Retirement really is different

…calling for improved fund governance, specialised products and targeted financial advice

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1. Making our super system fit-for-purpose in retirement

Former Prime Minister Paul Keating conceded some years ago that the super system was not designed for people who were going to live over the age of 80.

The system he conceived was for the 55-75-year-olds.[1] Today's retirees are now typically living into their late 80s, more than 9 years longer than they did in the 1990s. Sixty-five-year-old women today can expect to live to 90 on average, with one-in-five to live to 98.[2]

By 2030, our super savings mountain will basically double in size from its current $2.6 trillion to around $5 trillion.[3] Over that period, something in the order of $1,300bn of super savings will move into the retirement phase.[4]

Super is doing the first part of its job; it is allowing people to accumulate assets for retirement. However, there is no structure to the drawdown phase in our defined contribution model – flexibility is prioritised at the expense of risk management and income certainty and sustainability.

2. Ability to self-provide in retirement is increasing

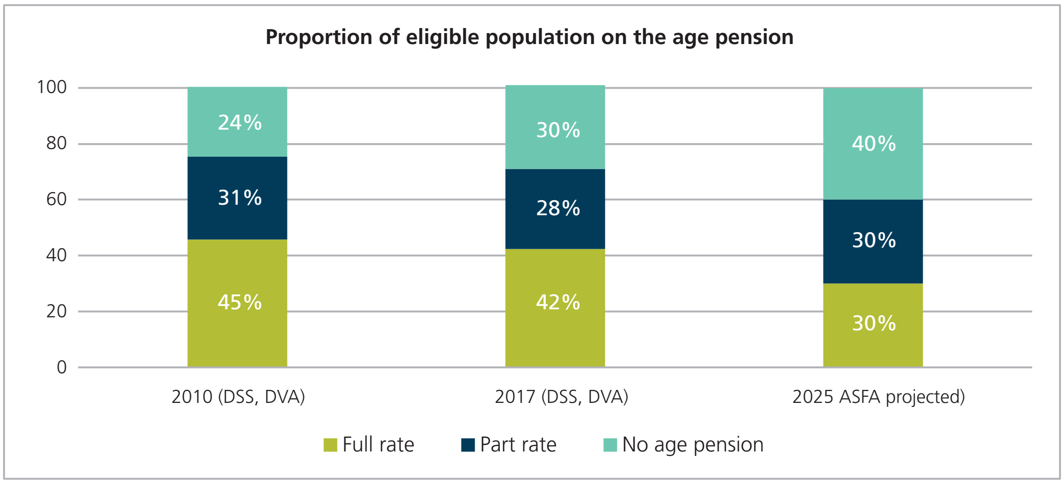
Super is moving from merely supplementing the age pension to substituting it for an increasing proportion of retirees. The evidence is already in. At June 2017, only 42% of the over-65 age cohort were getting a full pension, with a further 28% on a part age pension.[5]

Put another way, more than half of today's retirees (ie 58%) have sufficient means to reduce, or eliminate, their entitlement to government income support and growing super balances will be playing a material part in this story.

The trend towards the need for private provision of stable retirement income is clear, as Figure 1 shows. Apart from anything else, the eligibility age goes up from the current 65.5 by six months every two years until it reaches 67 in 2023. ASFA projections suggest that by 2025, around 20% of people aged 67 will still be working, with a further 40% or so ineligible for the age pension.[6]

1 Opening address at the 50th Anniversary ASFA Conference in Sydney on 28 November 2012.
2 Based on ALT2010-12 with 25-year mortality improvements from the Australian Government Actuary.
3 Source: Rice Warner Superannuation Market Projections Report 2017.
4 Rice Warner Superannuation Market Projections Report 2017, sum of flows June 2018 to June 2030 (in 2017 dollars).
5 Includes age-based veterans' pensions. Age of eligibility for the age pension increased to 65.5 from 1 July 2017.
6 ASFA Pre-Budget Submission for the 2018-19 Budget, February 2018.

