OPTIMUM PENSIONS

AUSTRALIAN SUPER FUNDS RETIREMENT TIME BOMB

Redesigning Retirement

Why savvy trustees aren't putting retirement income products on ice

With two years of considerable discussion around the provision of new retirement income products, savvy trustees are realising it's the perfect time to integrate retirement income products into the mix.

Funds may have had their focus diverted by The Royal Commission into Misconduct in the Banking, Superannuation and Financial Services, the Productivity Commission plus the review of insurance arrangements – all inevitably leading to a slow-down in the development of new products until potential legislation requires funds to provide better post-retirement solutions.

But one thing is clear. Funds are charged with managing the retirement outcomes of millions of Australians and carry a duty to act in their members' best interests.

Unfortunately, any delays may have adverse implications for both the sustainability of super funds themselves and the sustainability of retirement incomes for their retiring members. There will be around 600,000 Australians retiring over the next three years who may not have the retirement incomes they want or need.

Why lifetime retirement income products are the answer

Australians are living longer, and the retirement products currently offered by super funds are at best, only a partial solution and a poor or inadequate solution for those that live a long life. That's why lifetime retirement income products with longevity protection are an essential option that trustees should provide for their members.

> "A 65 year old woman now has a greater chance of living beyond age 97 than she does of dying before age 80."

> Statistics already show that the projected lifespan for many 65 year olds is nearly double the figures often quoted in the media.

The current standard product offer is an account-based pension (ABP) that provides no protection for retirees who either spend too much and/or who live a longer life. Some funds have considered a "bucket approach" for investing ABP assets – typically one bucket of money to meet short-term cash needs and other buckets of more diversified assets to provide higher returns for use in later years. This may reduce the volatility of retirement income, but it cannot insure retirees against having sufficient income to live a long and comfortable life.

Conventional annuities provided by life insurers pay an income for life and offer longevity protection. Some trustees might regard them as unattractive to their super funds because it requires them to transfer assets from their fund to an external annuity provider, potentially reducing economies of scale from investment for super funds. Rightly or wrongly, due to the level of capital required to be held in reserves to meet future guarantees, annuities can be regarded as poor value for money by members and their advisers.

Group self-annuitisation products, where retirees' super is invested into a pool from which their retirement incomes are paid, initially seemed to be the solution for super funds. However, their feasibility has been eroded by the risks of scale (having too small a pool) and systematic mortality changes (unpredictable factors that improve the lifespan of the entire group). The latter risk cannot be underestimated, given the rate at which advances in medical treatment are occurring. A great example is the introduction of heart bypass surgery on the life expectancy of older Australians. In fact, the death rate from heart conditions has fallen over 90 percent over the last 50 years (*ABS Changing Patterns of Mortality Report 2018*).

A sudden breakthrough in cancer or diabetes treatments would have a similar affect and put a significant strain on any self-insured pool of retirees; reducing these retirees' incomes.

New investment-linked lifetime and deferred pensions offer retirees the best of both worlds – the ability to choose investment options, including those with an exposure to growth assets that will better protect the value of their pension against inflation and the benefit of longevity protection insurance that ensures their pension never runs out no matter how long they live.

Australian retirees with a balanced attitude to retirement risks can allocate some of their assets to an investment-linked lifetime pension. This offers them the ability to choose from professionally managed investment options that best suits their risk profiles and enjoy a guarantee that their retirement income will last for life.

Redesigning Retirement

Why the opportunity and challenge for super funds exists now

Australians can access their super once they have reached preservation age; an individual's preservation age is between 55 and 60 depending upon their date of birth.

Chart 1, 'Australian population by preservation age', using 2016 Census data projections showed by 30 June 2017 there were 6,165,000 Australians (38% of people aged 25 or over) already old enough to access their super and commence a retirement income stream. Over the next three years a further 631,000 Australians (4% of people aged 25 or over) will have reached preservation age and be eligible to commence a retirement income steam.

When we also consider the APRA Statistics Annual Superannuation Bulletin at June 2017 (published 28 March 2018) the immediacy of the problem for superannuation funds becomes clear. Nearly 52% of superannuation assets at 30 June 2017 were held by members who have already reached their preservation age.

