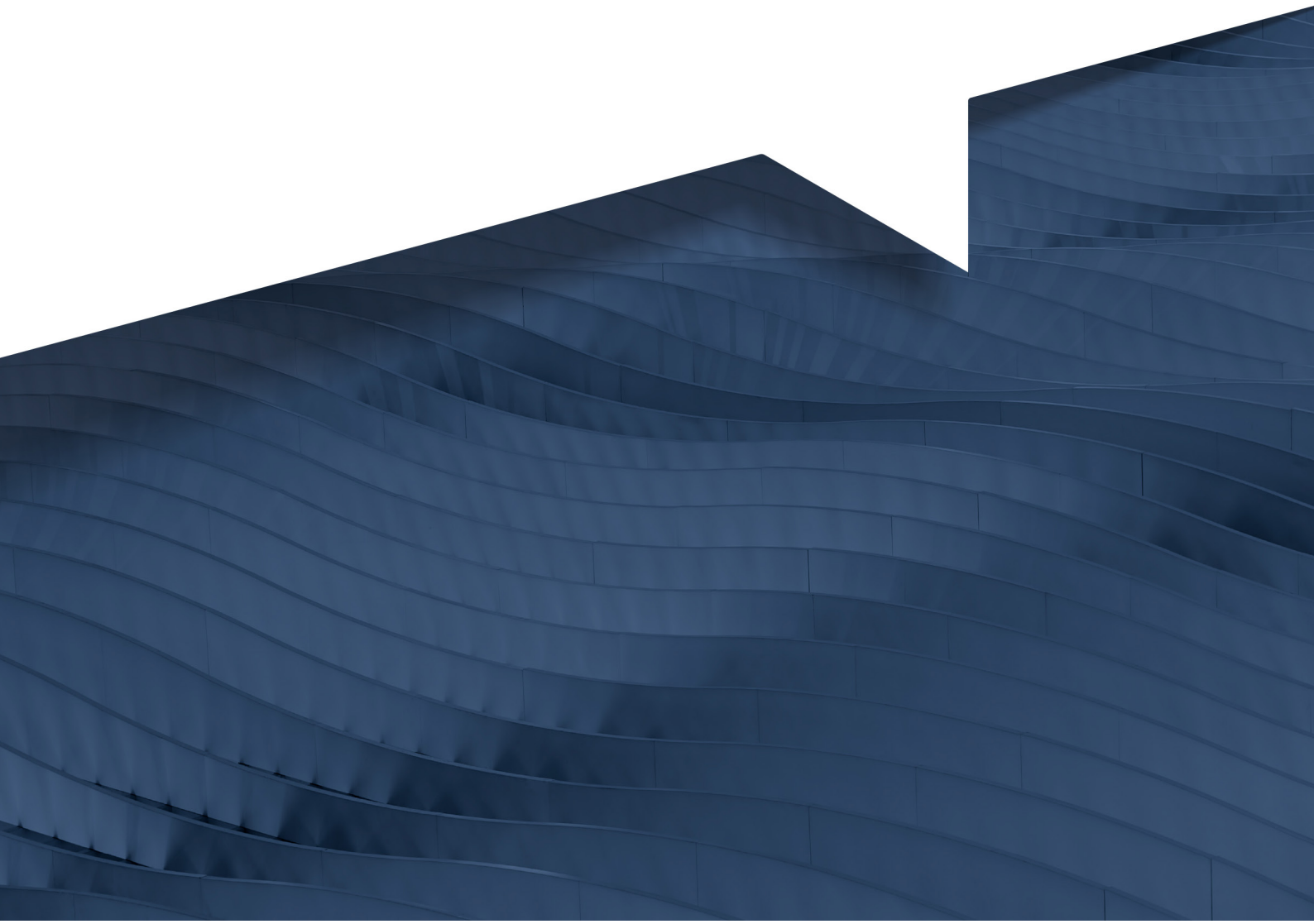
Are Australian superannuation funds ready for the Retirement Income Covenant?

Research, analysis and insights from super industry leaders



CORE | DATA

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A regulatory rollercoaster

In 2020 the Australian Government's Retirement Income Review found that mechanisms to optimise retirement income and ensure the efficient use of retirement savings was a major gap in Australia's almost 30-year-old superannuation system.

