between the current minimum rates and double these rates

The balance of the retirement benefit could be taken as a lump sum, invested in an unrestricted account-based pension and/or invested in any of these permitted retirement income products. In addition, a portion of this balance could be permitted to be invested in a capital reserve, as described in the Appendix to the Discussion Paper.

Appropriate transition arrangements are necessary to ensure that individuals approaching retirement are not significantly affected. For example, the new framework could be

² These fixed term annuities would require each payment to include both capital and interest components.

³ Market-linked fixed term annuities would assume a future investment earning rate and then adjust the next payment to reflect the actual earning rate.

⁴ Restricted account-based pensions would be very similar to current account-based pensions except that no capital withdrawals would be permitted and there would be an upper limit on the rate of withdrawal.

introduced five years after the initial announcement. It should also be introduced after the campaign to reframe the purpose of superannuation, thereby being a natural development from that campaign.

This recommendation, including the introduction of restricted account-based pensions (RABPs), recognises the current popularity of account-based pensions. Hence, it does not represent a significant shift from the behaviour of many retirees and should therefore be acceptable to the Australian community. Nevertheless, it would represent a significant shift from the existing framework as the provision of retirement income would become the primary focus of the system over the longer term.

RABPs would enable members to have similar drawdown strategies as today if desired whilst restricting 100% of the benefit being taken as a lump sum. Along with the information and guidance provided to members this would significantly reframe the dialogue to the provision of income in retirement. The maximum limit on drawdowns may also encourage members to utilise their savings rather than setting aside funds indefinitely.

It would also be possible for a retiree to purchase a lifetime annuity later in their retirement from the account balance in their RABP.

The Discussion Paper highlights the three desired features of retirement income products: namely flexibility, high income and risk management features. The above recommendation has each of these features but does not require the retiree to invest in longevity protection for three reasons:

- It is generally agreed that longevity protection is not required by retirees with relatively small balances (as the Age Pension fulfills that function) or by those with large balances, as discussed in Section 3.
- The introduction of restricted account-based pensions, with maximum drawdown rates, will ensure that these funds are available for many years.
- Longevity products should not be required for those in poor health or with lower life expectancy. Such a requirement would also run counter to the view that superannuation is their money.

These new arrangements would not apply to any individual who has retired before the commencement date of the new rules. Therefore, no grandfathering arrangements would be required.

The introduction of these income arrangements must also lead to the abolition of any taxation on the superannuation accounts of a member who dies. It is unfair to encourage or require retirees to move into retirement income products where there is a “death duty” tax on these products which does not apply to other financial products.

Therefore, Mercer recommends the abolition of any tax on the superannuation balance remaining on the death of a member.

This abolition would also represent an important simplification for retirees and their advisors.

If necessary, the financial hardship provisions that currently apply during the accumulation phase of superannuation could be extended to include the permitted annuity or pension products, where an account balance exists.

The new framework should also apply to self-managed superannuation funds. It is critical that any retirement requirements, whether they be in terms of policies or products, must apply to all sectors within the Australian superannuation industry.

Without an element of compulsion, Australian retirees will not make the most of their superannuation in retirement. The above recommendation continues to provide retirees with considerable flexibility with the ability to take up to 50% of their benefit as a lump sum and to receive income from the balance at double the minimum drawdown rate.

Section 5

A focus on individuals is essential

Understanding their financial position

It is essential that Australia's retirement income system focus on the needs and aspirations of Australian retirees, at both the individual and household level. It is also critical that this focus is not restricted to the superannuation system; that is, it must recognise that financial support comes from a variety of income sources including the Age Pension, superannuation (both compulsory and voluntary), other financial assets, aged care and other government income support, home equity release and paid employment. A broad holistic perspective is needed.

That is, providing the best outcomes for Australian retirees goes beyond the retirement phase of superannuation, important as that is. It must also include clear communication about the range of government services and benefits available and a clear statement that these services will continue to be available in the long term. This level of government support to the aged is underappreciated by many retirees and leads to unnecessary conservatism in their spending and hence a reduced living standard.

Uncertainties facing Australian retirees

There are many uncertainties and potential financial shocks facing Australian retirees as they approach and live through their retirement years. These include:

- **Longevity risk:** Simply put, retirees don't know when they are going to die and therefore how long their money must last. Given this uncertainty, it is not surprising that many retirees are conservative in their spending habits.
- **Market risk:** The most popular retirement product (by far) is the market-linked account-based pension. As the account balance, and therefore the level of future income, is directly linked to movements in the capital markets, most retirees are aware that a significant fall in the value of the balance will affect the level of their future drawdowns. This awareness can affect both investment decisions and the level of withdrawals.
- **Sequencing risk:** Although many retirees may be unaware of this risk, the sequencing (or order) of investment returns, particularly in the early years of retirement, can have a significant effect on the future level of withdrawals from the account-based pension.
- **Legislative risk:** Inevitably, from time to time, governments change the rules affecting the Age Pension, superannuation taxation, and the funding for both aged care and health services. With an ageing population, the popular premise is that government funding for these services in the future will reduce and become harder to obtain. Hence, it is not surprising that retirees conserve some funds given this uncertainty.
- **Inflation risk:** Until recently, inflation has not been seen as a significant risk by many retirees or their financial advisers. However, the consequences of the COVID-19

pandemic and the wars in Ukraine and the Middle East have changed that outlook. A period of inflation with the associated rise in the cost of living directly affects many retirees and, not surprisingly, generates additional conservatism.

- **Unknown future costs:** The retirement income covenant highlights the need for retirees to have access to capital. This access can be particularly relevant for home repairs or necessary refurbishments as retirees age and stay in their own home, and for medical or dental costs.
- **Changing in housing needs:** The need to move into assisted living or a residential aged care home can incur significant costs, particularly if it affects only one member of a couple with the remaining partner staying in the family home.
- **Cognitive decline:** This decline is inevitable for most people although its onset and the rate of decline varies significantly. The design of retirement products needs to allow for this possible outcome.

Given these significant uncertainties and risks which span two or three decades, it is not surprising that many retirees adopt a cautious approach to their financial affairs.

The desires of retirees

Most retirees wish to maintain their previous living standard in retirement, possibly at a level similar to that experienced in the previous 10 or 20 years. Retirees also need to consider the possibility of retirement lasting 30 or more years, which is well beyond the planning horizon for most people. Research also indicates that most individuals underestimate their life expectancy as they approach retirement. So, given all this uncertainty, what do retirees want?

Retirees want stability – that is, regular and reliable sources of income that, when combined, broadly keeps pace with price inflation. This income provides a secure base for their future living standards. There is some debate as to whether full price inflation is needed as several studies suggest that retired households decrease their consumption (when measured in real terms) over time. Although health-related expenditure may increase with age, some other expenditures, such as travel, decrease with age leading to an overall reduction in real expenditure.