Chart 2, 'The decline of superannuation assets', shows that people in the 55 – 65 age group (excluding self-managed super funds (SMSFs) have $523 billion which will soon leave the accumulation phase of super funds if it hasn't done so already.

This is clearly a current, not a future, issue for super funds that want to survive and prosper.

It is of course a far bigger and critical issue for the members who have a once-only chance to secure their income and thus lifestyle post-retirement.

It is also a critical issue for the Australian Government and we taxpayers who will fund Age Pensions for all members whose incomes decline too much in future, due to living too long and not having longevity protection.

Note that people who were age 55 at 30 June 2017 will not reach their preservation age until they are age 57. People who were age 56 or over at 30 June 2017 have already reached preservation age.

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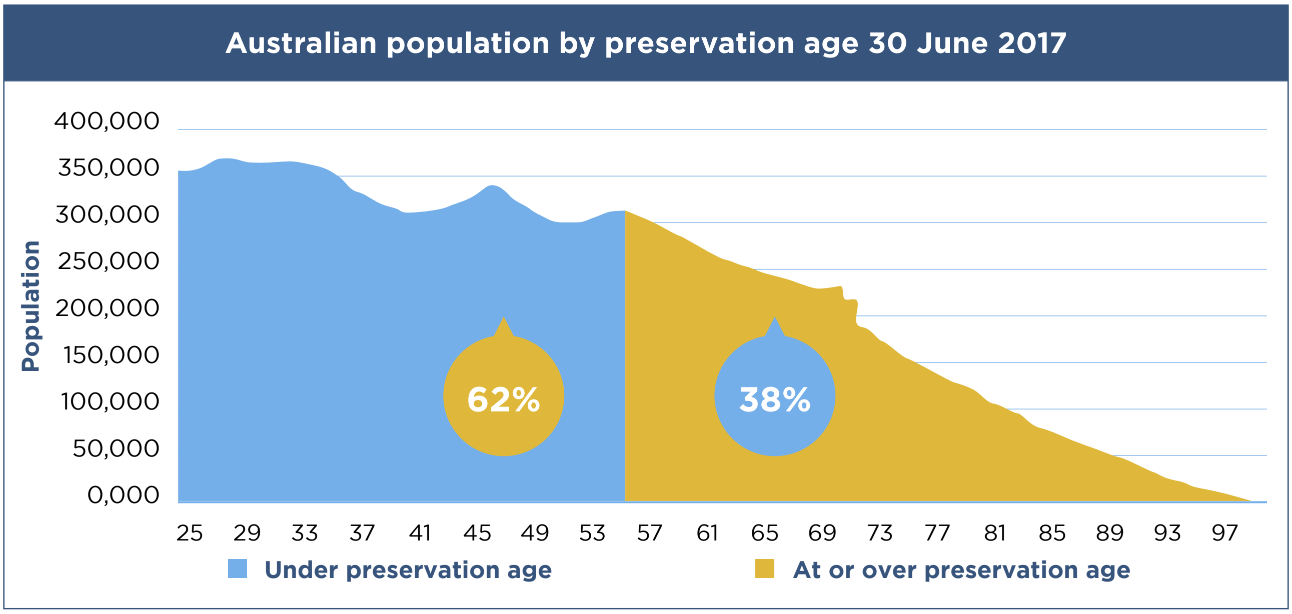


