Retirement Security in Australia

2021 White Paper

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Introduction

Michael Pennisi

Chief Executive Officer of QSuper, QSuper Limited and QInvest Limited

As one of Australia's largest and oldest superannuation funds, QSuper is here to grow our members' super. Today we administer approximately $117 billion in retirement savings for more than 594,000 Australians. As a profit for members superannuation fund, everything we do is for our members, including working hard to maximise returns through our unique investment strategy, providing innovative products and services, and striving to keep fees as low as possible.

I and everyone at QSuper are very aware that we are the custodians of our members' superannuation savings and that our members put a great deal of trust in QSuper to help them achieve the retirement that they deserve.

When I reflect about our role in protecting members, a significant additional risk I think about is the risk that our members may run out of money during retirement or, as we quite often see, live quite frugally in retirement for fear that they will consume all of their retirement savings prematurely.

To address this risk, QSuper has been working hard in the background to develop a product to provide greater confidence to members and to deliver an income stream such that they can have comfort that their retirement savings will be there for their whole retirement.

This white paper provides some insight into the social, demographic and economic background that has informed our thinking around retirement security, our considerations of the role of superannuation in Australia, and QSuper's response to the retirement income product needs of Australian retirees.

Michael Pennisi

Executive Summary

- Australians have the fortunate prospect of longer lives but the challenge of how to sustain them financially while maintaining physical and mental wellbeing.

- The nation has a well-developed retirement income system, supported by a combination of private savings and a safety net pension system, described in a federal government Retirement Income Review (2020) as one of the world's best.

- A series of reviews has put more focus on ageing issues – both the financing of retirement and the care available as people lose their independence.

- The Covid-19 pandemic has highlighted issues with the system – a loss of salary income and reduced investment returns through slower economic growth will impact retirement balances. The early release scheme of 2020 will also reduce the balances of those who needed to access superannuation funds to support living costs.

- This has generated debate about the need for legislated increases to the Super Guarantee levy to proceed and raised questions about whether the increase would be better paid as salary for immediate consumption or household saving.

- Retirement tends to have three phases – the active phase of intense activity, the passive phase of more leisurely activity and the frail phase which requires higher care. Each has different financing needs which the retirement income system needs to cater for.

- A possible problem with the current system is a tendency for retirees to underspend through unjustified fear they will have insufficient funds to see them through their life's needs.

- A good solution could be a pensions system that provides a steady and predictable income stream supported by sound advice and reliable products. This increases quality of life for retirees.

- Account-based pensions are the most popular form of converting superannuation retirement balances to regular income but strong value could be gained from annuity-based products which pool savings to guarantee income.

- QSuper has developed a solution which offers predictable earnings by pooling funds and taking full advantage of government incentives designed to encourage certainty and improve retirees' financial and mental wellbeing.

1

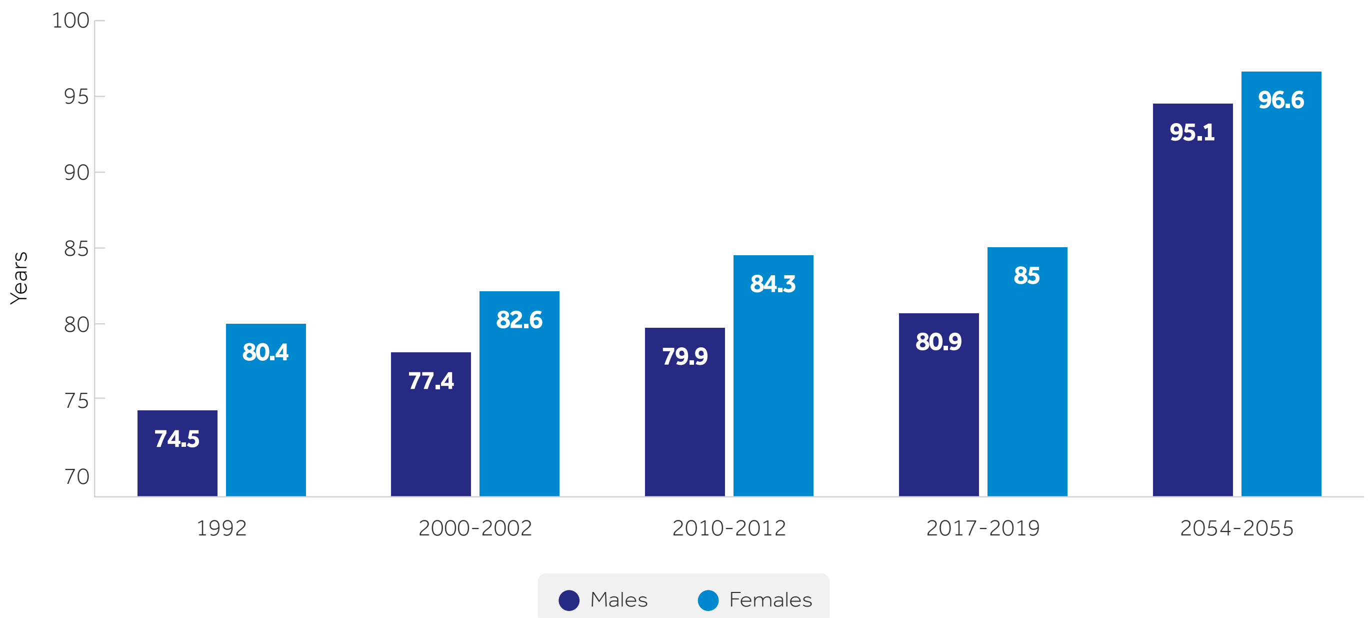
Part 1: Longevity and retirement in Australia

Longevity trends

Over the past few decades, retirement norms in Australia have evolved from a short period of post-work time to a fully developed lifestyle stage. Improved healthcare and an active exercise culture mean Australians are living longer and are more active and engaged in their retirement years. Current life expectancy for a child born in Australia today is 80.9 years for men and 85 years for women.[1] By 2054-55, life expectancy at birth is projected to be 95.1 years for men and 96.6 years for women.[2]

With baby boomers entering retirement and increasing longevity of today's population, retirement is no longer a short period after work but a lifestyle.

Research by Mercer found that some 20% of white-collar male and females are now expected to live to age 94 and 96, respectively. And 5% of the male white-collar cohort will live to age 99, with females living beyond 100. These statistics suggest that Australians planning to retire in their 60s potentially face a very long retirement period, which they will need to fund.