It found many retirees, in fear of outliving their savings and uncertain how their super would perform, were reluctant to draw-down their accumulated retirement funds which was compromising their quality of life in retirement.

As more Australian retirees become reliant on their super savings it will become even more important this gap is plugged and super funds put strategies in place to make members feel comfortable in drawing down their savings as they age.

The resulting Retirement Income Covenant (RIC) legislation, which takes effect from 1 July 2022, requires super fund trustees to have a strategy in place to manage retirement risks for their members, including longevity risk (the risk of outliving savings), and investment and inflation risk.

Among these risks, longevity risk is unique because it does not exist in the accumulation phase of superannuation and cannot be solved by stronger performance or reducing volatility. It is new territory for most super funds.

As outlined in its 2022 Information Paper on policy priorities[1], APRA has regulatory oversight for the RIC, and is expected to consult with super funds throughout 2023 to review individual fund strategies for compliance with the objectives of the RIC.

The consultation over and introduction of the RIC was one of a number of regulatory changes super funds have faced over the past three years including Design and Distribution Obligations, YourFuture YourSuper changes, enhanced data reporting requirements and early access to super under COVID legislation.

With the deadline to have an RIC strategy in place rapidly approaching, CoreData conducted qualitative and quantitative research on super funds' perceived readiness to comply with this new obligation. The research was commissioned by Challenger. This report outlines the findings.

1 APRA Information Paper, Policy Priorities, 1 February 2022.

Key findings

- Super funds are finding getting ready for the RIC is challenging but the industry is stepping up to the challenge.
- All funds are taking specific steps to address their obligations, and most have started an analysis of their member base.
- While senior executives in the majority of super funds believe they have a well-articulated strategy to comply with the RIC, less senior executives in these organisations have a lower awareness of this strategy or are not so sure their fund is ready.
- There is concern within some funds as to whether the operational aspects of the obligations can be met in time.
- While most funds believe they're well positioned to meet members' future needs, in March this year many were only then focusing on what needed to be done specifically to meet the looming RIC deadline.
- Funds are roughly divided between those that will both buy-in external resources and expertise and build internal capability to meet RIC obligations, and those that plan only to build internal capability. A small number plan only to buy-in external help and a similar proportion remain undecided.
- However, when it came to dealing with longevity risk two in three funds said they will outsource longevity risk to third parties while one in four funds did not yet know their approach.
- Most funds believe a retirement income solution will rely on financial advice for distribution.

Research methodology

The CoreData research consisted of one-on-one interviews and online quantitative surveys conducted with 43 professionals working at 19 super funds.

19 super funds
managing member benefits of

$1.14 trillion
in a total of

10.33 million
member accounts, including

1.35 million
accounts held by members within

10 years
of retirement

43 individuals
including:

21
c-suite executives

13
heads of product

6
product managers

2
customer managers

1
strategy manager

As at 30 June 2021 26% of member balances held were in the retirement phase; 15% were held by members aged 60-65 years.
Source: APRA Annual Superannuation Bulletin 2021.

Senior super fund executives feel strategically well advanced, but…

With the 1 July 2022 deadline fast approaching, delivering an RIC strategy was an important focus for surveyed super fund professionals. Overall, senior executives surveyed had a high level of confidence of being on track to have their RIC strategy in place. However, as leaders further down the corporate ladder were surveyed a divergence of opinion emerged.

8 in 10 senior executives see their fund as ready to meet market needs with a clearly articulated strategy

Just over **5 in 10** heads or general managers think their fund is ready with a clearly articulated strategy

Only **3 in 10** product/customer managers feel the fund is ready with a clearly articulated strategy

> We have made clear plans and we are starting to execute them.

> Retirement Income Strategy is well progressed; member research has been conducted.

> We've allocated money for this in our strategic plan. We have a high degree of capability for our size… so we knew this was coming and we allocated money and time.

The roadmap for implementation

While the RIC requires trustees to have a strategy in place from 1 July, implementation and development of products and solutions will take time.

In looking towards their roadmap for implementation, super funds surveyed did not have a specific deadline for delivering on their RIC strategy. The research suggests that while plans for implementation are yet to be fully defined by all super funds, seven in ten senior executives say they are very or somewhat confident they will have retirement income products and solutions in place when required.