Chart 1: Australian population by preservation age 30 June 2017

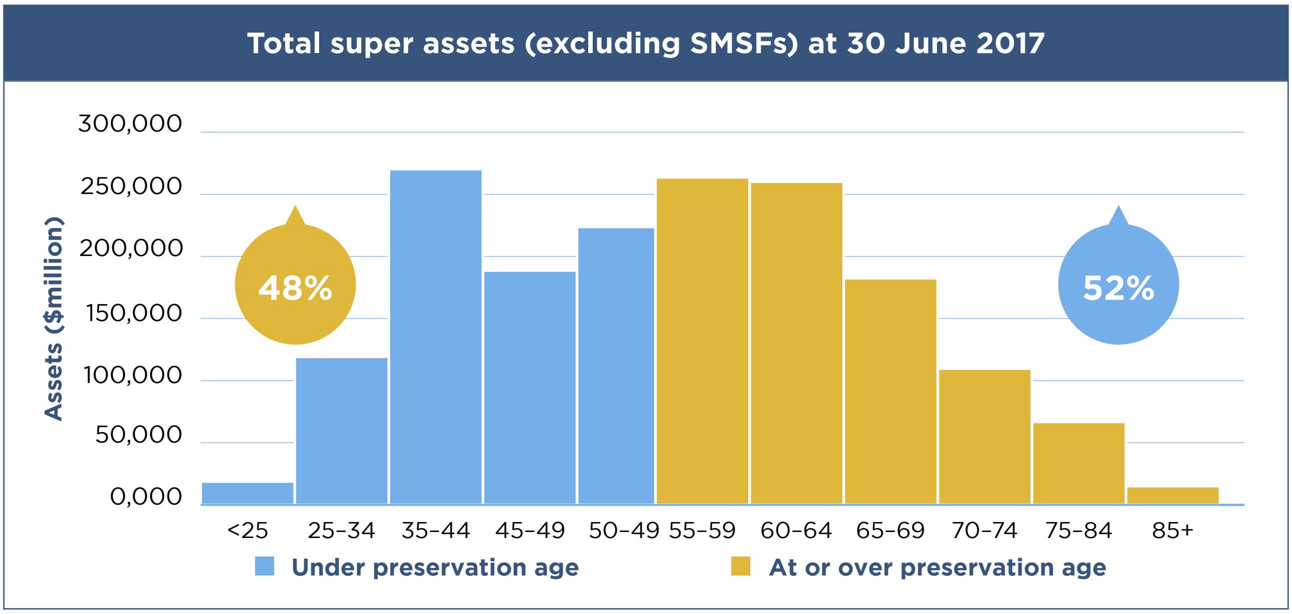


Chart 2: The decline of superannuation assets: APRA

The retirement time bomb of not addressing member's needs

Many super funds find it challenging to retain their members when they retire. Failure to provide effective solutions that are in the best interests of their ageing members, may potentially result in:

- **loss of members** to other institutions which promise better retirement services and products. This includes pooled lifetime income products which are scheduled to receive preferential Centrelink means testing from 1 July 2019 that will therefore result in higher Age Pensions for many retirees
- **trustees potentially failing to act** in the best interests of their retired members. In other feature articles, Optimum Pensions has shown how medical advancements will continue to increase the life expectancies of Australians. One in three retired households will see at least one spouse live into their late 90s. It could be argued that trustees are negligent if the only retirement product they offer fails to meet its desired outcome for a third of all members
- **funds failing to retain adequate amounts** of their retirees' money to remain sustainable and maintain economies of scale
- **Increased demand on cash flow** that causes more assets to be invested in liquid assets and could skew the available investment strategies, potentially reducing returns for all members.

For retired super fund members, not having access to products that protect them against living too long may result in their drawing down inappropriate amounts of money from account-based pensions. This may see them live too frugally if they don't draw down enough or even run out of retirement income altogether if they withdraw too much.

Those who run out of money will have an increased reliance on the Age Pension, which is sometimes considered only sufficient for a retiree to exist rather than have even a 'modest' standard of living *'A modest retirement lifestyle is considered better than the Age Pension, but still only allows for the basics'* – ASFA Retirement Standard 2018.

> "This potential demographic time bomb, that can severely affect the long-term viability of super funds, is already ticking."