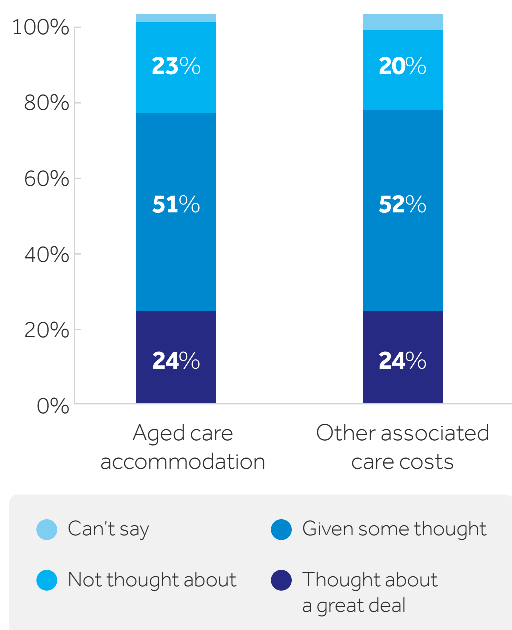
Source: ABS cat. no. 3105.0.65.001 and Treasury projections

1 Australian Bureau of Statistics (ABS). Life tables, 2017-2019.
2 2015 Intergenerational Report Australia in 2055. Published March 2015.

Healthcare costs, aged care accommodation and general wellbeing are important considerations for retirement. With the high life expectancies experienced by Australians, having a retirement plan that gives reasonable weight to aged care and associated costs is inevitable.

A 2014 survey by National Seniors Australia and Challenger[1] found that approximately three-quarters of seniors have given thought to the cost of aged care and other associated care costs.

Q: How much have you thought about the cost of future aged care needs



Source: How realistic are senior Australians' retirement plans? A report by National Seniors Australia and Challenger. Published July 2014.

The above survey also reported that over half of seniors planned to sell their family home to pay for the cost of aged care accommodation and related care costs. Given the high level of sentimental value associated with the family home, and the desire of many to use this as bequest, it remains a challenge to see this plan translated into action.

Retiring presents unique financial risks that make investing in retirement very different from saving and investing in your working years. One of the biggest risks in retirement is longevity, which is the risk of outliving your savings. As no one really knows how long they are going to live, or how their investments will perform, managing this risk can be difficult. Many pre-retirees and retirees also tend to underestimate their life expectancy, increasing the risk of outliving their savings. A National Seniors Australia survey found respondents underestimated their life expectancy by about five years.

Besides managing the risks associated with longevity and retirement, there remains several unknowns in retirement planning. How much you'll need in retirement, how long you'll live for and how long your savings will last are a few of the unknowns about retirement. However, the existence of Australia's compulsory superannuation system presents a universal opportunity to save for retirement. According to the Retirement Income Review (RIR) released by the government on November 20, 2020, Australia's superannuation system is ranked among the best in the world. A compulsory savings scheme means many Australians are contributing towards their own retirement.

There are also other benefits such as income protection and life insurance through the superannuation system. However, as noted by both the RIR and the Financial Services Inquiry (FSI) from 2014, the retirement phase of Australia's superannuation system has significant challenges. Primarily, there is no clear legislated objective for the superannuation system. The FSI recommended to set a clear objective for the superannuation system to provide income in retirement, and that superannuation funds have a retirement strategy for all members to meet this objective.

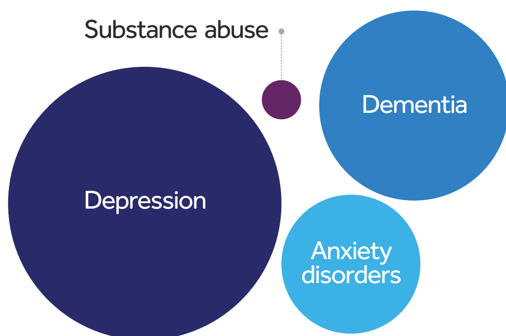
1 How realistic are senior Australians' retirement plans? A report by National Seniors Australia and Challenger. Published July 2014.

Mental health, healthcare and aged care

Mental health of older Australians

General wellbeing is an important element of enjoying retirement, and many super funds support the wellbeing of their members via education and information.

Globally, an estimated 15% of adults aged 60 and over suffer from a mental disorder with more than 6% of all disability linked to mental or neurological disorders.[1] According to the World Health Organisation (WHO), mental health problems are commonly under-identified by health-care professionals and older people themselves, with many people reluctant to seek help with mental health conditions due to the stigma associated with it. The most common mental and neurological disorders in this age group are dementia and depression, which affect approximately 5% and 7% of the world's older population, respectively. These form an unspoken part of retirement which generally cannot be planned for.



COVID-19 has challenged the mental health of older Australians, via lockdowns, mobility restrictions and social distancing.

Australia went into lockdown, and other lockdown measures have been imposed in different states and places. A number of mobility restrictions were enforced for several months in the approach to contain the pandemic. Among the measures taken and encouraged is social distancing. Social distancing, though a major strategy to fight COVID-19, is also a major cause of loneliness. In a pandemic, this creates an immense amount of stress for both adults and children, increasing stress and anxiety. However, in settings like nursing-care or old-age homes, loneliness is an independent risk factor for depression, anxiety disorders, and suicide.

Among other issues, the pandemic has brought to light the need for more support towards mental health.

Healthcare and aged care

Older adults may require long-term care for several reasons, such as reduced mobility, chronic pain, frailty or other health problems. Furthermore, experiences such as bereavement, reduced wealth, loneliness or psychological distress in older people may result in a need for care which may be unplanned or unexpected.

Uncertainty around the future need for long-term care adds to the complexity of retirement planning.[2]

It is well-known that the COVID-19 pandemic has disproportionally impacted older Australians, with this cohort being at the highest risk for both severity and mortality.

The pandemic has opened up discussions about the significance and dignity of a phase of retirement and life that is not often discussed: the latter years when one lives in an aged care home or home care. The pandemic has highlighted some pre-existing issues with the aged care system, and it is hoped that in finding solutions to these issues, all parties come together to support older adults to have a dignified aged care and healthcare experience.

Reference: Royal Commission into Aged Care Quality and Safety, Interim Report: Neglect, 2019

1 World Health Organisation. Mental Health of Older Adults factsheet, accessed January 2021.
2 See Royal Commission into Aged Care Quality and Safety, Interim Report: Neglect, 2019, vol 1, pp 186–190; 217–227

2

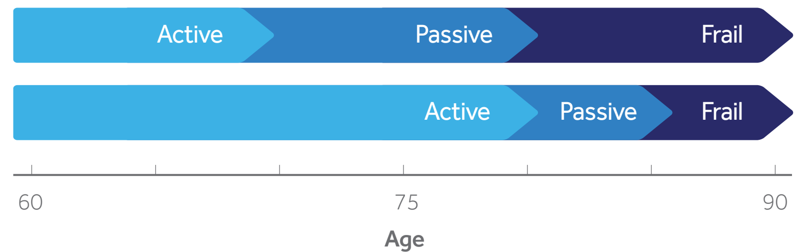
Part 2: Retirement stages and spending patterns

While there are no fast rules on when to retire, the conventional wisdom is that people retire in their mid-60s. This is reflected in age eligibility for the age pension in Australia.

