**Keywords:** superannuation, post-retirement policy, post-retirement products, longevity.

# POST-RETIREMENT POLICY — A VIEW

*Much of the recent focus on superannuation policy outcomes and settings has related to the accumulation phase, and considerable work remains to be done regarding the post-retirement phase. Although the Henry[1] and Cooper[2] reports raised a number of important post-retirement issues, their recommendations provided only a partial response to the challenges involved. This paper outlines these challenges and provides potential policy options to address them.*

ROSS CLARE is Director, Research and Resource Centre, ASFA. Email: rclare@superannuation.asn.au

The helpful input to this paper from the ASFA Secretariat and from the ASFA Retirement Outcomes Policy Committee is acknowledged. An earlier version of this paper was presented to the 16th Melbourne Money and Finance Conference — Retail and Household Finance: Current Issues. The conference was held in July 2011 by the Australian Centre for Financial Studies.

## Increasing longevity — implications

Over the next 40 years, the number of Australians aged 85 and over is projected to more than quadruple, from around 400 000 in 2010 to 1.8 million by 2050 (Treasury 2010).

The ageing of our population is largely in response to improvements in life expectancy. In 1983, a Australian female reaching the age of 65 could expect to live, on average, for another 18 years, while an Australian male could expect to live for a further 14 years. By 2002, these figures had risen to 21 years for females and 18 years for males. Despite increased superannuation savings, a substantial proportion of these will have only modest savings to fund their retirement.

Most Australian retirees take lump sums or make use of account-based income streams. Currently, sales of life annuities and deferred annuities are minimal although term annuities are becoming more popular.

Tax and other policy settings are likely to have played an important role in generating this outcome of very limited use of market-based longevity products. However, as a result, the attendant longevity risks and demands largely fall upon the government-provided age pension. A key argument of this paper is that both incentives and compulsion are needed for greater take-up of retirement income streams providing longevity protection for individuals post-retirement.

## Available post-retirement products

Post-retirement products are any financial products provided through a superannuation fund or scheme, or other financial institution, which enable an individual and/or their dependents to meet their income needs in retirement. These include the following products.

**Pensions**

A pension is a regular stream of income, payable from a superannuation fund. Many defined benefit schemes provide an income stream until death, with no residual value. At least partly because employers have generally closed entry to such defined benefit schemes to new employees, most Australian retirees have been opting for account-based income stream pension products (often referred to as allocated pensions). These provide for accumulated superannuation monies to be invested to generate income in the account, with withdrawals above some minimum amount related to account size required by government. In the event of death, the remaining account balance accrues to the investor's estate or dependents.

Such products involve two major risks for the retiree. One is that the capital and earnings can run out before a person dies (longevity risk). The other is investment risk, reflecting the variability of returns and thus the size of the available funds from which an income stream can be drawn.

**Annuities**

An annuity is an income stream[3] purchased by payment of a lump sum to a financial institution. That income stream is payable for a set period (usually referred to as a term annuity), or for life (lifetime annuity). The latter obviates longevity risk. Investment risk is also borne effectively by the product provider rather the investor — arguably a more suitable allocation of risk for those in retirement, although it does come at a cost in terms of the price paid for the annuity.

**Other post-retirement products**

There is a small, but growing, number of products where investment and longevity risks are shared between the customer and the product issuer. Some products offer (for a price) market-linked returns plus an income and/or capital guarantee and some also protect investors against longevity risk. Outside superannuation, investments such as bank term deposits, shareholdings and investment properties can be used to generate investment income in retirement. Reverse mortgages also are used by a small minority of retirees.

## Why retirement products are appropriate for retirees

For the great bulk of the population, the age pension is not considered to be sufficient to meet retirement needs. The ASFA Retirement Standard (Howell 2009) estimates that the annual expenditure currently required (as at March 2011) by a couple for a modest standard of living in retirement is $30,700 and for a comfortable lifestyle it is $53,880. While overall expenditure needs may decrease with age, recent work by ASFA indicates that at age 90, the expenditure needed for a modest lifestyle is only marginally lower (than $30,700), while for the comfortable level it is about 10 per cent lower (than $53,880). The age pension is not sufficient for a modest lifestyle and it is significantly lower than what is needed for a comfortable lifestyle.