Level of confidence a solution will be in place

At the **senior executive** level:

6 in 10
funds are very confident

1 in 10
are somewhat confident

3 in 10
are not very confident

While some funds have already established an internal operating framework to deliver their retirement income solutions, others are unsure about the mix of resources and expertise – internal and external – they will draw on for solution design and delivery.

Half the funds surveyed are expecting to manage development and delivery of their retirement income solutions in house. Several funds are in the process of building a robust and comprehensive retirement income capability within their existing operation. Comments from the research suggest these funds are looking to both their existing business functions and new dedicated teams to deliver fit-for-purpose retirement income solutions.

Taking the lead

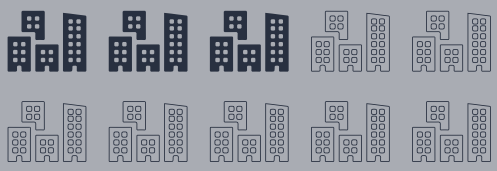
While super funds recognise a successful retirement income strategy requires input from strategy, product and investment teams, they have different views on which function should take the lead. Popular opinion at the executive level is that the customer team should be taking ownership of retirement income initiatives with one in two leaders holding this view. On the other hand, two in five senior executives think it should sit with their investment team.

> Developing retirement strategy, is it a legislative project, is it a product-related project, is it a strategy-related project? I think it's a mix of all three.

Seeking support from external partners

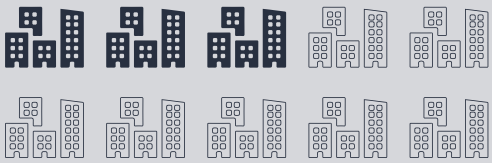
As stated, funds are roughly divided between those that will both build internal capability to solve for longevity risk and buy-in external resources and expertise, and those that plan only to build internal capability. A small number plan only to buy-in external help and a similar proportion remain undecided.

Build internal capability versus buy-in



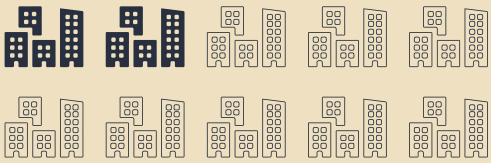
3 in 10

funds plan to both build internal capability and to buy in external resources to manage their Retirement Income Covenant obligations



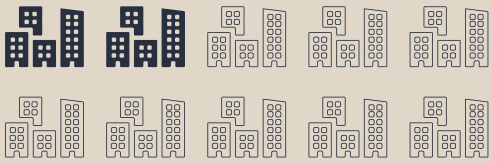
3 in 10

funds plan to build internal capability to manage their Retirement Income Covenant obligations



2 in 10

funds plan to buy in external resources to manage their Retirement Income Covenant obligations



2 in 10

funds do not know if they will build internal capability or buy in external resources to manage their Retirement Income Covenant obligations

External partners needed when dealing with longevity risk

There are two key ways super funds can help their members manage longevity risk. The first is by issuing a lifetime income product backed by a life insurer that will last for as long as the member lives. This co-created solution can sit alongside the super fund's existing account-based pension, in a way that keeps the super fund in the driver's seat.

The second is for the fund to pool member longevity risk themselves. Under this approach not all risk is removed as payments depend on a range of factors, including how long other people in the pool live, as well as performance.

However, the internal capability that a fund needs to implement a longevity solution or mitigate longevity risk is considerable in terms of operational capability and assets and liability management.

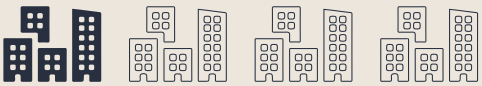
Several super fund executives surveyed questioned whether they had the internal expertise to deliver a solution that would manage longevity risk with enough flexibility, that is allowing lifetime cover to evolve over time to align with member needs in retirement.

Executives don't want to have to reinvent the wheel or alternatively build something that may become a problematic legacy system.

While super funds clearly felt they needed to own the retirement income proposition some executives said they would likely need an external partner to provide part or all of a longevity risk solution with sufficient flexibility that would avoid excessive set-up costs and unnecessary operational costs.