Figure 1: Trend of decreasing reliance on age pension 2010-2025



Improving the retirement phase is not just about products

3. A new retirement income framework

In late 2014, the Financial System Inquiry (FSI) recommended development of comprehensive income products for retirement (CIPRs). The FSI realised that a 'pre-selected' combination of products designed to deliver a regular and stable income stream, longevity risk management and flexibility would simplify decisions at retirement and, most importantly, deliver better outcomes for retirees. The availability of lifetime income streams in retirement is critical to ensuring savings accumulated through super can meet retiree consumption needs.

The government recently proposed that the CIPR concept would benefit from a heightened level of fund governance around retirement income; an improved retirement income framework. To this end, Treasury is currently working with an advisory group to assess a proposal for a new covenant in the SIS Act[7] requiring fund trustees to consider the retirement needs of their members when developing and offering retirement income products. This new governance initiative could form a major plank in the drive to improve the market for high quality retirement income products.

Improving the retirement phase is not just about products. Even with a 'soft default'[8] CIPR, many retirees will need targeted, specialist advice. The importance of the advice industry has been recognised by the government, with the Financial Advice Standards and Ethics Authority (FASEA)[9] established to improve the education, training and ethical standards of advisers. FASEA will have an important responsibility to ensuring that advisers are ready to service the mass market of retirees who will need advice about the safe spending of their retirement savings.

7 Superannuation Industry (Supervision) Act 1993 (Cth).

8 Generally taken to mean something that is offered as the preferred option, but falling short of an outcome that becomes the default in the absence of an active choice.

9 FASEA website https://fasea.gov.au

A 65-year-old female has only a 5% chance of dying in the year of her life expectancy

4. Why do we need to act now?

Around 51% of national wealth is owned by the 45-64-year-old cohort[10] and approximately 700 Australians are retiring every day. It is essential that this group gets sound financial advice both before and during retirement and that the financial products available to them meet their needs in retirement.

A recent National Seniors Australia (NSA) report on the behaviour and attitudes of senior Australians regarding their retirement finances shows that six out of ten Australian seniors are turning to financial advisers for advice or information about retirement finances.[11] This proportion is significantly higher than for the superannuation member population overall, where only one in five seek advice.[12]

5. The challenge - retirement is different from accumulation

So far, the super industry has focused on building up the savings pool. This has been an unquestionable success. The issue now is that spending those savings to improve living standards and manage risks in retirement is a very different paradigm.

In retirement:

- **There is usually no income other than an age pension entitlement:** the 'financial dynamics' of accumulation are reversed. There is generally no regular wage or salary (other than an age pension entitlement) and the retiree starts drawing down on their savings to fund consumption. This makes it a fundamentally different proposition from accumulating savings and introduces new risks;[13]
- **Retirees have specific goals:** the goal of most accumulators is simply to build up the maximum amount of retirement savings for a given risk appetite; time horizon and contribution rate (they may or may not be targeting a level of retirement income from those savings). This explains the risk-profiling approach used by most advisers. In retirement, most retirees will have a range of goals that will an income goal for spending; access to capital for emergency spending; growth; peace of mind and leaving a bequest. These goals create a very different dimension from the accumulation phase;[14]
- **Retirees are exposed to longevity risk:** the risk that they outlive their savings because of increasing life expectancies. Longevity risk also has another dimension: the uncertainty of how long people will live. There is a wide distribution of actual lifespans around the mean (ie life expectancies of retirees). A 65-year old female only has a 5% chance of dying in the year of her life expectancy (currently 90). This makes planning around retirement income needs all the more complicated;

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10 ABS (13 September 2017) 6523.0 Survey Household Income and Wealth 2015-16.

11 National Seniors Australia (2017): Seniors more savvy about retirement income
<https://nationalseniors.com.au/be-informed/research/publications/seniors-more-savvy-about-retirement-income>
There were over 5,500 respondents who were over 50; 55% were female and the average age was 68.

12 MLC Quarterly Wealth Behavioural Survey Q1:2017.

13 For example, dollar cost averaging works in reverse. See Challenger Retirement top tips: What works in accumulation works against you in retirement January 2012.
<https://www.challenger.com.au/funds/TechnicalUpdates/CRIR_One_minute_guide_-_what_works_in_accum.pdf>

14 This is usefully summarised in a 2013 white paper by Lonsec and Milliman entitled: Boomers, Herding, Denial and Zeitgeist: Who will be First to Grasp the Post-Retirement Advice Opportunity?