ASFA Retirement Standard Guidelines

Comfortable retirement	Modest retirement	Age Pension
Replace kitchen and bathroom over 20 years	No budget for home improvements. Can do repairs, but can't replace kitchen or bathroom	No budget to fix home problems like a leaky roof
Better quality and larger number of household items and appliances and higher cost hairdressing	Limited number of household items and appliances and budget haircuts	Less frequent hair cuts or getting a friend to cut your hair
Can run air conditioning	Need to watch utility costs	Less heating in winter
Restaurant dining, good range & quality of food	Take out and occasional cheap restaurants	Only club special meals or inexpensive takeaway
Fast internet connection, big data allowance and large talk and text allowance	Limited talk and text, modest internet data allowance	Very basic phone and internet package
Good clothes	Reasonable clothes	Basic clothes
Domestic and occasional overseas holidays	One holiday in Australia or a few short breaks	Even shorter breaks or day trips in your own city
Top level private health insurance	Basic private health insurance, limited gap payments	No private health insurance
Owning a reasonable car	Owning a cheaper more basic car	No car or, if you have a car, it will be a struggle to afford repairs
Take part in a range of regular leisure activities	One leisure activity infrequently, some trips to the cinema or the like	Only taking part in no cost or very low cost leisure activities. Rare trips to the cinema

Graphic 3: ASFA Retirement Standard 2018 Guidelines

Innovating ways to meet the challenge of a long retirement

The key need of retirees is to confidently provide for their desired standard of living while managing the risks involved. Superannuation changes that came into effect on 1 July 2017 permit new superannuation products that help retirees to achieve this. Superannuation fund trustees, CEOs and management must take this issue seriously and allocate resources to rapidly adapt their offerings to meet the best interest of retired members.

One product, the Real Lifetime Pension (RLP), developed by Optimum Pensions, addresses these concerns. The RLP is an investment linked lifetime pension or deferred pension.

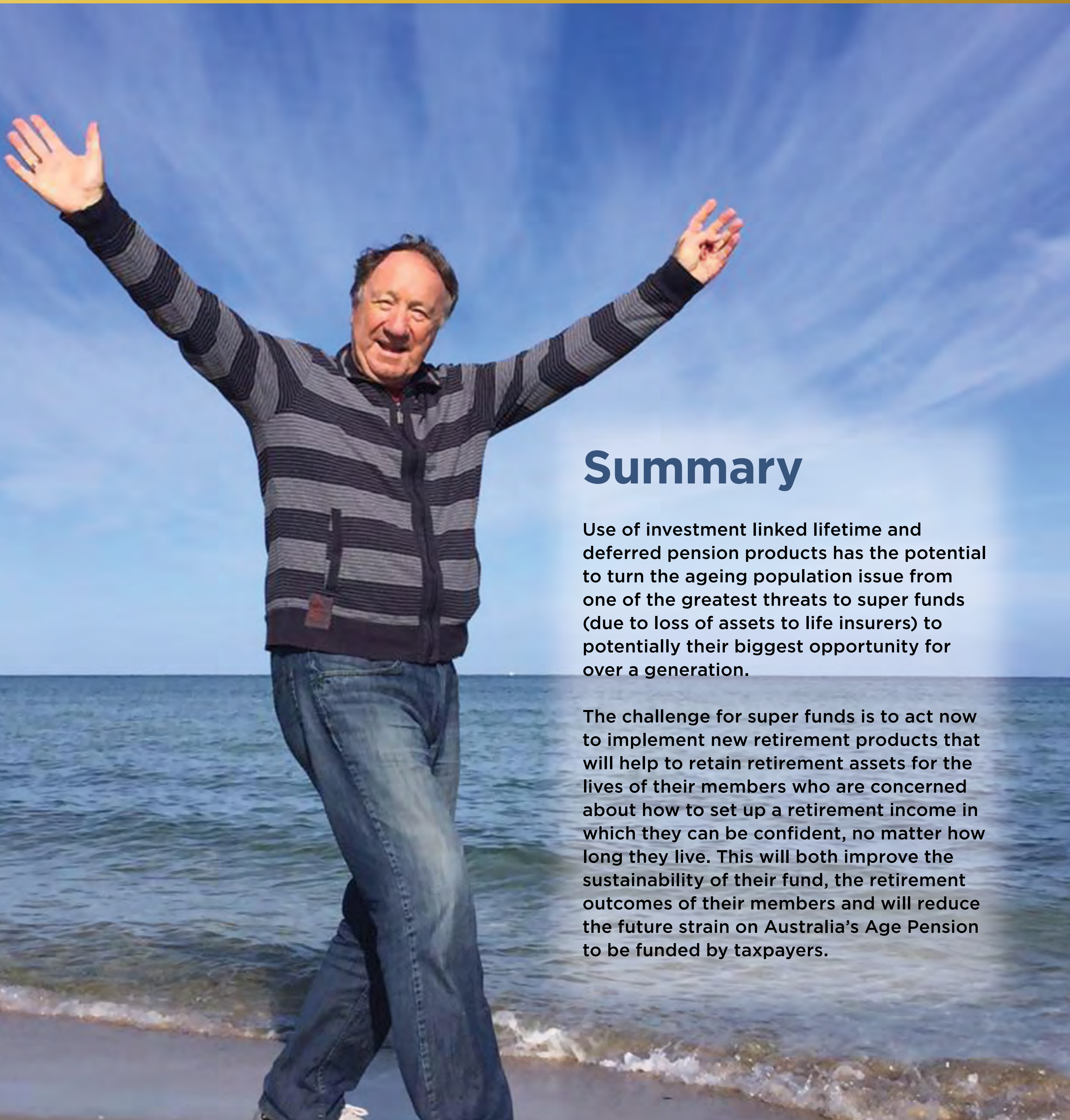
Used in isolation or in combination with an account-based pension it offers income for life and the potential to maintain income in real terms over the long term, thus helping to meet the financial needs of those living a longer life. It allows members to choose investment options with a suitable exposure to long term growth assets.