Your birthdate	Your Age Pension age
1 January 1954 to 30 June 1955	66 years
1 July 1955 to 31 December 1956	66 years and 6 months
On or after 1 January 1957	67 years

In reality, though, retirement and the decision to retire is usually more complex than that. Retirement stages may be classified into three; active, passive and frail.[1] While these stages may overlap and will vary for individuals, it broadly encompasses the retirement phase. An effective retirement plan will budget for these three major stages.

The diagram below shows the three different stages in retirement and the varying ages that may be covered by each stage.



The active phase is representative of early retirement when the retiree is generally in good health and can choose to work full or part-time. This stage may extend from retirement until early 80s for some, while others may move to a more passive phase earlier, depending on their health status. In the active stage, retirees can explore new hobbies, volunteer, and engage in activities such as and travelling and home renovations. Not much health spending is required in this stage.

The passive stage is when physical fitness slowly declines, and retirees adapt to less-strenuous activities, community engagement and volunteering. Health expenditure begins to increase at this stage as expenses on hobbies and other activities decline.

The frail stage, in late retirement, is usually characterised by high health care costs and low mobility. Retirees spend less on everyday activity and more on age and health care.

1 The classification of these three stages originates from Michael Stein's 'The Prosperous Retirement: Guide to the New Reality'. **7** AIST report: Expenditure patterns in retirement. Published August 2016

There is ample evidence in recent comprehensive surveys in many countries about income needs in retirement. The studies conclude that annual spending in retirement tends to reduce over time. This finding is consistent across different wealth groups. One explanation for the observed decline is that it reflects the need for precautionary savings for out-of-pocket healthcare needs in late retirement. However, evidence of similar declining trends in other countries where such health costs are less substantial suggests that the decline cannot be attributed solely to later-life healthcare costs. More realistically, this decline in spending can be attributed to the decrease in utility derived from large spending such as vacations, purchases of cars, homes and expensive meals in late retirement.

Australian evidence[1] compiled by the Australian Institute of Superannuation Trustees (AIST) and the Australian Centre for Financial Studies (ACFS) suggests that this decrease in real spending is not evident among Australian retirees. This conclusion is based on analysis of retiree household spending in the Household Income and Labour Dynamics Survey (HILDA) data. A major shortfall of this survey is that it does not collect information on discretionary spending on vacations and other large entertainment expenditures in retirement which other studies have found to be a primary driver of the reduction in spending in later years.

ASFA Retirement standard has attempted to address this by publishing a separate retirement standard budget for individuals and couples aged 85 years and over. These are lower than the budgets for households of retirees aged around age 65 years.

Recent studies report that in real terms, retiree spending decreases slowly in the early years, more rapidly in the middle years, and then less slowly in the final years, in a path that looks less like a slow and steady decline and more like a "retirement spending smile" instead.[2]

We believe that despite the lack of clarity on specific age ranges on the three stages of retirement, they remain essential in retirement income planning. It is important to understand that the different stages of retirement require different income levels for a sustainable retirement based on the above discussions. This should be critically considered in income-level decision making and solutions.

1 AIST report: Expenditure patterns in retirement. Published August 2016
2 Blanchett, David, (May 2014): Exploring the Retirement Consumption Puzzle, Journal of Financial Planning; Denver Vol. 27, Issue. 5, 34-42.

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Part 3: Economic impact of & responses to COVID

The federal government's response to the COVID-19 has sought to provide financial assistance and support to individuals and households through the economic impacts of the pandemic. Some of these impacts are discussed below, and may potentially have long-term implications for retirement planning and retirement income in Australia.

Un/employment

Before COVID-19, the participation of older people in the labour force was trending upwards. At a global level, the share of older persons in the labour force increased by almost 10 per cent in the past three decades. According to the International Labour Organisation (ILO) these trends may be explained by demographic shifts including gains in life expectancy, the reduction of fertility rates and the resulting ageing of the population. Economic changes may be a driver in this evolution, as we observe insufficient old-age pensions leading older workers to postpone their retirement.[1]

With the onset of COVID-19, social distancing, self-isolation and travel restrictions led to a reduced workforce across all economic sectors. In November 2020 over 950,000 Australians were unemployed,[2] Australia's unemployment rate was 6.8% and another 9.4% were underemployed.

The pandemic briefly drove Australia into its first recession since 1990-91 (recession defined as two consecutive quarters of negative growth).[3] However, key economic indicators returned to positive territory in the September 2020 quarter, and Australia continues to be in a much better position compared to several developed countries.

Historically, after events that cause market volatility and unemployment, older workers were less likely than younger workers to lose their jobs. However, those who lose their jobs may find themselves near the back of the line when employers begin rehiring. An American survey[4] found that after the Global Financial Crisis (GFC) in 2007-2009, American workers aged 62 and older who were unemployed, were about half as likely to become re-employed as their counterparts ages 25 to 34. And when unemployed older workers found a new job, they earned barely half as much as they did on their previous job. For people close to retiring who have lost their jobs, this is an unsettling reality, a red flag in the lead up to the next phase.

Future investment uncertainty

When we encounter events such as the GFC and more recently COVID-19, some people may seek to find a safe haven for their investments.

As an example, the 2020 share market volatility caused by COVID-19 prompted a small but significant percentage of QSuper retirees to reallocate a larger amount of their retirement funds into cash. The cash allocation of retirement funds under management more than doubled, from approximately $500 million in January 2020 to $1.1 billion in June 2020.

In trying to avoid market volatility risk – some investors inadvertently lock themselves out of future share market increases by investing conservatively. This may also leave them vulnerable to inflation risk; this is the risk that investment returns do not grow enough above inflation, meaning that a retiree's money will effectively be worth less than when they invested.

Another interesting observation during the recent pandemic is that many people looked to take advantage of the market uncertainty in early 2020 to make quick money. A record number of people opened share accounts and began trading shares while in lockdown, and ASIC analysis revealed a substantial increase in retail activity in the share market.

1 Source: ILOSTAT, ILO Labour Force Estimates and Projections, November 2017 and UN, World Population Prospects: 2017 Revision.
2 Australian Bureau of Statistics (ABS) Labour force, Australia. Reference period November 2020. Published December 2020.
3 ABS. Australian National Accounts: National Income, Expenditure and Product, June 2020.
4 Urban Institute. Age Disparities in Unemployment and reemployment during the Great recession and recovery. Published May 2012.