Recent estimates produced by the Treasury RIM Group (Rothman 2011) indicate that on current policy settings in regard to compulsory contributions, around 70 per cent to 80 per cent of future retirees will reach the modest lifestyle level, at least in the first five years of retirement. Only 20 per cent to 30 per cent of retirees are projected to reach the comfortable level.

Post-retirement products assist individuals in reaching these expenditure levels in retirement. Retirees also have the capacity to supplement other forms of income, which can include more generic investments, casual or part-time employment income, and receipt of the age pension.

Managing risks associated with private retirement savings is an important consideration in relation to the design of post-retirement products. These risks include 'consumer risks' such as longevity risk, 'conservatism' risk (that individuals might under-spend due to worries over running out of money) and 'advice risk' (that bad financial advice is given exposing the retiree to inappropriate products).

Also relevant are 'product risks' including: inflation risk (deterioration in the purchasing power of income streams); investment risk (of either or both excessive downside risk, capital loss, and inadequate exposure to potential upside gains); 'time-of-purchase risk' (being locked into a product with poor returns because rates are unfavourable at the time of purchase); 'irreversibility risk' (making a purchase decision which does not turn out to best meet income needs and which cannot be easily reversed); and 'counterparty risk' (of the provider defaulting on their promised obligations)

As well as protection from risk, individuals look for varying levels of flexibility from their retirement savings. Account-based income streams tend to have more flexibility but they also have greater exposure to a number of the risks set out above.

Other more structured retirement income products protect against a number of the risks outlined above, but at a cost built into the price and/or characteristics of the financial product (including limited or no access to capital once the product is purchased).

There is no 'perfect' retirement product which will meet the needs of every retiree. Preferences and circumstances will differ between individuals and it may be necessary for a retiree to make use of a range of post-retirement products.

## Encouraging better take-up of post-retirement products

A number of policy levers might be considered to encourage or require greater take-up of post-retirement products. Incentives can encourage individuals to actively seek out appropriate retirement products. Default arrangements can nudge retirees into what are considered desirable products from a public policy point of view. Finally, mandating minimum requirements ensures that there will be better take-up, albeit at the cost of flexibility and individual choice.

In this context, possible specific policy levers would be to:

> require retirees to spend a proportion of the value of their superannuation benefits to purchase longevity insurance (mandating);

> impose both minimum and maximum payment requirements each year in income stream products to protect against premature exhaustion of savings and to ensure that tax-preferred retirement savings are actually used for retirement;

*More generally, attention should be given to how principles of behavioural finance can be used to 'nudge' individuals into desirable decisions about post-retirement products. 'Nudging' individuals can provide most of the outcomes desired from a public policy point of view without imposing arrangements that may not always be appropriate or desired by specific individuals.*

- offer Centrelink means-tested incentives to encourage individuals to invest some proportion (e.g. more than 25 per cent) of their superannuation in longevity insurance or income stream products; and
- specify a default retirement product for superannuation fund members who do not actively engage in retirement planning.

More generally, attention should be given to how principles of behavioural finance can be used to 'nudge' individuals into desirable decisions about post-retirement products. 'Nudging' individuals can provide most of the outcomes desired from a public policy point of view without imposing arrangements that may not always be appropriate or desired by specific individuals.

These behavioural finance principles include: specification of appropriate defaults (such as regarding investment mix and drawdown arrangements); promoting life-cycle savings culture norms; and framing available options in ways which encourage the take-up of public policy preferred post-retirement products.

## Increasing the supply and attractiveness of longevity products

**Regulatory settings — flexibility**

Investment risk and longevity risk are interrelated and any move to push retirees into more conservative investments in retirement may increase their longevity risk, which is, arguably, the more significant of the two.