Retirees want sustainability – that is, income that does not run out, whatever the future may hold. While most retirees will be unaware of their life expectancy (which, after all, is only an average number), they are aware that they do not know their date of death. Or, to put it another way, how long the income needs to last? A related risk is that poor investment decisions, economic conditions or a fall in asset values may reduce the real value of their superannuation faster than expected.

Retirees want flexibility – that is, to be able to access some capital or a “rainy day” fund. Unexpected costs occur and retirees want to be able to meet them. The extent of these capital needs, which could relate to significant medical costs or pharmaceuticals, necessary refurbishment of the home to accommodate reducing mobility or the costs associated with aged care will vary considerably between individuals. It also depends on the extent to which government assistance is available to meet such costs. Where government funding is available, it is essential that retirees fully appreciate its availability.

Retirees want simplicity – that is, retirees do not want to have to make financial decisions on a regular basis. Furthermore, it must be appreciated that the cognitive capability of

individuals is likely to reduce during the two or three decades of retirement. Hence, retirement products must be simple to understand and, where appropriate, simple to change.

Retirees want to understand available Government resources – It is well accepted that the Australian retirement income system is very complex. This includes the need for retirees to appreciate and understand the significant level of government support available. For example, many retirees do not understand their Age Pension will increase as they reduce their superannuation assets. Similarly, the features of the Home Equity Access Scheme are not well understood. The available funding for aged care, particularly for those with limited means, is also not well appreciated.

Some **retirees want to leave a bequest**. On the other hand, Alonso-Garcia et al (2022) conclude: “The intra-household bequest is important ... but not the intended bequest motive. This suggests that people save for unexpected expenses and to financially protect their partner as a surviving spouse but are less concerned about the distant future.”⁵ Nevertheless, the combination of a “rainy day” fund and a mild bequest motive means that many retirees wish to preserve some of their finances for the future.

Finally, **retirees want transparency**. Retirees need to know the fees, any social security implications and the possible outcomes of the various options available to them. As costs are normally disclosed during the accumulation period of superannuation, it is important that future costs should also be disclosed in respect of retirement products.

The current retirement phase of the Australian retirement income system does not meet the above desires of retirees in a consistent and well understood approach. In short, we can, and should, do much better. Retirees need easy access to help, guidance and advice throughout retirement so that their needs are met, and they can live with confidence and dignity.

⁵ Alonso-Garcia J., Bateman H., Bonekamp J., van Soest A and Stevens R., Saving preferences after retirement, *Journal of Economic Behavior and Organization*, 2022, p 427.

Section 6

Actual member behaviour

The Discussion Paper suggests that some retirees perceive minimum drawdown rates as the Government's recommendation for them or that they may have the minimum drawdowns chosen for them by their fund.

However, the actual experience is somewhat different from the implied suggestion that the use of minimum drawdowns is prevalent.

For example, our analysis of the behaviour of account-based pensioners in a major superannuation fund shows that:

- Only 35% of pensioners withdraw at the minimum drawdown; that is, 65% withdraw at a higher rate.
- The average drawdown rate for those who do not use the minimum rate is 14%, after excluding those who fully withdraw their benefit.
- These average drawdown rates (excluding the minimum) range from 11% for those aged 60-64 to 21% for those aged over 85.

Interestingly, the use of the minimum drawdown rates is highest for those with balances under \$100,000. This may indicate an element of conservatism for those with smaller balances. Of course, these individuals may also be receiving the full Age Pension.

It is also worth noting that more than 50% of the pensioners who died left a superannuation balance more than 60% of their initial pension balance. More than 60% of these pensioner deaths were aged 85 or higher.

Evidence from another major superannuation fund shows that only 24% of members aged under 65 withdraw at the minimum rate. This percentage gradually rises with age to 46% of members aged 85-89 and 60% of members aged 90-94.

Another intriguing piece of evidence from this fund's experience is that 34% of members from 2019 to 2022 withdrew the same benefit (when expressed in dollars) each year. If one allowed for variations of the nominated withdrawal benefit of no more than \$1,000, the percentage of members who withdrew the "same" benefit each year increased to 50%.

This evidence suggests that some retirees may think in nominal and not real terms and therefore live accordingly. In periods of inflation, such behaviour would have a significant impact on their standard of living.

The above evidence suggests that the use of the minimum drawdown rates may not be as prevalent as often assumed. The ability of superannuation funds to offer broader financial advice, as recently announced by the Government, is also likely to reduce the percentage of retirees who "automatically" select the minimum drawdown rates.

Section 7

Supporting members

Benefit projections

We agree with the comment in the Discussion Paper that individuals spend decades saving for retirement with little, if any, focus on the future income that superannuation can provide during the retirement years. This must change and hence our recommendation for the need to reframe the purpose of superannuation. Of course, traditional defined benefit pension schemes do exactly that; the accrued pension is expressed as a future income every year. This does not happen within a defined contribution arrangement where the member's accruing benefit is expressed as a lump sum. This focus needs to change throughout a member's engagement with their superannuation fund, including their retirement years. For instance, a projection during the retirement years could also indicate when the money is expected to run out.

Hence, Mercer recommends that benefit projections, expressed as both a future income and a future lump sum, expressed in current dollars, be a required component in the vast majority of annual statements provided to members of defined contribution plans and to retirees in market-related products.

It is noteworthy that eight of the 11 leading pension systems discussed in Section 8 require benefit projections to be provided on a member's annual statement.

We are advocating both income and lump sum projections during the accumulation phase to aid member understanding and to highlight the relationship between lump sums and future income, which is poorly understood. We are also suggesting the vast majority of member statements and not all member statements as there will be some situations where it does not make any sense to include such projections. For example, a member who has joined the fund in the last 12 months.

Assisting members with guidance and nudges

Mercer supports the requirement within the retirement income covenant that superannuation funds should assist members both as they approach retirement and during their retirement years. It should not be a "once and for all" form of assistance. However, to enable funds to provide the greatest level of assistance, the current financial advice rules need to be modified to provide trustees with certainty that they can provide appropriate nudges and suitable retirement guidance without breaching regulations.

Superannuation funds currently refrain from providing a range of materially useful guidance to members on the basis that to do so would be considered Personal Financial Advice. If our regulatory framework relating to the provision of personal advice enabled superannuation funds to directly provide guidance or nudges to members, without triggering a substantial regulatory requirement (while still holding to the best financial interest duty), then retirees approaching and in retirement would be in a much better position. We acknowledge that the Government is aware of this current need in their recent announcements. However, without a

significant change to the current regulations, superannuation funds will be unable to provide the most appropriate assistance to members.

Mercer therefore recommends that superannuation funds can provide guidance and nudges to retiring and retired members without it being considered personal financial advice.

As will be presented in Section 9, there is not a single drawdown approach that is suitable for all retirees. It is much more complicated than that. It also depends on the individual's situation relating to the Age Pension, superannuation balance, other financial assets, health, marital status and so on.