Additionally, it also avoids the need to lock in low yields for life, which is a concern advisers typically have with traditional lifetime annuity products. Although this type of product is new to the Australian market, uptake in America has proven to be highly successful seeing hundreds of billions of dollars being invested.

The benefits for a superannuation fund offering investment linked lifetime pensions are that it can:

- **potentially provide members with (up to 30%) more retirement income**
- **allow retirement assets to be kept within the member's current superannuation fund, not moved to an external provider**
- **transfer 100% of the longevity risk to a global reinsurer**
- **allow members to choose investment options with a suitable exposure to long term growth assets, providing greater inflation protection and to switch between available options.**

> "The challenge for super funds is to act now to implement new retirement products."



Summary

Use of investment linked lifetime and deferred pension products has the potential to turn the ageing population issue from one of the greatest threats to super funds (due to loss of assets to life insurers) to potentially their biggest opportunity for over a generation.

The challenge for super funds is to act now to implement new retirement products that will help to retain retirement assets for the lives of their members who are concerned about how to set up a retirement income in which they can be confident, no matter how long they live. This will both improve the sustainability of their fund, the retirement outcomes of their members and will reduce the future strain on Australia's Age Pension to be funded by taxpayers.

Contributors

DAVID MOXON
PENSIONS CONSULTANT

A highly experienced super and marketing professional, David has held senior roles at a range of financial institutions. He brings his experience in product development, marketing, communications and planning to developing the marketing strategies and materials for Optimum's products.

DAVID ORFORD
MANAGING DIRECTOR

With several decades actuarial, product development and consulting experience, together with a highly successful career in Australia's superannuation industry, David Orford today is committed to helping Australians lead a comfortable retirement. Optimum Pensions is his latest venture to provide a superior solution to longevity risk – an issue facing every Australian.

JIM HENNINGTON
HEAD OF INNOVATION

Jim is a recognised thought leader on retirement income strategy and modelling. An Actuary, he is involved in product design and developing modelling tools to make Optimum's pensions accessible to planners and retirees.

PETER ROWE
GENERAL MANAGER

Peter has spent over 35 years in the superannuation industry with over 30 years in senior management roles. He has had extensive experience in pension management and administration and is keen to implement this new range of income streams.

Optimum Pensions

Optimum Pensions has developed and tested an innovative lifetime income stream solution, the Real Lifetime Pension, that may be delivered by Funds to their members to comprehensively address Australians' longevity risk while providing higher performance than other solutions such as the current lifetime annuities in the market.

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