However, there are regulatory impediments that may be making certain post-retirement products more expensive and/or otherwise less attractive than they might be. For instance, some current regulatory provisions restrict product development in the retirement space. Income Ruling IT 2480 and SIS regulation 1.06 (2) basically assume that products are either account-based or a pension, and do not deal well with products that have elements of each or have certain benefits that are deferred. This makes the regulatory process more complicated and it also increases the costs of such products. Withdrawal or amendment of the Ruling and the SIS Regulation would assist both the development and marketing of products providing protection against the financial consequences of longevity.

As well, product providers must deal separately with the ATO, APRA, ASIC and Centrelink, further complicating the product development process. Also, there are little or no tax and social security incentives for taking a retirement benefit in the form of an income stream as opposed to a lump sum, and no real incentives for purchasing a product which provides protection against the financial consequences of longevity.

**More education and advice to fund members**

Better take-up of post-retirement products is also likely to occur when superannuation fund members are better educated and advised about such products.

In this regard, the scaled advice model mooted under the Future of Financial Advice reforms is intended to enable trustees (or those employed by them) to discuss issues such as adequacy of superannuation accumulation, interaction between the member's superannuation interest and Centrelink entitlements, and nomination of beneficiaries (all of which are retirement issues), within the intra-fund advice framework.

**SMSFs and access to longevity protection**

At present, capital gains are taxed when a person transfers funds from a self-managed superannuation fund (SMSF) to a post-retirement product in an APRA-regulated superannuation fund offering. This may inhibit the purchase of products which provide longevity protection if provision of such protection via a SMSF is more difficult or expensive.

## Other retirement policy issues

Retirement is not necessarily an either/or (full-time work or not work) decision, and policy development also needs to focus on a number of issues regarding the interaction of labour force features with retirement. In particular, some part of the income needs of those of retirement age can be met by full-time, part time or casual work and, in this regard, the impact of policy settings (and societal attitudes) on the market for older workers warrants examination.

Specific links exist between superannuation policy and product provision and the current superannuation settings with regard to preservation and early retirement. Some superannuation schemes encourage early retirement through maximising benefits at certain ages, such as age 55 or 58. The merits of providing incentives for such employees to continue in employment (or ultimately removing early-retirement incentives) also warrant attention; so does developing more effective transition to retirement tax and other policy settings to retain older workers in the paid labour force.

Age-related contribution rules and the upper age limit for SG contributions are also important considerations from a policy perspective, with the proposed increase in the maximum age for receipt of Superannuation Guarantee contributions likely to encourage (albeit marginally) longer workforce participation.

Increasing age leads to increased rates of disability and greater need for residential care facilities. Residents of such facilities are generally required to provide both a capital amount in the form of an accommodation bond and ongoing contributions for the costs of care. For a society with an ageing population structure, it should be a priority that policy settings are put in place which facilitate the financing of such expenses, together with the development of retirement products that address the expense requirements of older retirees. Methods of pre-funding or making allowance for aged care accommodation bonds also need to be compatible with post-retirement income products that are sold or are required to be purchased.

Increased age also brings decline in cognitive abilities and thus the capacity to manage individuals' own retirement finances. Consequently, regulatory and fiduciary frameworks in superannuation need to have sufficient flexibility to enable SMSF trustees to easily transition their investments back into APRA-regulated superannuation. This would enable trustees of SMSFs to transition members who are mentally incapable of managing their own affairs back to a default investment strategy for retirement.

## The Henry and Cooper Report recommendations on retirement incomes

Both the Henry (AFTS 2009) and Cooper (SSRFR 2010) reports made a number of recommendations that are relevant to post-retirement products. However, neither report provided (or indeed intended to provide) a comprehensive package of recommendations dealing with post-retirement issues.

A further complication in considering the Henry Report recommendations is that they were designed to be considered as a package and interact with other recommendations relating to personal income tax. The Government has not adopted the great bulk of these latter recommendations.

Some of the Henry recommendations, if adopted, would assist in ensuring greater supply and take-up of post-retirement products but a number of the recommendations would actually make post-retirement products less attractive.