Eligibility for the Age Pension is obviously a critical element in providing members with the best guidance. Yet many individuals are not fully aware of their current eligibility for the Age Pension and, in some cases, are not even aware of the assets or income that limit their eligibility to receive the Age Pension. Of course, individuals are informed by Centrelink of their entitlement when their Age Pension begins. However, both the financial situation of individuals and the Age Pension rules change over time so that pensioners can become confused and uncertain of their entitlement.

Therefore, Mercer recommends that, with the consent of the individual and their partner (where appropriate), financial advisers and superannuation funds providing advice are able to access their eligibility for the Age Pension directly from Centrelink data.

The Discussion Paper notes that the minimum drawdown rates may be interpreted as a recommendation or default. Of course, this is not their purpose. A nudge, taking into account the individual's particular circumstances, is to be preferred. However, a single nudge may also be misleading.

Therefore, Mercer recommends that superannuation funds be required to suggest to members two or three retirement offerings (e.g., different combinations of products or different drawdown rates) which provide different outcomes for the future, taking into account income from superannuation and the Age Pension.

This approach will provide members with a limited decision making process, consistent with findings from behavioural finance, whilst also highlighting the different outcomes that can occur. This information and the different approaches may also lead to individuals asking more questions and thereby receiving improved assistance.

Such guidance should not be called "Financial Product Advice" as it would be quite distinct from a full examination of the client's circumstances that the industry currently associates with that term. A regulatory obligation should exist for this guidance to be generally positive, but with lesser obligations and no formal documentation requirements.

We also prefer using the term nudges rather than defaults as the term "default" implies that the member does not need to make a decision, as occurs with MySuper. However, when an individual transitions to retirement, the individual must be involved, if only to provide the

necessary bank account details. Hence, an individual cannot be defaulted into a retirement product without some engagement.

One exception may occur when an individual reaches a certain age (say 75) in the accumulation phase. A default transfer into a pension product, with opt-out provisions, could be considered to ensure that a member's account does not remain in the accumulation phase longer than necessary.

The Discussion Paper asks whether a policy option similar to the UK's Pension Wise service may improve the member experience. Our UK colleagues note the following:

- Levels of financial education are low in the UK, and many people are unwilling to pay for financial advice, so a centralised source of free pension guidance is better than nothing.
- Pension Wise provides guidance, not advice. However, it is free, and pension schemes must signpost it at various points.
- The usage levels are low, possibly as little as 10%, even with the mandatory requirement for pension funds to nudge members to use it.
- Nevertheless, it has been reported that 90% of Pension Wise users say they're well informed about their options for accessing their pension pots after an appointment or using their resources.

Mercer believes a better approach is to continue with the Government's current approach to broaden the advice that a superannuation fund can provide to its members. After all, many individuals already have a long-standing relationship with their superannuation fund such that a level of confidence or trust already exists.

Section 8

Evidence and principles from overseas

Findings from the 2023 Mercer CFA Institute Global Pension Index

The 2023 Mercer CFA Institute Global Pension Index (MCGPI) assessed and ranked 47 retirement income systems from around the world. The Australian system was ranked 5th, obtaining a B+ grade, which indicates that it has many good features but, as indicated in the Discussion Paper, there is work to be done to improve the outcomes for Australian retirees.

This section considers the framework and related rules for retirement income from private pension arrangements in the top dozen systems in the MCGPI, excluding Australia. We identify lessons and approaches that could be useful for the Australian system as the retirement phase develops with the objective to improve the outcomes for retirees.

The first finding of this review is the geographical spread amongst these top eleven systems. Although four of the eleven systems are members of the European Union (i.e., Denmark, Finland, Netherlands, and Sweden), the other seven systems are from diverse locations (i.e., Canada, Iceland, Israel, Norway, Singapore, Switzerland, and the United Kingdom) which, in turn, reflect a range of cultural, economic, historical and social backgrounds.

These different backgrounds are important because when it comes to improving the retirement phase of superannuation, we should not restrict our purview to economies, cultures or systems similar to Australia's. Retirement is a worldwide challenge with the continuing growth of defined contribution plans and increasing pressure from ageing populations, so that we need to seriously consider policies and lessons from the best retirement income systems in the world.

The first key observation from the MCGPI is that nine of these eleven systems require an income stream to be taken at retirement. It is only in the UK⁶ and Switzerland⁷ where it is possible to take the benefit as a 100% lump sum.

However, what is even more interesting is the form of income that is required to be taken.

In six of these nine systems, a lifetime pension or annuity is required. However, there are some variations within these systems.

In Canada and Finland, the full benefit must be converted into an annuity whereas in Iceland, Israel and Singapore there is flexibility after the required minimum pension has been attained. From January 2024, the Netherlands requires 90 per cent of the accumulated benefit to be converted into a pension but permits 10 per cent of the benefit to be taken as a lump sum. The rules relating to the required pensions vary between systems, but the

⁶ In respect of the UK, it should be noted that pension freedoms were introduced in 2015 and gave people the freedom to choose what to do with their retirement benefit. Previously 75% of the benefit had to be converted into an annuity.

⁷ In Switzerland, there is a prescribed conversion rate that is used to convert the lump sum into an annuity. This rate is considered to be generous which encourages the voluntary annuity take-up.

Singapore requirements are interesting. In this case, the individual has a choice of three options: a pension increasing by 2% pa; a level pension and a reducing pension.

The other three systems, namely Denmark, Norway and Sweden, require the accumulated benefit to be converted into an income stream but provide flexibility beyond a lifetime annuity. For example, in Sweden an annuity is required but it can be taken for a fixed period of between 5 and 30 years or for life. In Norway, the annuity term must be at least 10 years and cannot finish before age 77. Private pension arrangements in Denmark vary with some providing a lifetime pension and others offering an annuity for a period between 10 and 30 years.

There are also some exceptions to these rules where the balances are small, permitting the whole balance to be taken as a lump sum.

The following table summarises these requirements.

Lifetime pension		Income stream	No requirements
100%	Canada Finland	Denmark Norway Sweden	Switzerland United Kingdom
90%	Netherlands		
Minimum pension	Iceland Israel Singapore		

Of course, these income streams (annuities or pensions) from private pension arrangements should also be considered in the light of the available state pension. Except for Singapore, a state or minimum pension is available from the other retirement income systems. In some cases, it is a universal pension (Netherlands, UK) whereas there is a state pension with a means-tested supplement in Canada, Denmark, Iceland, Israel, Norway, Sweden, and Switzerland. Australia and Finland are the only systems where the state pension is fully means-tested. Singapore provides a range of income support measures to older citizens.

The relevance of these policies is that the impact of the Australian means-tested Age Pension is not unique. That is, for retirees who reduce their income or assets, it is expected that their income from the Age Pension will increase over time.

Two other examples are worthy of comment.