> "ASIC analysis of markets during the COVID-19 period has revealed a substantial increase in retail activity across the securities market, as well as greater exposure to risk. We found that some retail investors are engaging in short term trading strategies unsuccessfully attempting to time price trends.
>
> Trading frequency has increased rapidly, as has the number of different securities traded per day, and the duration for holding the securities has significantly decreased: indicating a concerning increase in short-term and 'day-trading' activity."
>
> ASIC media release: Retail investors at risk in volatile markets.

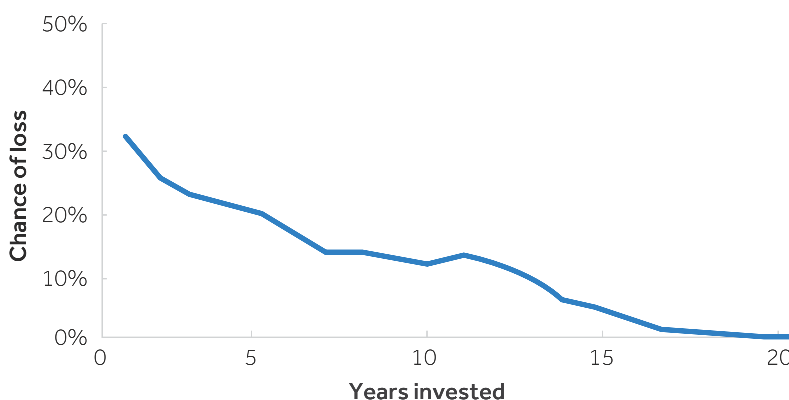
Significant market uncertainties and events have a potential ongoing impact on pre-retiree and early retirement investments, as it exposes their savings to what is termed "sequencing risk". This is the risk that the order and timing of one's investment returns are unfavourable. For a pre-retiree, this may result in less money for their retirement. For a retiree drawing an income from their investment on a regular basis this, coinciding with a sharp decrease in investment returns, means selling more of their investment to provide the same level of income.

Australians approaching retirement and in early retirement have the highest average superannuation balances.[1] This puts them at the highest risk of large losses in the event of falling investment markets as they do not have the time, compared to say a 30-year old, to accumulate to cover these losses before retiring. For these members with a larger amount of money at risk, the order (or sequence) of returns in the last decade of their working life is considerably more important than the average return they will receive over the decade.[2]

To echo what super funds continually say; past performance is not a reliable indicator of future performance. While historical returns may help to forecast a wide range of future investment returns, the future, as the saying goes, is uncertain. For anyone who does research or practices in the area of pension and retirement finance, we are essentially working in a field where decision making under such uncertainty is the core task.

Although having a good level of savings for retirement is important, the choice of retirement products and high-quality advice may be necessary to ensure that these savings last for the remainder of a person's life. In the current low interest rate environment and uncertainties with financial markets, there is still one thing economists agree we can count on. In the near future, stocks could keep ahead of inflation and may increase the purchasing power of your money. The biggest caveat here is that timing is everything. For a short investment horizon, stocks may not be your best bet, but your odds may improve significantly with time (see image below).

Chance of losing in the stock market



Compiled by Nobel laureate Robert Shiller.

While this is great news for Australians with long periods until retirement, it is no consolation for pre-retirees who do not have a 20+-year investment horizon. It is also worth mentioning that a positive long-term outlook does not show the associated volatility along the way, which may be a deterrent for many who do not have the tolerance for such volatility over the leading short periods.

1 Source: Association of Superannuation Funds of Australia, Experience to date with the early release of superannuation, June 2020, pg. 15.
2 See Basu, Anup, Doran, Brett, & Drew, Michael (2013) Sequencing risk: The worst returns in their worst order. JASSA, 2013(4), pp. 7-13.

Government COVID interventions

The Australian government's response to the recent pandemic has been widely endorsed by many. It is touted that the country has averted a major health crisis and is on track for economic recovery. Interventions such as JobKeeper have enabled employers to continue to keep their employees on payroll, and the Jobseeker payment boost helped those who were unemployed to meet their living costs.

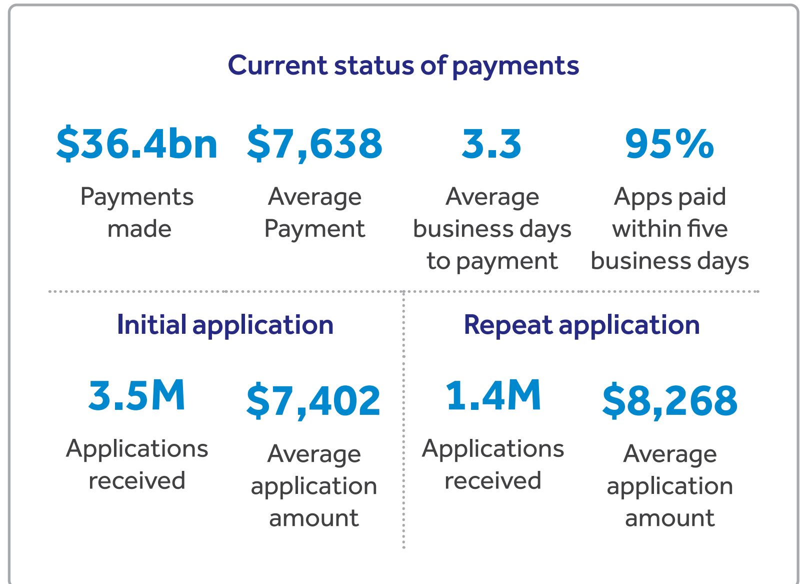
The upper deeming rate for income in excess of the income threshold reduced from 3% to 2.25%, and the lower deeming rate from 1% to 0.25% for those eligible for the age pension. And a raft of other measures including early childhood and education relief, temporary cashflow support and lump-sum cash payments helped to financially buffer Australians and the Australian economy.

Two new temporary schemes that directly impact retirement and the superannuation industry were the early access to super and changes to account-based pension income minimum drawdown rates.

Early access to super

On March 22 2020, the government announced that individuals who were financially impacted by the coronavirus may be able to have early access to their super, through to 31 December 2020.

If a person was eligible, they were able to withdraw up to $10,000 in 2019-20, and another $10,000 in 2020-21. The government's decision to allow members to withdraw their super early was met with mixed reaction. As at 31 December 2020, APRA advised that $36.4 billion had left the superannuation system due to this initiative. This involved 3.5 million initial applications, and 1.4 million repeat applications.



Source: Australian Prudential Regulation Authority (APRA). COVID-19 Early Release Scheme – Issue 36

The scheme has allowed many Australians to completely empty their super accounts as part of the $36.4 billion in early access withdrawals. The impact of low balances and closed accounts for long-term retirement planning cannot be underestimated. Withdrawing early from super means many people will miss out on compounding interest, which over several decades represents a significant amount foregone in retirement savings.