- **Sustainability of retirement savings:** becomes a new and important concept. This has two elements: the probability of success of the retirement plan (expressed as a percentage of likelihood of reaching a particular age with savings still intact) and the range of potential outcomes based on market returns that deviate from long term averages;
- **An understanding of life expectancies is critical:** to advise on the sustainability of a retirement portfolio and the rate of safe spending from that portfolio, advisers need a strong understanding of life expectancies, including concepts like mortality rates, mortality improvements and, most importantly, the deviation of actual lifespans from the mean;
- **Market risk takes on a new dimension - sequencing risk:** when drawing on a portfolio, the sequence of returns matters. Negative market movements early in retirement have can have an adverse impact on the sustainability of cash flows.[15] A retiree's ability to recover from poor investment returns (or take advantage of lower market prices) is generally limited because strategies available in the accumulation phase (take more risk; keep working and contribute more) are generally not available;
- **Household expenditure is funded by individual savings:** yet the predominant way people approach the financial challenges of retirement is by sharing them with another person. Around 70% of people start retirement in a couple household. We accumulate retirement savings individually, but generally spend it jointly. As a result, retirement income advice is generally best framed to align with this reality;
- **Inflation becomes a significant risk:** inflation takes on a new dimension because the retiree's capital is disconnected from wage rises and retirees can generally only be confident of maintaining purchasing power via the age pension and explicitly inflation-linked investments. Recent low inflation rates, following an extended period of inflation at 'average' rates, does not make it any less likely that inflation could deviate strongly from the mean during a lengthy retirement;
- **Long-term investing is no longer a panacea:** plans based solely on notions like 'investing for the long term' are generally less relevant in retirement, although growth assets will play a material role in most portfolios. Due to spending needs, approximately half of a typical retiree's savings are consumed in the first 10 years and a smaller proportion of savings can be set aside for 'the long-term'. Later retirement spending is funded from dollars created by compounding returns during retirement;
- **Diversification does not mitigate all risks:** by itself, diversification of asset risks is much less able to deal with retirement income challenges than is widely thought. For example, for most retirees, longevity risk cannot be ameliorated solely by exposure to growth assets. It is not just about having money later, but it is the ability to spend confidently, and not run out;

For most retirees, longevity risk cannot be ameliorated solely by exposure to growth assets

15 <https://www.finsia.com/docs/default-source/Retirement-Risk-Zone/the-bca-cab-bac-abc-of-sequencing-risk.pdf?sfvrsn=2>

Pooled retirement income products produce a distinct form of income known as a 'mortality credit'

- **Importance of cash flows:** retirees say that they want a 'retirement pay cheque'[16] and yet most retirement plans are based on investment returns and capital accretion, rather than regular, stable income;
- **Pooling benefits can be realised:** pooled retirement income products produce a distinct form of income known as a 'mortality credit': effectively the yield from capital belonging to those who predecease the projected life expectancy of the pool. This form of retirement income is uncorrelated to market assets like equities or bonds and can be distributed from the start of retirement, based on actuarial assumptions. It is unique to pooled retirement income products and significantly enhances the rate of return to surviving members of the pool;
- **Cognitive decline:** sound retirement income planning and advice involves the recognition that there is a high likelihood that at some point along the way, one or both members of a retired couple will suffer cognitive impairment or dementia. Many strategies involve more complexity and decision-making than is suitable for late stage retirees;
- **Elder financial abuse:** older Australians are exposed to financial abuse, often at the hands of family and carers. An increase in online and card-based services means that older people are even more vulnerable to such exploitation. Those giving retirement income advice need to be attuned to this problem; and
- **Each retiree's needs tend to be distinct:** there are no universal solutions to funding a retirement and the individual circumstances of retirees' (such as their health; intended consumption patterns; financial literacy; marital status and their likely longevity) play a much bigger role in the advice and planning process than in accumulation. This is largely because accumulation does not involve any element of spending.

6. Retiree behaviour

Good retirement income advice involves understanding and pre-empting certain inherent biases that people exhibit. These include lump sum bias (the tendency to overvalue a capital sum as opposed to its actuarially fair income value); hyperbolic discounting (the tendency to undervalue future income) and retirees' aversion to loss which is greatly increased compared to the accumulation phase.[17] The average person does not have the financial literacy to deal with each of these on their own. Financial advisers need to have the appropriate level of professional expertise to guide their clients through these biases.