- In South Africa, the cash lump sum is limited to one third of the benefit. The balance must be taken as a lifetime annuity or a “living annuity”, which is similar to an account-based pension. However, no capital withdrawal is available, and each year’s benefit must be between 2.5% and 17.5% of the account balance.
- In the US, there is a required minimum distribution that must be withdrawn annually by retirees from a prescribed age for benefits held in relevant retirement plans. The factor used to calculate the minimum is adjusted regularly and is linked to life expectancy.

Suggested principles for a retirement income system

This global review does not provide a blueprint for the Australian system. However, it does suggest some principles that apply in the world's best pension systems.

A focus on income

The objective of a retirement income system should be to provide regular income during the retirement years. This is a clear focus in all these pension systems, even in the UK where there is a universal pension and a long history of defined benefit pensions.

The presence of some rules

The provision of regular income will not occur without some rules or regulations requiring or, at the very least, strongly encouraging such an outcome. Hence in nine of the above eleven systems, there is a requirement that a majority, if not all, of the retirement balance is converted into an income stream.

The need for flexibility

The needs, aspirations and goals of retirees are not all the same. There is much greater heterogeneity amongst members in the retirement phase than in the accumulation phase. This diversity is recognised in the Scandinavian systems which offer a range of income products. In addition, the financial needs of retirees can change dramatically during the retirement years; they do not remain constant.

Hence, a single income stream (even if it is indexed to inflation) is not the full answer for many retirees. There is the occasional need for capital (as the Netherlands has recently recognised) and which is also recognised in the retirement income covenant. Of course, this possible need for future capital also depends on the financing of health and aged care in each country, which goes beyond the scope of this submission.

Simplicity is essential

The Discussion Paper and the Retirement Income Review both acknowledged that the financial decisions facing Australian retirees are complex. In fact, we suggest that our retirement income system is more complex than any of the systems mentioned above as the Age Pension is fully means-tested with separate assets and income tests. In addition, the Aged Care system has different means tests, there are no rules relating to the required format of an individual's superannuation benefit, and the relevant taxation rules are not straightforward.

Given these facts, it is no surprise that the ultimate outcome for many retirees is not as good as it could be.

While we acknowledge that it is not feasible to remove the means tests, it is possible to simplify the retirement income framework and limit some of the choices available. The current arrangements with so many choices and so little guidance, go far beyond what is necessary for a flexible system that can respond to individual circumstances. A simpler system must be an objective for any reform.

Certainty helps well-being

The Retirement Income Review noted that several stakeholders highlighted the important principles of certainty and integrity. This is critical especially as retirement is full of uncertainties and unknowns, especially at the point of decision.

Removing some of these uncertainties can be a great contributor to a retiree's well-being. Hence, most of the world's leading pension systems provide retirees with a level of income. This is an outcome that provides confidence to retirees.

As mentioned earlier in this submission, certainty relating to future government support in respect of the Age Pension, health costs and aged care is also critical in providing retirees with confidence to spend now.

Section 9

An analysis of alternative retirement income products

Modelling of alternative retirement income products

The Discussion Paper correctly noted that account-based pensions are the most popular retirement income product in Australia. Yet Section 8 showed that in the better pension systems around the world the most prevalent products were annuities, either for life or for a fixed period of years. Hence, it's appropriate to compare these products with an account-based pension.

Page 9 of the Discussion Paper observes that the minimum drawdown rates are not designed for, and do not lead to, an optimal retirement income. It's therefore appropriate to consider alternative approaches to maximise income; some of which could be developed as rules of thumb⁸ for use by superannuation funds.

The alternative drawdown patterns that will be considered are:

- The current minimum drawdown rules + 2%
- Double the current minimum drawdown rules
- An initial drawdown of 6% of the balance, which is then fixed in dollars, unless it breaches the minimum drawdown rates
- An initial drawdown of 5% of the balance which is then indexed to inflation every year
- A drawdown with a fixed period of 20 years, so that the drawdown is adjusted each year to be 1/20th of the balance in year 1; 1/19th in the second year and so on
- A drawdown where the amount withdrawn is adjusted each year using the life expectancy relevant to the retiree's current age

These six options will be compared with the minimum drawdown rates, as well as level annual payments from a lifetime annuity and term-certain annuities for 10 and 20 years. Of course, comparing income streams from account-based pensions with an assumed but uncertain long-term investment return and known annuity payments is not comparing like with like. The underlying differences are significant. Nevertheless, this is the decision that faces Australian retirees.

The following analysis⁹ will compare these options using a risk-return graph similar to that often used to compare investment options, except the definitions of risk and return will be different.

The vertical axis will show the weighted net present value of the future real income (i.e., inflation adjusted) received by a single homeowner retiree for 30 years from age 67 to age 96

⁸ Some of these alternatives were drawn from a paper by the New Society of Actuaries entitled *Decumulation Options in the New Zealand Market: How Rules of Thumb can help – A summary*.

⁹ The model assumes an investment earning rate of 6.5% p.a. before fees for an account-based pension and an inflation rate of 2.5%. The annuity payments are based on market rates as at January 2024, although it is recognised these rates can change significantly from month to month as interest rates change. Of course, the actual investment returns earned by a market-linked account-based pension may be more or less than the rate assumed.

and the present value of any bequest should they die before age 97. The annual income is weighted by the probability of survival from age 67 which means that the income in the 30th year is less important than in the first year of retirement. Similarly, the value of the bequest allows for the probability of death every year from age 67. Without these adjustments, every year of income is given equal weighting yet only a minority of retirees are expected to reach age 97.

The horizontal axis shows the annual variation (or standard deviation) of the annual real income over the 30 year period. The Australian retirement system with the means-tested Age Pension and varying drawdown amounts means that there can be considerable variation in the real income received from year to year. As noted in Section 5, one of the wishes of many retirees is to have a consistent income, when expressed in real terms.

It should be stressed that these results are based on a deterministic model which assumes a constant investment return for the account-based pension. This does not represent reality as investment returns will vary considerably over 30 years. However, in the time available following the release of the Discussion Paper, it was not possible to develop a relevant stochastic model. Of course, it should also be noted that as investment returns vary, the level of the Age Pension received by many retirees will also vary due to the effect of the means tests.