As at September 2020, QSuper paid out over $670 million to approximately 83,000 applicants. This represents over 51,000 members, with about half this number making two claims across the two financial years. Another important highlight is that over 4,000 accounts have either $0 balance or below $6,000 after this withdrawal, with a proportion of members exiting their accounts.

Change to minimum drawdown rates

In March 2020, the Government also announced a temporary reduction to superannuation minimum drawdown requirements for account-based pensions (such as QSuper's Income account) and similar products by 50% for 2019-20 and 2020-21. QSuper data shows that a significant number of retirees have taken this option, cutting their regular incomes by half.

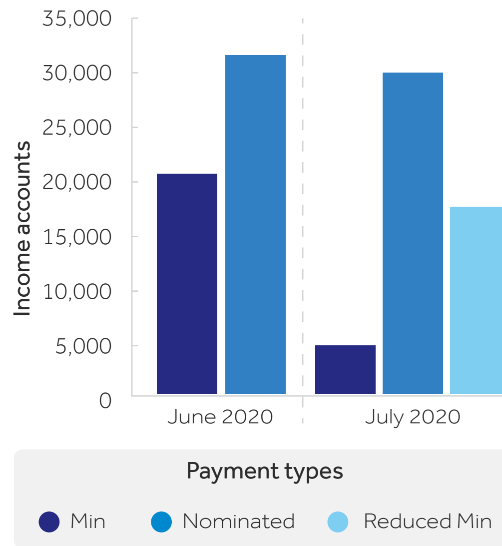
It is important to note that there is no maximum amount of income that can be taken from these products; this change only affects investors choosing to take the minimum payment possible.

Your age	Minimum payment mount for 2020-2021 financial year
Under 65	2%
65-74	2.5%
75-79	3%
80-84	3.5%
85-89	4.5%
90-94	5.5%
95 or over	7%

This option offers flexibility for retirees, reducing the need to liquidate larger amounts of their investments during what may continue to be an uncertain time in the market. With the halving of rates, retirees can avoid capitalising their losses while keeping more of their funds invested.

QSuper data suggests approximately 21,000 Retirement Income accounts were on the minimum drawdown option as at June 1, 2020 before the new minimums came into effect (became default). As at July 30, only 5,000 accounts remained on the default minimum drawdown, with about 17,800 accounts reducing their drawdowns to the new reduced minimum.

QSuper minimum drawdown changes (2019/20-2020/21)



There are more QSuper Retirement Income accounts on the nominated income drawdown option. This income level is higher than the minimum drawdown, and members may choose this option when they need more income than provided by the minimum. This means a higher proportion of our retirees remain unaffected by this change to drawdowns.

For retirees drawing a nominated income amount, they enjoy the benefit of stable incomes as economic volatility (changes to their balance) does not impact their income amount. Members' drawdown option, however, changes their portfolio life expectancy (i.e. when their account balance is expected to be depleted). On the other hand, retirees on the minimum rates are guaranteed not to run out of money but have to accept volatile income that is expected to increase over time, even though expenditure is expected to decrease. The drawdown choice leads to very different risks being borne by retirees with many moving to a lower level income to preserve the certainty of their income (not their income levels necessarily) and to ensure that they do not deplete their account balances.

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Part 4: The future of pensions

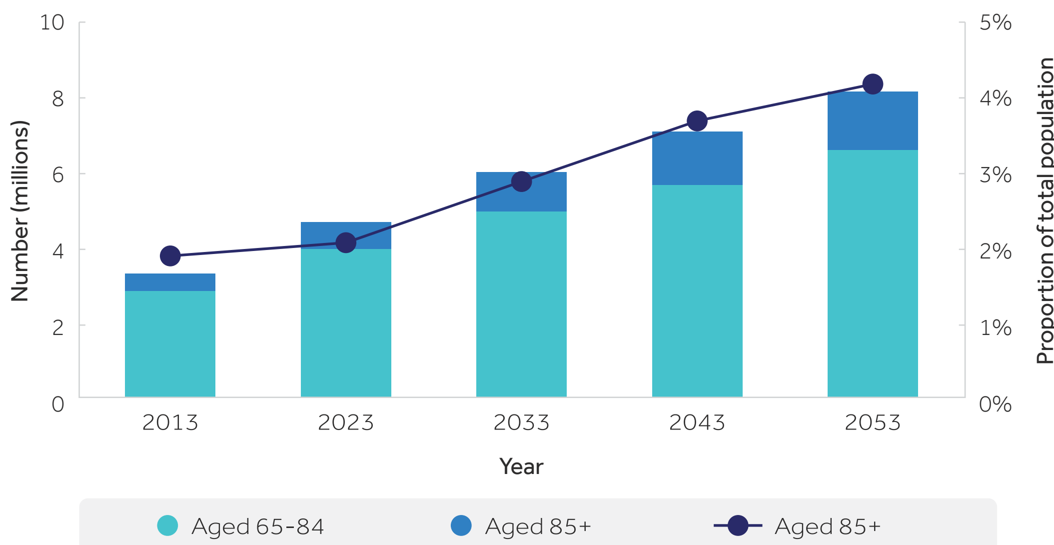
Deficits and demography

During 2020, Australia's economy fell – briefly – into its first recession in 30 years, with gross domestic product shrinking 3% in the first quarter of 2020, followed by a reduction of 7% over the April – June quarter10. The temporary schemes introduced by the Australian government to manage COVID-19 come at a cost to the Australian taxpayer.

Demographic changes also mean that older Australians are accounting for an increasing proportion of the Australian population.

In 2013, 14% of the population (3.3 million people) were aged 65 and over and 1.9% were aged 85 and over (439,600 people). By 2053, based on Australian Bureau of Statistics (ABS) medium-level growth assumptions, 21% of the population will be aged 65 and over (8.3 million people) and 4.2% aged 85 and over (1.6 million people).[1]

Number and proportion of older people, 2018-2053



Note: Data are as at 30 June. Data presented for 2023 onwards are based on population projections (series B).Sources: AIHW analysis of ABS 2013a, 2013).

What these changes mean for the age pension

On 9 March 2016, the Government released a discussion paper, '[Objective of superannuation]', to provide the basis for further consultation on establishing an objective for the superannuation system. The Government's preferred objective, identical to the Financial SI recommendation is – 'to provide income in retirement to substitute or supplement the Age Pension.'

Further consultation and submissions suggested that most major interest groups support the idea that there should be a legislated objective for the superannuation system. The differences, however, lie in the expression of this objective. The Age Pension was one that was repeatedly mentioned in the objective by various interest groups.