16 Ibid 11

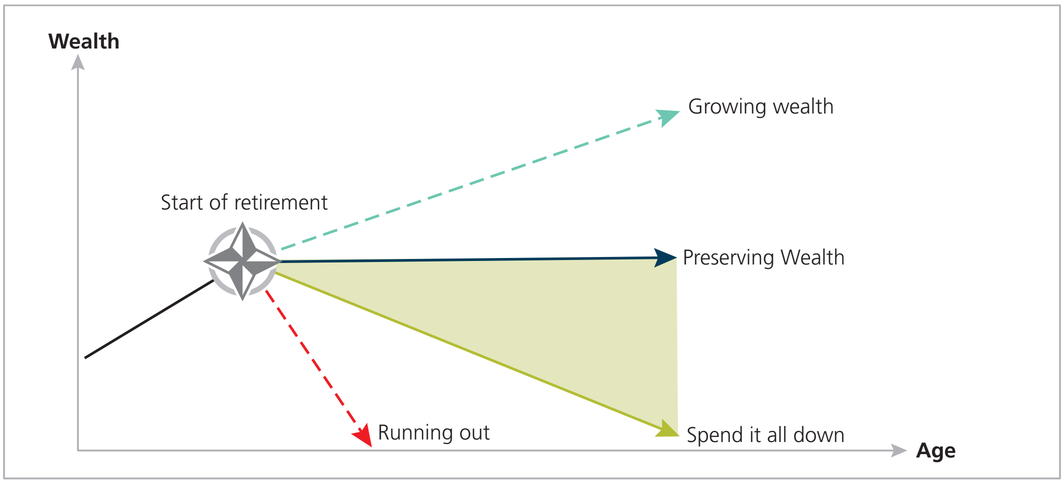
17 Mitchell, Olivia S. and Utkus, Stephen P., Lessons from Behavioral Finance for Retirement Plan Design (October 2003). PRC Working Paper No. 2003-6 <https://ssrn.com/abstract=464640> provides background to some of the issues. See also Allianz/ Shlomo Benartzi: Behavioural Finance and the Post-Retirement Crisis: <http://befi.allianzgi.com/en/Publications/Documents/allianz-dol-rfi-response.pdf>and What Now? How Retirees Manage Money to Make It Last Through Retirement, Report of Findings, AARP and American Council of Life Insurers, Dec 2007 <http://assets.aarp.org/rgcenter/econ/guaranteed_income.pdf>.

7. Wealth segmentation and spending rate

A way of clearly seeing the cohort most in need of improved retirement income products and advice is to segment retirees according to their wealth at the start of retirement and their spending intentions. A stylised form can be seen in Figure 2, which highlights that retirees fall into four broad segments: those will continue to grow their savings throughout retirement; those who maintain or preserve their wealth; those who spend all their wealth down over their lifetime; and those who run out of savings and become completely dependent on the age pension.

As the super system matures, the cohort of retirees who spend all their wealth down quickly and rely on the age pension will decrease. Most retirees with less than $1.6m in retirement savings will be in the yellow zone in Figure 2. These retirees will have a material level of retirement savings, but not so much that they can preserve or grow their wealth, and they will not be able to ignore the risk of running out. To maximise their standard of living, they will need to spend a substantial part of their savings. They will need specialised retirement income products and targeted financial advice to enable them to do this with peace of mind.

Figure 2: Retiree spending paths – highlighting the emerging mass-market need



Most retirees will not be able to ignore the risk of running out of money

We save up our super individually, but most of us spend it jointly in retirement

8. Household view

In practice, retirement spending happens at a household level. This is another big challenge: we save up super individually because it's employment-based, but most of us spend it jointly in retirement. Sharing a roof is the most basic element of shared consumption of retirees. In the 2016 Census, nearly 70%[18] of people aged 60-64 were married or partnered and less than 20% were living alone.