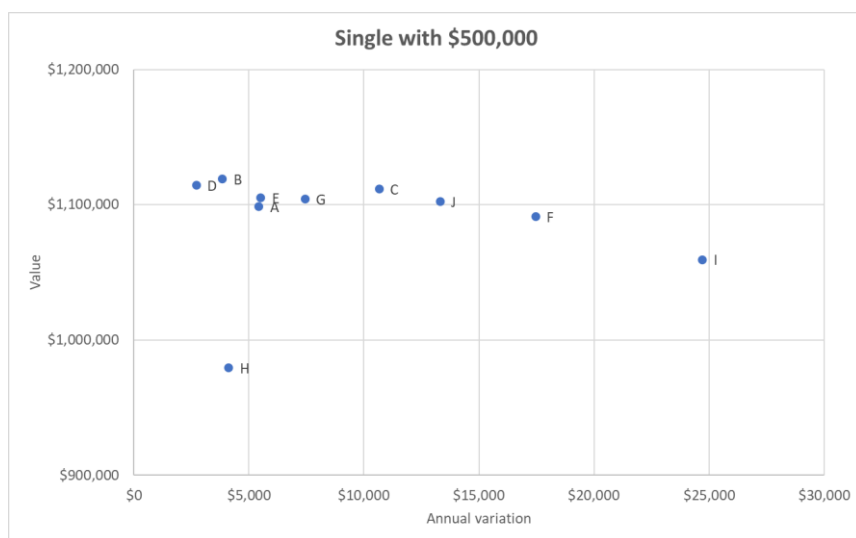
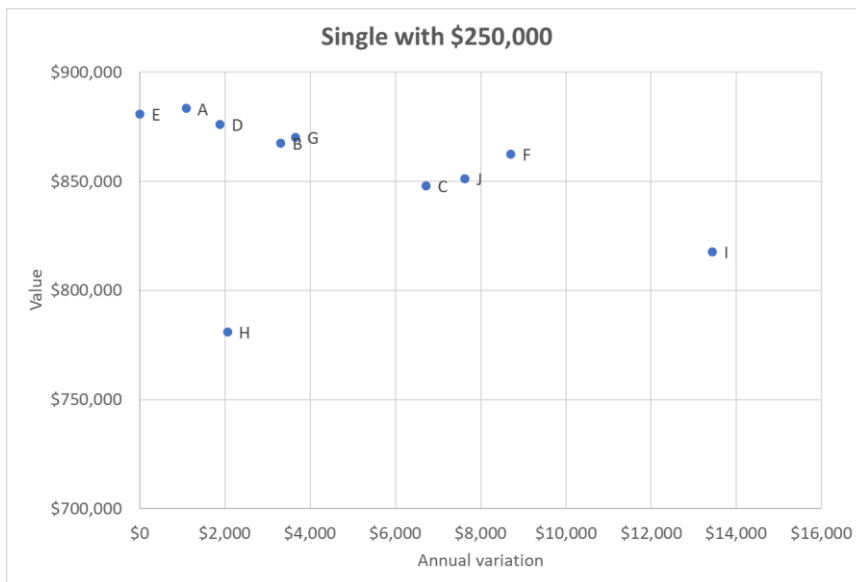
Whilst a simplified approach, it serves to illustrate the fact that there is no single answer on how to drawdown a member's retirement savings and deliver the best outcome for all retirees. This is before considering variability in investment returns and inflation. If these factors were also included, the need for greater support for members in utilising their retirement savings becomes even more apparent.

The following graphs show the results for a single homeowner with superannuation balances at age 67 of \$250,000, \$500,000, and \$1 million respectively.

The code used in the graphs is shown below.

Code used in figures	Description of product
A	Minimum drawdown rates
B	Minimum drawdown +2%
C	Double minimum drawdown
D	6% Rule (fixed in dollars)
E	5% Rule with indexation
F	Fixed date rule (20 years)
G	Life expectancy rule
H	Immediate life annuity
I	10 year term certain annuity
J	20 year term certain annuity

The “best” results occur in the top left hand corner of the graphs with maximum value and minimum annual variation. These results highlight the fact that there is no single answer for the best outcome for all retirees.



The best three options for the balance of \$250,000 are the indexed 5% rule (shown as E), the minimum drawdown rules (shown as A) and the fixed 6% rule (shown as D). Similar results apply for a couple with a total superannuation balance of \$250,000. These results are not surprising as retirees with relatively small balances are expected to receive the full Age Pension throughout their retirement.

The result for Option E showing zero annual variation is worthy of comment. The reason is simple as both the account-based pension payments and the Age Pension are linked to inflation so that there is no variation in real terms.

The lifetime annuity option performs relatively poorly which is not surprising as the lifetime annuity represents a guaranteed income for life with the associated risks and capital requirements borne by the provider. The guaranteed income provides stable income to the retiree and does not expose the retiree to market risk. The value of this outcome will vary greatly between retirees as it will, in part, be determined by their individual attitude to risk.

In each of these three graphs the value of the lifetime annuity is 9-12% lower than the value of the average of the account-based pension options. This general outcome is to be expected as there will always be a trade off between risk and return in financial products.

The term certain annuities have higher annual variations as the annuity income ceases after 10 or 20 years.

The next graph shows the results for a superannuation balance at age 67 of \$500,000. In this case, the preferred options are the fixed 6% rule (shown as D) and the minimum drawdown rates +2% (shown as B).

Interestingly the results for a couple with a total superannuation balance of \$500,000 are slightly different with the preferred options being the indexed 5% rule, the minimum drawdown rules and the fixed 6% rule. These are the same preferences as shown above for a single or couple with a \$250,000 balance. This different outcome makes sense due to the more generous means tests for a couple, when compared to a single person.

The final graph shows the results for a superannuation balance at age 67 of \$1,000,000. This represents a much more complicated picture than the previous two examples. For example, the 20 year term-certain annuity (shown as J) has the highest value albeit with a relatively high annual variation. In terms of account-based pensions, the double drawdown rate option (shown as C) has the highest weighted net present value. Both these options highlight the increasing value of the Age Pension as the value of the superannuation asset reduces during retirement.

A similar picture emerges for a couple with total superannuation balances of \$1,000,000 with several options clustered closely together.

These product options have different characteristics and features which means making fair comparisons is difficult. For example, while a lifetime annuity provides certainty of income, the purchase price of this product can significantly vary month to month as economic conditions change. On the other hand, the fee for an account-based pension is known although the account balance will vary with market conditions.

The above results highlight the fact that there is no single answer for the best outcome for all retirees. The best answer depends on several factors including the individual's account balance, health, marital status, attitude towards risk and their need or desire to have access to capital.

Section 10

Supporting superannuation funds

Sole purpose test

One of the topics not mentioned in the Discussion Paper is the sole purpose test outlined in Section 62 of the SIS Act. The overall purpose of this test is clear; it is to ensure that regulated superannuation funds provide benefits to members on their retirement or in other specified circumstances, or to the member's dependants on the member's death. Although these purposes are clear and understandable, they are also restrictive as Section 62 uses the wording that each trustee "must ensure that the fund is maintained solely" for these purposes.

However, the objective of superannuation (currently before Parliament) discusses the concept of a dignified retirement which implies a broader concept than just maximising retirement income. As the recent Actuaries Institute paper entitled *Retirement Matters* noted:

"The critical elements of a successful retirement include financial, physical and mental health, along with a sense of purpose and identity. Any successful retirement planning approach needs to consider the whole person and not just the financial elements."¹⁰

Therefore, as superannuation funds assist members in approaching and during retirement, it is critical that their help, guidance and advice are not restricted to the provision of the financial benefits from the superannuation fund. A more holistic perspective is needed responding to the actual needs of the individual or household. In that respect, it is helpful to distinguish between retirement guidance and financial advice, where the former could consider a range of topics including but not restricted to financial advice.