The Australian government spends $50 billion each year on the age pension and another $30 billion on superannuation tax breaks.[2] Spending on the age pension has been slowing despite the ageing of Australia's population. Australia spends just 4% of GDP on pension benefits (including disability

1 Australian Institute of Health and Welfare 2014 Australia's health 2014. Australia's health series no. 14. Cat. no. AUS 178. Canberra: AIHW.
2 Grattan Institute: Superannuation review first must set goal posts. Published May 2019.

and other pensions) and is expected to spend just 3.7% by 2055.[1] With more than 3 million Australians dipping into their super for COVID-19 relief, previous forecasts on age pension spending may need to be revisited. This will become necessary as the uncertainties of the financial market and budget deficits resulting from the pandemic and the government's response begin to bite. There is also the possibility of a delay to the legislated increase in the superannuation guarantee.

Security in old age

Can we depend on the age pension being available in the future, or are there other options? In the aftermath of COVID-19, massive economic reforms may be needed to bring the country back to some form of normality. This may take years, and among other discussions of ways to save money and grow the economy, addressing issues related to the retirement system will be a key one. A $3 trillion superannuation sector cannot be left out of any large economic reform conversation. The compulsory nature of superannuation and the various associated tax concessions help to create a financially secure future for many Australians. This will likely lead to a reduced cost of providing for age pension.

Superannuation and private savings have a complicated relationship to the age pension. With eligibility for the age pension based on an asset and income means test, the more private savings (whether inside or outside super) an individual has, the less age pension they are likely to receive – if any. For many, this may provide a disincentive to save amounts beyond the compulsory contributions.

On the other end of the spectrum is the idea of a universal age pension as administered in New Zealand and the Netherlands. Of course, such an approach would mean every aged person would receive a pension so the costs to government would increase significantly and would necessitate changes to the tax system or level of pension payments to find these costs. Under this approach, every dollar you save you keep, as there are no means tests. While this may sound attractive, the possibility of a full overhaul of the retirement system is unlikely, considering the cost of such a system change.

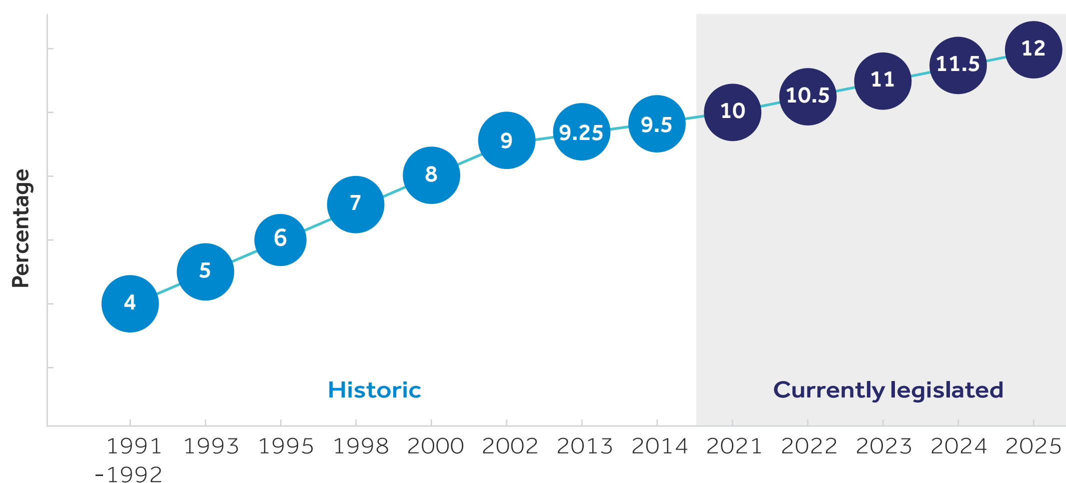
Somewhere in the middle is the Denmark approach, where half the pension is paid to everyone and the balance is income tested. This effectively provides a basic minimum wage to avoid poverty in retirement. Australia's old-age relative income poverty rate is high at 23% compared to 14% across the OECD in 2016. Women had a slightly higher prevalence to be in poverty than men with single older women more likely to be living in poverty.[2] Retirees who rent are also more likely to experience retirement poverty.

One way to reduce poverty in old age is to encourage higher contributions towards retirement when young people are working. This means forgoing current spending for future spending, a core argument in the superannuation guarantee debate.

1 Grattan Institute: Commonwealth Orange Book 2019: Policy priorities for the federal government. April 2019.
2 Pensions at a glance 2019, How does Australia compare? OECD, November 2019.

The Superannuation Guarantee debate

The superannuation guarantee is currently 9.5%, legislated to increase to 10% in July 2021 and annually thereafter to 12% by July 2027. There is some concern that the government is hesitant to proceed with the legislated increase. This has met with mixed reactions. The Retirement Income Review final report has a big focus on the increase to the SG and its impact on wages growth.



Some commentary questions the relevance of the entire superannuation system, arguing that it is unfairly stripping wage earners of immediate access to their own money. They believe that it should be up to individuals to decide whether they will put money aside for retirement, and to choose how much they want to save. Research, however, has shown that unless there is some nudge or compulsion, many people will not voluntarily save for retirement. For those who save for retirement, many will not save enough to sustain their retirement lifestyle. Australia's compulsory superannuation system, whilst not perfect remains among the finest systems globally.

Association of Superannuation Funds of Australia (ASFA) argues that for many young people who are facing long-term unemployment, a higher superannuation guarantee is 'critical'. Given the significantly high number of people who have taken up the government superannuation early access scheme and emptied or reduced their accounts, not increasing the SG will have severe long-term impacts. Analysis of individuals who have used the early access scheme shows that many of these people are young people who have lost their jobs. Industry Super Australia estimates that approximately half a million Australians have "completely cleaned out" their superannuation accounts, 460,000 of which are under the age of 35.

On the other hand, the Grattan Institute research shows that most working Australians today can afford a retirement lifestyle that is on par with their current standard of living, and often higher. The research paper released in February asserts that workers effectively paid for increasing the super guarantee with lower wages. They argue against an increase to the superannuation guarantee. They advocate for more support to retirees who rent as well as women on low incomes, both segments being largely at risk of poverty in retirement.[1] The argument of a legislated increase of the superannuation guarantee impacting wages was echoed by the governor of the Reserve Bank, Philip Lowe saying the government will need to be mindful of the impacts of the increase. He advised that the increase could impact not just wages but spending and employment.

The Retirement Income review asserts that increasing the SG will come at a massive cost to the budget and will come at the expense of wage growth. It concludes that people can achieve both higher working life income and retirement income if they draw down their superannuation more efficiently. This does not end the debate, afterall, there has been six years of evidence that keeping the SG rate steady does not translate into strong wage growth.