2 in 3

funds will outsource longevity insurance to third parties



1 in 4

funds do not yet know if they will outsource management of longevity risk to third parties

Financial advice will play a part in distribution

Part of the intent of the RIC is for super funds to make products and information available to help members maximise their expected retirement income while managing risks and providing flexible access to savings. The RIC makes no prescription for how members should access products and make choices as to whether products and strategies on offer are suited to their needs.

Given the complexities of managing the three retirement risks called out in the RIC – inflation, investment and longevity – it's not surprising to learn that three-quarters of super funds surveyed are expecting advice to play a role in distribution of their retirement income solutions.

The big question is how this will be possible without the use of digital enablement or guided choice frameworks for those (the majority) that won't seek traditional comprehensive advice.

3 in 4

funds believe a retirement income solution will rely on financial advice for distribution

> It'll be a strategy that's delivered predominantly through advice. It will be a complex product, that we might not be able to offer ourselves outside the context of intra-fund [advice].

Longevity risk: the number one knowledge gap

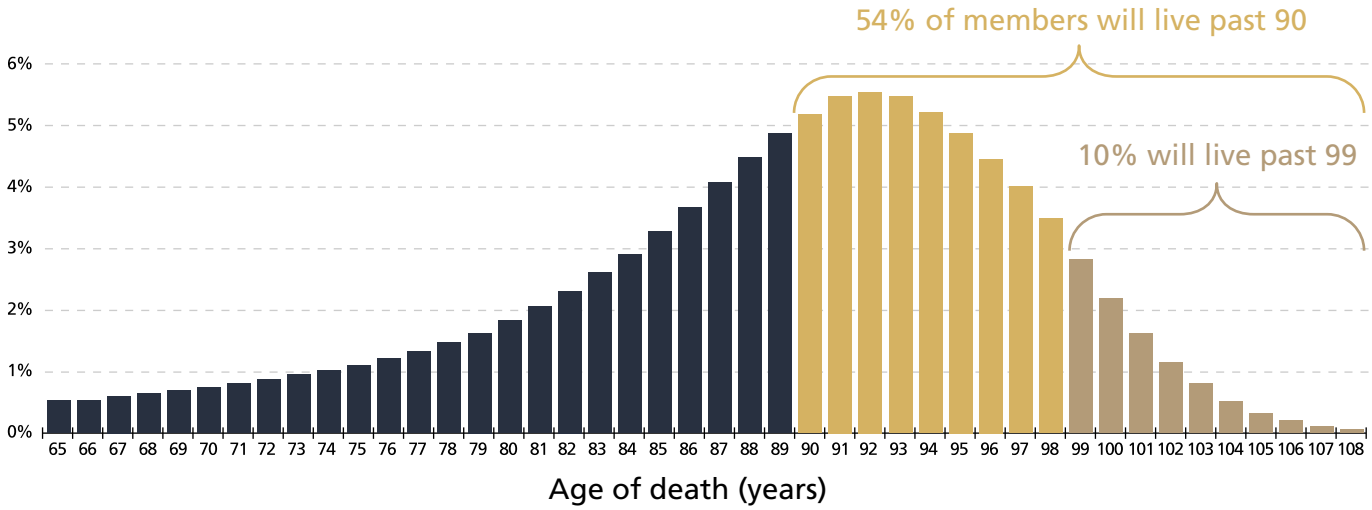
Delivering products and solutions that address longevity risk is a critical requirement for RIC strategies and solutions for fund members.

The law of averages doesn't add up

A key element of the RIC legislation is that expected income must be calculated over the 'period of retirement'. While average life expectancy figures can be used to make assumptions about the likely duration of retirement, applying this average to all members means some will run the risk of living beyond their expected 'period of retirement.'