Considering this broader perspective, many individuals take time out of the workforce to provide informal care, or to arrange appropriate accommodation, for ageing relatives. Women often bear this burden. In essence, this activity requires time out of the workforce and therefore leads to reduced superannuation contributions. Yet, the purpose of such activity is to provide these older individuals with dignity in retirement – a purpose consistent with the proposed objective of superannuation. The current wording of the sole purpose test is likely to prevent superannuation funds from supporting their members in such activities which result in time out of the workforce and lower superannuation benefits.

We also note that some uncertainty exists within the superannuation industry surrounding the payment of financial advice fees from a member's superannuation account. A revised sole purpose test should remove this uncertainty to ensure that all superannuation funds are able to deduct fees to provide financial or broader retirement advice to individual members in a manner consistent with the Government's recent announcements following the Quality of Advice Review.

A revision of the sole purpose test must also remove any doubt that superannuation funds are able to act in the member's best financial interest by providing nudges or defaults. For example, in respect of transitioning a member from the accumulation phase to the retirement

¹⁰ Actuaries Institute (2023), *Retirement Matters*, p23.

phase. Without such clarity, funds may be less willing to proceed in the direction announced by the Government, in its response to the Quality of Advice Review.

Mercer therefore recommends that the sole purpose test be revised significantly to enable superannuation funds to provide nudges or defaults, charge fees for financial advice, provide guidance and advice relating to the broader issues of retirement, and to provide services to ageing individuals.

Standardised product disclosure

The Discussion Paper suggests that a standardised retirement product disclosure could help consumers have access to information on a product, compare it to others, understand more about its performance and how it may suit their needs.

However, retirement income products are incredibly difficult to compare. The income from some products cannot be determined in advance and will depend on any, or all, of the following:

- Future investment returns
- Future inflation levels
- Future mortality experience of the pool of investors
- Future expenses, which may be adjusted by the provider
- Future taxation, which may be amended by Parliament

For example, let us compare three 10 year fixed-term annuities. In each case, each payment will comprise both capital and investment earnings. Yet, the differences are significant, as described below:

- Product 1 is a guaranteed level fixed term annuity supported by the capital of a life insurance company. It is expected that the annual payments would be constant and known throughout the 10 year period.
- Product 2 is also a guaranteed fixed term annuity but in these cases the annual payments will be increased by inflation, subject a maximum increase of say, 3 per cent per annum. As with product 1, it would be supported by the capital of a life insurance company.
- Product 3 is a market-linked fixed term annuity where the annual payment would be adjusted up or down according to the investment return from the previous year compared to the expected return.

It would be expected that Product 3 would offer the highest payment in year 1 for the same investment, as there is no guarantee and hence no need for any capital to support the product. On the other hand, Product 2 would be expected to have the lowest payment in year 1 due to the guarantee of inflation indexation in future years.

It is also likely that Product 3 would have a very clear description of fees in the relevant product disclosure statement whereas Products 1 and 2 would have no specific fee disclosure as it is an insurance product.

In terms of the projected income payments to be received by the retiree, the payments for Product 1 are known and guaranteed. However, the payments from Products 2 and 3 will depend on the future inflation levels and future investment returns respectively.

The comparison of these three products, which are relatively simple and similar, is not straightforward. There are different returns and different risks.

In addition, and as highlighted in the Discussion Paper, every retiree is different. There is not a uniform appetite for risk nor a standard planning time horizon, as some retirees have a reduced life expectancy and others expect to live for decades.

For these reasons, Mercer does not support the introduction of a standardised product disclosure framework for retirement income products as the underlying characteristics of these products can vary significantly.

The Discussion Paper suggests that the simple first steps could apply to account-based pensions but even that is difficult as some are linked to a mortality pool whereas others have “standard” drawdown rates that are above the minimum rates.

The above recommendation does not imply that Mercer does not support transparency regarding product description, expected income, fees or previous performance. Such disclosure is essential for a well-functioning competitive market.

Therefore, Mercer recommends that to assist members in their understanding, some standardised definitions be developed and the requirement to include a worked example in the product disclosure statement be introduced.

Above all, it must be remembered that the range of available retirement income products cannot be easily compared. A more helpful way forward is for superannuation funds to assist members before and during retirement that takes into account the member’s individual circumstances and preferences.

Tests for comparison and performance

The Discussion Paper notes that government regulators can provide tools to make comparison and performance assessment more accessible. As expected, such comparison tools and performance tests drive the behaviour of providers in the market. This has become obvious in the accumulation phase of superannuation as trustees adopt behaviour to minimise the probability of failing the existing APRA performance test. The consequences of this behaviour have not always been in the long term interest of fund members.

As a result, the Treasurer has announced a review of the performance test to ensure that it is not “influencing investment decisions to the detriment of member outcomes, including investment in asset classes that can strengthen the economy, ..., even where it would be in the best financial interests of members.”¹¹ Hence even the relatively simple task of comparing and testing investment outcomes in the accumulation phase has led to unintended consequences.

¹¹ Chalmers J., Investor Roundtable to help modernise our economy and maximise our advantages, media release, 5 December 2023.

The Discussion Paper notes that the retirement phase is much more complex and there are unique challenges in this phase, including the consideration of liquidity and longevity risks. However, the challenges go beyond the differences in retirement products which were presented in Section 9. There is also considerable heterogeneity in the characteristics and needs of retirees when compared to fund members in the accumulation phase. Hence establishing metrics that are valid and relevant to all retirees would be difficult.

Therefore, Mercer strongly opposes the introduction of any performance test in the retirement phase.

The introduction of any performance test in the retirement phase will inevitably mislead some retirees as the test cannot allow for personal circumstances. Furthermore, it is likely to limit the development of new retirement income products at the time when product innovation is being sought.

While opposing a performance test in the retirement phase, Mercer agrees that it is necessary to measure the success of retirement income strategies developed and implemented by superannuation funds. With this objective in mind, Mercer has developed an approach outlined in the attached paper in the Appendix entitled *Measuring Retirement Strategy Outcomes*.

Section 11

Are lifetime products the answer?

The Discussion Paper correctly notes that annuities represent a very small proportion of the retirement product market in Australia. In fact, it is even less than that suggested, as many of the annuities sold are term annuities and not lifetime annuities.

And yet, the Discussion Paper notes on p24 that “Over time Australians in defined benefit schemes have increasingly chosen to take a lifetime income stream over a lump sum indicating that, when they have confidence in the product, Australians appreciate the security of longevity protection.”

However, this conclusion does not represent the full picture for several reasons:

- The pension option in these DB schemes is often financially advantageous when compared to the lump sum option; that is, the options are not of equal value.
- Most of these retirees have been members of DB schemes for many years and a pension benefit has been their expectation. That is, the long-term framing has been about pensions.
- Public servants have longer life expectancy than the average Australian so that the pension option is even more attractive.
- These pensions are also indexed to inflation which provides greater protection to the retiree.
- Many of these retirees will receive generous superannuation benefits and therefore be ineligible for the Age Pension.