For instance, it would be a step forward if the recommendation were adopted that the Government issue long-term securities, where this is consistent with its fiscal obligations, in order to help product providers manage the investment risk associated with longevity insurance. One of the current constraints in relation to the development of products dealing with the financial consequences of longevity is the need to match liabilities stretching over a number of decades with assets held by the provider. Long-term securities are of considerable assistance to providers both in pricing and facilitating longevity products.

It would also be helpful for government to adopt the recommendation that it make available the data needed to create and maintain a longevity index; this would assist product providers in hedging longevity risk. Currently, this data is not readily available and often providers have to make use of partial and/or overseas data.

Less helpful was the recommendation that investment earnings of assets supporting income streams in retirement (currently untaxed) should be taxed at 7.5 per cent p.a. While the Henry Report recommended that the rate of tax on investment earnings during the accumulation phase be reduced, the overall impact would be to remove an incentive to take an income stream within superannuation rather than a lump sum.

The Henry Report also recommended that the Government become a direct provider of immediate and deferred annuity products. This was something the Government has ruled out, for good reason. Governments do not have any particular expertise in such products. The report did not demonstrate any market failure that only direct government provision could remedy. While government could provide such products at a lower cost than private providers, this would only be possible if it were at the cost of taxpayers more generally. Government involvement as a provider would also discourage private providers from becoming involved in immediate and deferred annuity products.

There were a relatively small number of recommendations relating to post-retirement issues in the Cooper Report and, hence, in the Stronger Super decisions by the Government (Shorten 2010). One such recommendation, that consideration be given to default retirement products for some members, is designed to 'nudge' retiring fund members into appropriate post-retirement products. The MySuper Working group considered that this policy work would need to be completed by the end of the MySuper transition (2015) in order to deal with the needs of the new wave of retirees and recipients of the age pension — the baby boomers.

## The change process

While bringing about change in post-retirement policies may not be easy, a number of activities will assist in bringing it about. These include:

> development of a consensus across the superannuation industry on what should be the goals in the post-retirement phase and how these might best be addressed;

> development of a political consensus on the importance of post-retirement issues;

> providing a stable regulatory and tax environment for post-retirement products, which is also clear and understandable so that individuals can plan with confidence for the future;

> undertaking comprehensive research and consultation before any measures are put in place so as to

better meet objectives and avoid any unintended consequences; and

> undertaking a program of public education on post-retirement issues and how to plan better for retirement.

## Conclusion

Compared with most other countries, Australia is unusual in that, apart from a small minority of individuals in defined benefit funds, the great bulk of Australian retirees take lump sum benefits or maintain an account-based income stream in retirement.

While account-based income streams provide considerable flexibility for retirees, they provide relatively little protection against the financial consequences of living beyond average life expectancy. Such account-based products also expose the retiree to variations in both investment returns and in the capital value of assets supporting the income stream.

There are sound public policy grounds for supporting greater take-up of income stream products which provide protection in relation to the financial consequences of longevity and/or variation in investment returns.

Increasing support for such products is likely to require a variety of measures. These include removing regulatory and tax impediments to the development of new post-retirement products, 'nudging' retirees to take-up such products through the setting of appropriate default arrangements, and compelling retirees to insure against the financial risks of longevity in appropriate cases.

## Notes

1. *Australia's Future Tax System,* Report to the Treasurer (2009).
2. *Super System Review Final Report* (2010).
3. Strictly speaking, it is a cash flow stream involving a return of the original capital and income earned on that (declining) capital.

## References


AFTS 2009, *Australia's Future Tax System,* Report to the Treasurer, December, Canberra.

Howell, G. 2009, *Updating and extending indicative budget standards for older Australians in 2009*, Harvest Marketing, Sydney. Available at www.superannuation.asn.au

Rothman, G. 2011, 'Projecting the adequacy of Australian retirement incomes', paper to the Nineteenth Annual Colloquium of Superannuation Researchers, University of New South Wales, July.

Shorten, The Hon. Bill, 2010, *Stronger super, the Government response to the Super System Review*, Canberra, December.

*Super System Review Final Report* (SSRFR) 2010, Canberra, June.

Treasury 2010, *Australia to 2050: future challenges, the 2010 intergenerational report*, Canberra.