Likelihood of passing away at each age

For example: Age of death for female members aged 65 years



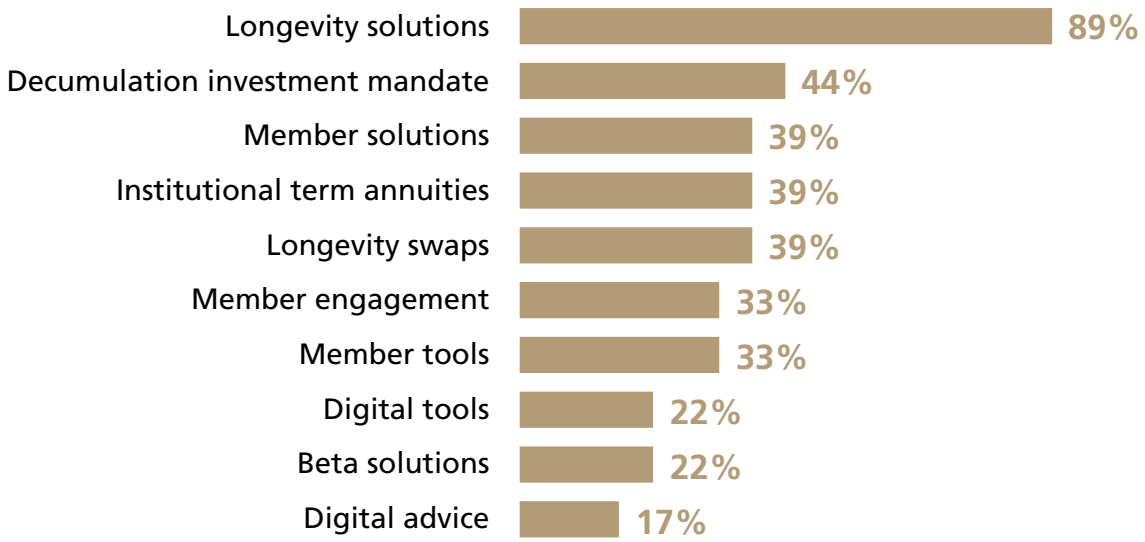
Source: ABS Life tables.

Considering average life expectancy, a 65-year-old woman retiring today is expected to live to age 90. But this being an average, more than half of women in this retirement cohort will live past 90 and 10% will live past 99.