That is, while most public servants choose to take a pension from their DB scheme, one should not apply this decision making process to most Australians who have been members of defined contribution arrangements with no pension option and expect to receive a part or full Age Pension during their retirement.

The presence of the Age Pension represents a major disincentive for many Australian retirees to purchase a lifetime annuity at retirement. After all, the Age Pension is indexed and is guaranteed by the Government – a gold plated income stream!

As shown by the modelling in Section 9, a lifetime annuity is not an obvious and attractive proposition for many retirees. However, the guaranteed nature of a lifetime annuity provides certainty and security – features that many retirees seek in retirement.

But the key question is: How do retirees perceive lifetime annuities?

Or, to put it another way, do they see lifetime income products as insurance, investment or gambling?

If they see it as insurance, it is very different from any other insurance product taken out by most Australians. These other insurance products (such as home and car insurance) are paid on an annual basis and policyholders can easily switch companies, if needed. This is not possible with longevity insurance.

If they see it as investment, the underlying investment returns from a lifetime annuity are not clear and cannot be directly compared with an account-based pension or their history in the accumulation phase in a defined contribution plan.

Of course, most retirees will not see a lifetime annuity as gambling in the normal sense of the term. However, a lifetime annuity is only valuable if the individual lives longer than the average or beyond their expectation. As retirees tend to underestimate their life expectancy at retirement, they also tend to underestimate the value of lifetime protection from an annuity.

It is also worth noting that unlike defined benefit members with their guaranteed retirement benefit, defined contribution members have become accustomed to the effects of volatile capital markets on the value of their superannuation. Hence, while a stable and sustainable retirement income is desirable, this does not imply that the income must be fixed or guaranteed.

Lifetime income products have a role to play in the retirement phase of Australian superannuation. However, they are not the most appropriate product for many retirees (as discussed in section 3) and some of their features are not attractive to others. The best approaches to encourage lifetime income products are to:

- to change the framing of superannuation and thereby change the expectations of members, and
- to compel that a certain percentage of all retirement benefits must be converted into products that provide an income stream

in line with Mercer's major recommendations.

Section 12

Some reflections on standardised products

As recommended in this submission, a retirement income framework that leads to a focus on income while also providing some choice and flexibility for individuals is desirable. Hence, there is no need for a standardised retirement product as suggested in the Discussion Paper. A standardised product is likely to limit innovation rather than encourage it. Furthermore, it is likely to provide benefits that are not needed or desired by some retirees, for example, longevity protection.

It has been suggested that a standardised product may be needed to encourage Australian superannuation funds to move their members from the accumulation phase to the pension phase. However, a standardised product, by itself, will not change the attitude of members or their advisers. Hence Mercer is recommending the reframing of superannuation and the subsequent introduction of an element of compulsion.

It must also be recognised that there is no single product or solution that is appropriate for all Australian retirees. It is not that simple due to the many and varied characteristics and needs of retirees. It is essential that the system encourages flexibility whilst at the same time guiding individuals and households to the most appropriate outcome for them. In addition, under the retirement income covenant, superannuation funds are required to consider the needs of their members. A standardised product is unlikely to assist funds to develop and offer the most appropriate products to their members.

Therefore, Mercer does not support the introduction of a standardised product.

However, in our major system recommendation relating to the retirement phase of the superannuation system, we believe there are certain features within the permitted annuity or pension products that would provide improved outcomes to retirees.

Section 13

Appendix: Measuring Retirement Strategy Outcomes

As super fund trustees progress the development and delivery of their retirement income strategies, they must measure the effectiveness of their retirement strategy in improving members' outcomes.

Regulator focus

APRA and ASIC recently issued their joint thematic review report on the implementation of the Retirement Income Covenant. Their report highlighted that “*the majority of RSE licensees lacked metrics to assess the retirement outcomes provided to members*”¹². Clearly, measuring the effectiveness of retirement strategies in improving member outcomes is front of mind for the regulators. Since then, APRA issued draft updates to its member outcomes framework (SPS 515, SPG 515 and SPG 516) which, if implemented as currently drafted, will require a trustee to:

- As part of the Business Performance Review, demonstrate how its retirement income strategy has led to appropriate member outcomes, including appropriate assistance to members who are retired or approaching retirement. This includes examining a variety of measures to assess the success of its retirement income strategy, how retirement outcomes can be improved, and how the trustee helps members better achieve and balance the retirement objectives set out in the Retirement Income Covenant of:
 - 1) maximising expected retirement income over the period of retirement
 - 2) managing expected risks to the sustainability and stability of retirement income, and
 - 3) having flexible access to expected funds in retirement¹³.
- Develop metrics to measure the outcomes sought for members in or approaching retirement, and track the success of these metrics, to inform the continual improvement of outcomes for these members. This would involve a mix of specific, measurable, quantitative and qualitative metrics to measure how the outcomes delivered to members are assessed. Such metrics may include, but are not limited to, changes to the rate of regular pension drawdown and member confidence in meeting their retirement goals.
- Examine how it helps members and whether this assistance is fit for purpose by tracking and testing measures of the effectiveness of this assistance.

¹² APRA, ASIC. Information report - Implementation of the retirement income covenant: Findings from the joint APRA and ASIC thematic review, 19 July 2023

¹³ Refer section 52AA of the SIS Act

The challenge of assessing a Retirement Income Strategy

The Government has proposed the purpose or objective of the super system is: **“to preserve savings to deliver income for a dignified retirement, alongside government support, in an equitable and sustainable way”**¹⁴.

To date, the focus of the industry has predominantly been on the accumulation phase of superannuation where the primary objective is to maximise the risk-adjusted net returns to members over several years. It’s clear that the superannuation industry must now turn its attention to the challenge of delivering retirement income, a more complex and nuanced challenge than purely delivering investment returns.

Delivering retirement income is made more difficult by Australia’s predominantly accumulation-based superannuation system than it would be under traditional defined benefit (DB) arrangements provided in many overseas pension systems (and formerly in Australia before the introduction of the Superannuation Guarantee). A DB scheme provides members with pre-determined, longevity protected incomes, creating a well-defined solution to the retirement income problem. That’s not to say, however, that the DB system is wholly better.

With our compulsory system, strong contribution rates and preservation, many members are now approaching or are in retirement with reasonable balances and need help to determine how best to use their superannuation. There are a few pension systems in the world who have solved for this well and our means-tested age pension in Australia makes the challenge for members even more difficult.

Trustees are developing a multitude of solutions to tackle this problem, such as a greater focus on member education, increasing minimum drawdown rates, enhancing advice channels, and launching new products. The approaches taken by trustees will differ as will their members’ needs. Cracking this problem would create a world-leading pension system in Australia.

So how do you effectively measure the success of a retirement income strategy?