While it is important not to forget the minority of singles and the extra burden they often face, the majority engage in, and benefit from, pooled household consumption. Where possible, all participants in the retirement income system (ie policy-makers, funds and advisers) need to be more accustomed to distinguishing between the solo retirement and the pooled retirement. They are very different experiences and need different treatment. We are often not making this distinction and much of the debate about the gender gap in superannuation overlooks this fact.

9. Success or failure of a retirement plan

One of the biggest challenges in providing appropriate products and advice for the retirement phase is the lack of a clear success measure. In accumulating assets, there is only one goal, accumulate as many assets as possible, with minimal outgoings and an optimal level of volatility to create the largest possible pool of savings. This provides a clear success measure and well-known steps to improve the ultimate outcome, including: asset allocation; saving more; reducing costs; minimising taxes; contributing (working) for longer; right down to the typical competition to get better investment returns. Advisers are well accustomed to working in this paradigm.[19]

In retirement, typically, there are four forms of expenditure to plan for:

- Everyday living costs which requires predictable and regular cash flows. These can be further divided between needs (essential expenditure) and wants (discretionary expenditure);
- Emergency or lumpy items (financial assistance for an adult child or renovating a bathroom);
- Expenditure beyond life expectancy (which is itself only an expectation based on averages); and
- Bequests for the estate.

Success will often involve meeting all these objectives; making success much more difficult to measure in retirement.[20] Retirement advice also calls for a focus on the lengthy time horizons involved. Retirees who start spending in year 1 of retirement need to know how that is going to affect the availability of income in year 20 and beyond.

18 The exact figure was 69%.

19 J. Stock, W. Sharpe and J. Watson, 2009 'The 4% Rule - At What Price?' Journal of Investment Management Q3 2009 provides a discussion on the different costs associated with failure and the surplus with success for a retiree following a simple plan.

20 A discussion of some of these objectives in an Australian context can be found in 'Retirement Solutions I: Gaps in the state of the art' Russell Investments, April 2012 <https://russellinvestments.com/au/insights/library/retirement-solutions-i--gaps-in-the-state-of-the-art>

10. Implications for advice standards

The predominant focus of super advice, historically, has been building wealth for investors while they are in the workforce. Retirement advice has often focused on tax strategies that, until recently, were available in transitioning to retirement, and estate planning. Currently, only the leading advisers provide advice on spendable cash flows, the sustainability of retirement savings, mitigating longevity risk, cognitive decline and aged care.

A key challenge for FASEA in designing new standards and education pathways for all advisers is the difference between the government's objective for superannuation and the typical role of the adviser to date. Financial advice was developed as a wealth management tool, focussed on growing and preserving wealth and this is still largely reflected in the training advisers receive today.

On the other hand, the government sees the role of super as providing income through retirement, which includes consuming capital to create a higher standard of living for retirees. The $1.6m transfer balance cap is designed as being enough to provide $100,000 a year across an average retirement, but only if all capital is consumed. The age pension taper rate clearly contemplates a reduction in accumulated savings through retirement. As means reduce via spending, support from the government increases through the age pension.

FASEA will need to contemplate the advice needs of the cohort of retirees who will spend down their capital through retirement, rather than the traditional wealth management cohort who aim to preserve retirement capital. This should be reflected in the content of courses that are approved for existing advisers, as well as the training requirements for new advisers.

The risk of running out of money in retirement cannot be managed by most retirees on their own

11. Call to action

People are living longer than was envisaged when we designed our super system. The system is working well in building up retirement savings. Typical household super wealth at retirement is in the $350,000-500,000 range and increasing.

This wealth was accumulated to provide income in retirement, but the system is not yet set up to do this next phase successfully. It is increasingly clear that many Australians will be substantially living off their own resources in retirement. Private provision of an age pension-like outcome will be increasingly important part of retirement income plans.

The risk of running out of money in retirement cannot be managed by most retirees on their own. This risk needs to be pooled or outsourced to a stronger balance sheet.

We can contribute to addressing these issues comprehensively as part of the government's CIPR framework reforms, now focused on a potential governance solution. In addition, there are various consultations being run by FASEA on the reform of the training, competence, standards and ethics that should apply to financial advisers. Between these two reforms initiated by the current Coalition government, there is every chance that we can create a world-class retirement income system.

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21 Ibid 11.

The information in the report has been compiled by the Challenger Retirement Income Research team.

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