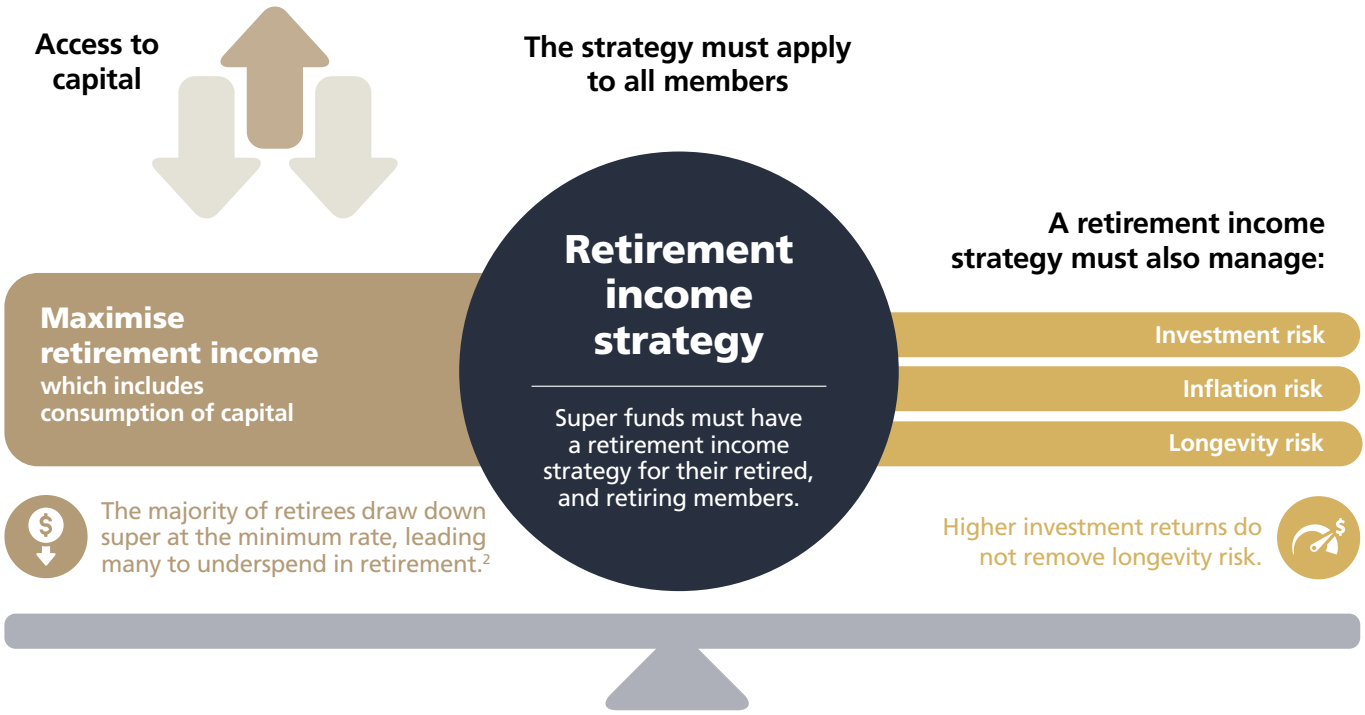
Seeking support from experts

Given the statistical uncertainty associated with longevity risk, it's no wonder there is expected to be significant demand for external experts to help super funds address this component of their RIC obligations. It's twice as high compared with any other gap in the knowledge base they are drawing on to support their RIC strategy and program of work.

Longevity solutions top the list of funds' needs



Seizing the opportunity in retirement income



Where the market stands

During the next 15 years, working Australians aged over 57 will be the fastest growing group in the super fund market, holding the most assets.[3] This makes retention of members in the pre-retirement and retired cohorts even more critical. Designing trusted income products for retired members that are simple to understand will give super funds a strong competitive advantage with this cohort.

While compliance is requiring the industry to better meet the needs of this market segment, staying competitive makes it even more important for super funds to deliver a compelling offer for their members.

2 Retirement Income Review Final Report 2020.

3 Australian Historical Population Statistics 2014. ABS Catalogue No. 3105.0.65.001 and CoreData Wealth research.

Solutions in development

Steps super funds are taking to meet the needs of working Australians as they approach retirement include:

Member Services	"…ensure we offer the **products and services** required to optimise members' retirement income. **...enhancing member journeys,** providing more **pre-retirement member education**, …ensuring our longevity product has the **flexibility to accommodate** the various needs of members and their **post-retirement spending patterns**."
Product Solutions	"Building **new products and services** - building out a team which handles their needs."
Member Education	"[We] launched **v1.0 of a digital solution**, which we can improve over time. We are also preparing a holistic retirement income strategy that will cover **product, service and engagement solutions** for different cohorts of members."
Digital Touchpoints	"Building **a comprehensive pre-retirement customer guidance, marketing and communication solution** which will assist this cohort of customers. Our average customer is well on track to achieve ASFA 'comfortable' standard based on current [Fund] modelling."

About Core Data

CoreData Research is a global specialist financial serdisclvices research and strategy consultancy, founded in 2002 and headquartered in Australia, with operations in Sydney, Perth, London, Boston and Manila.

It provides clients with bespoke and syndicated research services through a variety of data collection strategies and methodologies, along with consulting and research, database hosting and outsourcing services.

CoreData provides both business-to-business and business-to-consumer research, while the group's offering includes market intelligence, guidance on strategic positioning, methods for developing new business, advice on operational marketing and other consulting services.

This research was commissioned by Challenger.

About Challenger

Challenger Limited (Challenger) is an investment management firm focused on providing customers with financial security for a better retirement.

Challenger operates three core investment businesses, a fiduciary Funds Management division, an APRA-regulated Life division, and an APRA-regulated authorised deposit-taking institution. Challenger Life Company Limited (Challenger Life) is Australia's largest provider of annuities. Challenger Life (ABN 44 072 486 938, AFSL 234670) provides regular income to thousands of customers. We're a multi-award-winning Life Company and have $22.9 billion in assets under management (as at 31 December 2021).

Challenger Life is not an authorised deposit-taking institution for the purpose of the *Banking Act 1959 (Cth)*, and its obligations do not represent deposits or liabilities of an authorised deposit-taking institution in the Challenger Group (**Challenger ADI**) and no Challenger ADI provides a guarantee or otherwise provides assurance in respect of the obligations of Challenger Life. **Accordingly, unless specified otherwise, the performance, the repayment of capital and any particular rate of return on your investments are not guaranteed by any Challenger ADI.**

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