Mercer’s retirement outcomes scorecard

We have developed a scorecard to assist trustees and their management teams to measure the success and effectiveness that their retirement strategy has had in improving their members’ outcomes in retirement. We believe this meets the regulators’ challenge in their joint thematic review to use metrics to assess the retirement outcomes provided to members.

This scorecard consists of three overarching sections: **benefits, member support and offerings**. Each of these sections is scored according to a series of weighted measures and detailed metrics, as illustrated in Figure 1 (note that the percentage scores shown are examples only). Trustees will be able to customise the weighting of each measure and metric depending on their strategic priorities. These scores should be tracked by trustees for two purposes:

¹⁴ Australian Government, The Treasury. Legislating the objective of superannuation – Consultation on Superannuation (Objective) Bill 2023 – August 2023

1) to compare where the trustee is now to where it wants to be when developing and implementing an effective retirement income strategy, and

2) to measure the improvement of their members' retirement outcomes over time.

Our scorecard enables trustees to capture the complexity of the retirement problem within simple but meaningful outputs.

Let's consider each section in more detail by focusing on the 'measures' layer of the framework.

Figure 1. High-level framework scorecard



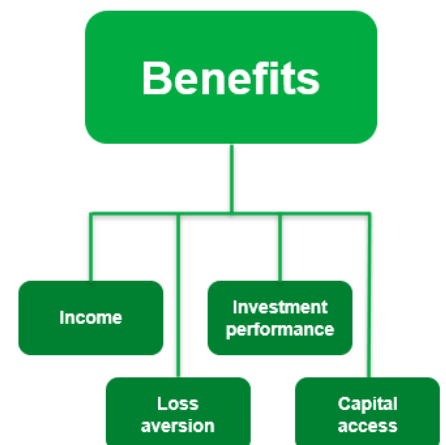
Benefits

Income

Within the income measure, we focus on quantitative measures of retirement outcomes towards retirement incomes and not balances. Rather than comparing member balances at retirement to an industry standard as is common practice today, our goal is to measure how optimal incomes are being delivered to members from a given balance at retirement, accounting for the trade-offs to achieve and balance the objectives of the Covenant. The age pension must also be considered within this measure as it is a source of income for many retirees.

Loss aversion

The loss aversion measure recognises that capital losses are likely to be less tolerable to retirees than accumulation members. Hence, we measure whether the fund's investment options deliver as advertised.



Investment performance

The performance measure recognises that risk-adjusted net returns still have an important role to play from the perspective of capital. However, we emphasise this plays a smaller role in the bigger retirement picture than in accumulation.

Capital access

The capital access measure reflects the Covenant requirement for flexible access to capital and members' ability to withdraw lump sums to meet their needs at any point in retirement.

Member support

Retention

The retention measure consists of metrics looking at member and asset retention from the accumulation phase into retirement. We pay particular attention to whether a lump sum withdrawal can be considered a good outcome for certain members. We believe that retention is a good indicator of whether the services offered by the fund are seen as attractive.

Retirement journey

The retirement journey measure assesses the education, information and tools provided to members to support their journey from accumulation to retirement. This includes assessing the level of personalisation on the retirement journey, as well as a focus on the quality of the retirement journey, not just the quantity of support provided.

Advice

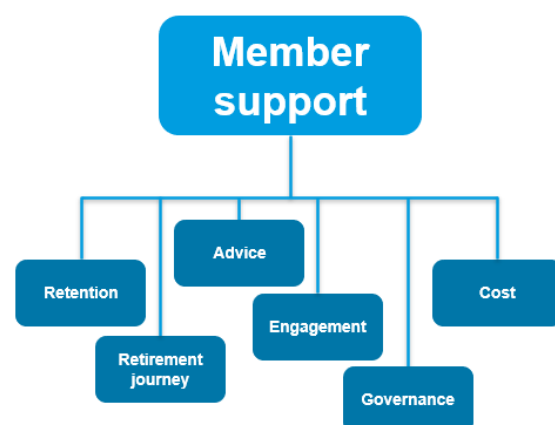
The advice measure assesses the availability and quality of advice services offered to members by the fund, ranging from general to comprehensive financial advice. It also focuses on the relationship that the fund has with their advisers, and whether advisers find the fund easy to work with. Of course, the changes following the Government's response to the Quality of Advice review are likely to impact on what this measure may look like in the future.

Engagement

The engagement measure directly addresses one of the items raised in APRA and ASIC's joint review, being the measurement of the effectiveness of engagement in driving better member outcomes. This involves measuring the usage of member support services and the rate of positive actions being taken following assistance provided to members. We also emphasise the need to maintain engagement with existing retirees, i.e., staying connected to members after they have started receiving an income.

Governance

The governance measure reflects the underlying building blocks needed for funds to show that they are prioritising the retirement phase of their members appropriately. The metrics underlying this measure may be described more as "operational hygiene" but remain



important to ensure that funds have the underlying governance structure required to deliver good outcomes to members.

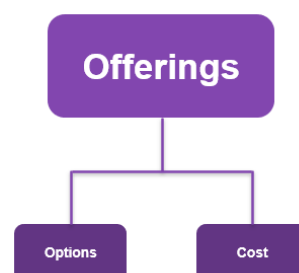
Cost

The cost measure recognises that the support and assistance that funds provide to their members will come at a cost. Therefore, the efficiency in which this is delivered to members and the trade-off of cost should be considered and is becoming increasingly important with the proposed changes to SPS 515 and APRA's recent consultation on fee transparency.

Offerings

Options

The options measure consists of an assessment of the range of products offered to members, either directly by the super fund or from a third party. The focus of this is on the design and integration of the product suite, rather than on the number of products offered.



Cost

The product cost measure is a simple measure of product costs relative to peers.

Metrics

Underlying the measures described above sit the detailed metrics that are actually measured and monitored. Broadly, these include quantitative, qualitative and *maturity model* metrics. Quantitative and qualitative metrics are nothing new, however maturity model metrics are an important differentiator of this scorecard.



The concept behind maturity model metrics is to allow trustees to assess their current state and compare this to their end or aspirational state. Our maturity models consist of five stages, ranging from a base-level to an industry-leading (or even aspirational) offering. The key idea here is that not all funds will aspire to reach a stage four or five state on all metrics. Depending on the objective of the fund, their aspirational state may be a stage three and the maturity model can help trustees decide how to use their finite capital and people resources.

Conclusion

The regulators have clearly called out that super fund trustees should effectively measure their retirement outcomes - trustees must turn their attention to developing ways to measure this. We believe that Mercer's retirement outcomes scorecard will assist trustees and their management teams effectively measure the success of their retirement strategies and the impact that their strategies have had on member outcomes. The scorecard aims to synthesise the complexity of retirement assessment into simple but meaningful outputs for trustees. This is a critical input in an overall retirement strategy that will not only allow trustees to assess their current state, but importantly how their strategy continues to improve overall retirement outcomes.



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