1 No free lunch: Higher superannuation means lower wages, Grattan Institute, February 2020.

The superannuation guarantee debate revolves around the superannuation guarantee slowing down possible future wage increases, and whether another delay in increase is only compounding on future Age Pension costs. It doesn't help that this decision has come at a time when Australia is in a recession and during a global pandemic. Is this the right time to concern ourselves with encouraging savings or should we be supporting spending to boost the economy? Current government initiatives to address COVID such as early access to super will have a significant impact on the future of super and retirement. For many Australians entering retirement in the next few decades, whatever decision is taken regarding the superannuation guarantee will have an impact on the outcome of their retirement. This decision is one that requires careful consideration, as there are more factors to consider today than otherwise will be needed for such a decision.

If the goal is to ensure that savings are efficiently spent in retirement and not left as a bequest, increasing the SG or delaying the increase both have merits and demerits and will impact people in different income categories differently. In putting our efforts and arguments towards the goal we're trying to achieve for retirees – it is imperative for superannuation to have a clear objective – to help people retire on an adequate level of income.

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Part 5: What Australians need from their superannuation

The sole purpose of superannuation is to provide income in retirement. It is therefore no surprise that a large proportion of people primarily want their savings to generate a stream of income in retirement. Our own evidence from talking to our members suggests that besides the need for periodic income from their superannuation balance, they also expect to be able to have easy access to their balances for lump sum drawdowns which enables them spending flexibility. Finally, many retirees expect to be able to leave some of their superannuation balances to their beneficiaries or reversionary as a bequest in the event of early death.

This demonstrates that to support their members, super funds may require a retirement strategy and available resources. This could be a suite of education, advice, products and services. The diverse retirement needs of Australians may not be met with a single product, but possibly a combination of products and services. Many super funds provide general advice about topics such as investment options, insurance options, consolidation and super contributions to their membership at no additional cost.

What makes a good retirement income solution?

It is important to have a good understanding of the benefits of different retirement income solutions and how they meet member needs. The heterogeneity of retirement means any solution should have the flexibility to accommodate the different phases of retirement, outlined in Part 2, and the varying income and capital needs of retirees.

From the reduction of minimum drawdowns in the aftermath of the GFC, to the current halving of income drawdown rates, it's clear that simply sticking with the minimum drawdown strategy may not be a reliable strategy for many retirees. A more reliable strategy can help ensure that when such volatile events occur, the retiree has options within their portfolio to maintain a steady income stream at a level relevant for their life stage.

Retirees could also use a simple layering strategy, with a basic annuity style product, ensuring that their everyday needs are met with a guaranteed level of income irrespective of market movements. The relevance of such reliability for income streams in retirement and the importance of lifetime income cannot be understated.

Advice & Education

Good professional advice is an integral part of any good retirement solution. However, many people do not seek professional financial advice in the lead up to retirement, and funds and advisers overwhelmingly recommend account-based pension.[1] Pre-retirees who tend to get advice are generally those with high superannuation balances and other assets, seeking a way to manage their wealth in retirement. This has led to what is termed biometric risk – that most advised clients are often wealthier and therefore healthier than the average, resulting in longer than average lives.

Advice and education about retirement and retirement planning can help people to feel more confident about their retirement. Unfortunately, surveys have shown that the decision to engage a professional advisor is positively correlated to wealth and income levels, and to a lesser degree, marital status, age and educational level.[2] This means the wealthy are more likely to receive advice and be confident about their retirement while the more vulnerable may not. Although not an end in itself, good advice adds value to a person's portfolio, and there are research findings to support the conclusion that obtaining and implementing financial advice in the retirement planning process leads to a demonstrable increase in the level of sustainable retirement spending.

1 Financial Services Inquiry Final Report 2014.
2 The Use and Value of Financial Advice for Retirement Planning, W. V. Harlow, Keith C. Brown and Stephen E. Jenks The Journal of Retirement Winter 2020, 7 (3) 46-79; DOI: https://doi.org/10.3905/jor.2019.1.060.

Retirement products

Account-based pensions

The account-based pension (ABP) continues to be the most popular retirement product in Australia. It is a product designed to draw an income from the retirement savings accumulated over one's working life. The ABP gives members the flexibility to access their super while they receive a periodic tax-free income from their savings. Their savings remain invested and can continue to grow even in retirement.

Most account-based pensions (ABPs) offer a range of investment options to choose from, which are designed to help retirees protect and grow their investment by utilising different asset classes. Super funds usually offer a default investment option if no choice of investment option is selected by the individual. For members who make no active choice, the fund's default investment option aims to support their need for a stable income and steady fund growth.

All investment comes with risk. The key for retirees is to understand the different types of risks and how they might be impacted. While market volatility is a key investment risk that is widely covered and well understood, another important investment risk is inflation risk. This is the risk that investment returns do not grow enough above inflation, meaning that the spending power of a retiree's money will be reduced because of increases in goods and services. Retirees can be vulnerable to inflation risk when in times of market uncertainty as discussed in Part 3, they move their funds into conservative assets such as cash in search of 'safety'. This could increase the risk of early depletion of funds, but there is the potential for negative real returns from cash and other conservative assets in the current low yield environment. With current low cash rates, retirees are effectively paying a premium for the 'safety' of their retirement funds.

Annuities

Annuities are not as popular in Australia as they are in the UK or USA. According to the Australia Prudential Regulatory Authority (APRA), annuities make up 6% of pension member accounts and 3% of Australia's total pension member benefits.[1]

An annuity product can be purchased with a lumpsum from a life company, in return, the life company guarantees to pay the holder a regular stream of income over a specified period or for the rest of their life, depending on the type of annuity. In Australia. retirees can use savings outside super or super money to purchase annuities from a life company.

A life annuity provides lifelong periodic income, and by itself or with the age pension, can provide a basic level of income to cover everyday retirement needs. Annuities provide a reliable source of income, not subject to market fluctuations, giving retirees the confidence that they will not run out of money in the later stages of life.

Despite some benefits of annuitisation, they remain a comparatively unpopular product among Australian retirees. This has led to what some researchers have called the "annuity puzzle". There are many possible explanations for the annuity puzzle. Researchers have hypothesised both rational and behavioural factors, including pricing, bequest motives and lack of understanding.

Can we overcome these barriers to make annuities more attractive? More importantly, can super funds provide members with the sort of certainty in income that comes with traditional annuities?

Group self-annuitisation products (GSA)

Group self-annuitisation, also known as pooled annuities, provides members with lifetime income by sharing longevity experience within a pool. A benefit of such a pooled product is that a large enough pool almost eliminates individual longevity risk. Pool members will still face some level of systematic longevity risk, if the whole population is living longer, although this can be managed through income adjustments. A simple GSA structure will involve the fund setting initial payments based on assumptions to expected mortality rates, investment returns, fees and costs. Subsequent payments will be adjusted to reflect actual investment returns and mortality.

A well-designed group self-annuitisation scheme will provide income for life for all members without any significant increase in the risk of running out of money. Super funds can pool these members together to provide them with payments for life from their super, in a way similar to annuities with a life insurance company. With the certainty of a lifelong income stream, retirees can confidently manage their remaining resources to meet their retirement needs.

GSA | **Age Pension**

Regular income paid for life

Income to pay for the things you cannot live without, such as:

Housing

Transportation

Utilities

Food

Clothing

Medical expenses

Account-based pension | **Other income sources**

Flexible payments and accessible funds

Income to pay for the things that improve your standard of living, such as:

Meals out

Regular coffees

Long travel

Leisure

Sports and memberships

Weekends away

1 APRA, Annual Superannuation Bulletin June 2019 (Issued 31 January 2020).

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Part 6: Conclusion

A world of possibilities

A number of post-retirement income products can now have tax-free investment earnings on their underlying assets thanks to recent changes to legislation. These include deferred superannuation income streams and certain "innovative income streams" such as pooled pensions. These can be offered by life companies or super funds, and they promise to provide an income for life, although this income level may vary from time to time.

New means test rules have also been put in place to encourage the uptake of such products. Under the new means test rules, 60% of all payments from lifetime income streams will be assessed as income. For the assets test, only 60% of the purchase price of the product will be assessed until their life expectancy at purchase, and then 30% for the rest of the person's life. With the increased possibilities for product development, a soft start for super funds will be an annuity style product with the certainty of one, while giving members the flexibility of being able to access their funds when they need it.

Is GSA the supplement super needs?

Many super funds have a large number of members in the retirement phase. There are approximately 3.9 million retirees with another 500,000 Australians intending to retire in the next 5 years.[1] Super funds with members in the retirement phase can design ways to provide a lasting income for these members, giving them the confidence to spend in retirement. One such product is a GSA. For super funds to provide such a scheme for members, it is important to address the nagging issues that arise from the reluctance to annuitize retirement wealth. Although a GSA has some similarities with annuities, they are also different in several ways.

GSA schemes may be cheaper than traditional annuities. With no requirement for a super fund to hold capital, unlike a life company, a fund can invest in any of their investment options with a long-term proven record. Using a well-known investment option or strategy can result in good returns over the long term which will flow on to provide higher payment levels for the members. Also, as it can be designed to pay in line with fund's investment option performance and mortality experience, payment may go up or down, reducing the need for a strict capital requirement.

- A GSA may provide a form of money-back protection – this is akin to a guaranteed period for annuity payments when you make a purchase from a life company. This ensures that the retiree does not feel that they 'lose out' on purchasing this annuity if they die soon after purchase or are deemed terminally ill.
- A GSA can be designed such that if a retiree passes away before receiving income payments at least equal to their purchase amount, the balance of their purchase price will be paid to their estate. A similar arrangement is made in case of a terminal illness. With this arrangement, the retiree can overcome the feeling of 'loss' of their funds, in case their circumstance change soon after starting a GSA.
- Such a product can also offer the option for payments to continue to a spouse after the passing of the member. This is similar to a joint annuity, where payment is made until the death of the longer living spouse. Mortality salience is not lost on anyone, but such a product is a simple insurance for a member loved one.

If a GSA meets certain government legislation, members may be entitled to the discounted treatment in the assessment of their assets and income tests for the Age Pension. This legislation is called the capital access schedule, placing a limit on the amount of money one can access from a product, either through voluntary exit or in the event of death. If a GSA is designed to meet this limit, then retirees will receive this discount on their asset and income assessment for the means test. This discount may enable retirees to receive the Age Pension, which they otherwise may not have been entitled to, or receive a higher level of Age Pension than they ordinarily would. It may also make some members eligible for the Pensioner concession card, for which they may not have been eligible previously.

1 Retirement and Retirement Intentions (2018/2019), Australian Bureau of Statistics (ABS), 2020.

The QSuper response

Our retired members have told us that what is important to them is the certainty of a lifetime income. Having access to their funds is also important, so they don't feel at any time in retirement that an investment in a product is a 'loss' of their funds or flexibility. Finally, our members, especially those who have access to the age pension, are interested in maximising their pensions.

We use feedback from our members as a guiding principle in designing our retirement income products to ease the transition from wealth accumulation to income without the usual complexities. QSuper has engaged experts in the design of such a group self-annuitisation scheme, to provide the benefits of a lifetime income while continuing to give members the security of a fund they trust. This product will require no ongoing financial advice because the management and investment within the product is fully managed by QSuper. This means members in this product do not need to make any investment decisions, eliminating the pressure to be reactive in times of market volatility. This presents immense value to our Defined Benefit (DB) members who are unaccustomed to market risks and will want to enjoy the peace of mind in retirement without the added pressure of investing their own funds.

Our product will deliver higher incomes than drawing the minimum from an account-based pension, while also boosting Age Pension entitlement for many who are eligible because of its unique means testing assessment. Overall, this will present an efficient conversion of their superannuation into income to support our members lifestyle. The income from this product is expected to increase over time to support the rising cost of living. With our track record in investments, and no requirement to hold capital (unlike a life company), QSuper can support higher rates of income than a traditional annuity could.

At QSuper, we believe in helping our members make the most efficient use their hard-earned superannuation. Many retirees are not confident in their spending, with legitimate concerns about running out of money. In most cases, they underspend, with many passing away with large unplanned bequests. We want to give our members the confidence to spend to meet their lifestyles. By providing a reliable lifetime income stream, our members can be assured that irrespective of market or economic outcomes, an income will be available to them. At the core of what we stand for, is to make our members confident about their future.

About the author

Dr Osei Wiafe is the Retirement Product Manager at QSuper, one of Australia's largest superannuation funds, and is responsible for the design and management of fund's retirement income product and service solutions. He has held this role since 2017. He is also an Adjunct Research Fellow at the Griffith Centre for Personal Finance and Superannuation (GCPFS), Griffith University.

Dr Wiafe's interest is in the application of actuarial and financial modelling to pension finance and product design. His research expertise is in the areas of retirement asset allocation, superannuation, investments and retirement product design. Dr Wiafe is also interested in the behavioural aspect of financial decision making.

Dr Wiafe holds a PhD in Finance and Investments from the Queensland University of Technology (QUT), Brisbane, Australia and a Bachelor of Science (BSc) Degree with First Class Honours in Actuarial Science from the Kwame Nkrumah University of Science and Technology, Ghana. He has a number of academic peer-reviewed published articles ; his research has been presented at domestic and international conferences and workshops and cited widely across the media.

Dr Osei Wiafe

Product Manager - Retirement Product and Services

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