Submission to the Review of Retirement Income Stream Regulation

September 2014

National Seniors Australia

About National Seniors Australia

National Seniors Australia is a not-for-profit organisation that gives voice to issues that affect Australians aged 50 years and over. It is the largest membership organisation of its type in Australia with more than 200,000 members and is the fourth largest in the world.

We give our members a voice – we listen and represent our members' views to governments, business and the community on the issues of concern to the over 50s.

We keep our members informed – by providing news and information to our members through our Australia-wide branch network, comprehensive website, forums and meetings, bi-monthly lifestyle magazine and weekly e-newsletter.

We provide a world of opportunity – we offer members the chance to use their expertise, skills and life experience to make a difference by volunteering and making a difference to the lives of others.

We help our members save – we offer member rewards with discounts from thousands of businesses across Australia. We also offer exclusive travel discounts and more tours designed for the over 50s and provide our members with affordable, quality insurance to suit their needs.

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Introduction

Increasing life expectancy is creating a need for innovation to manage longevity risk within the retirement phase of superannuation. Annuities are considered the preferred option by some to manage longevity risk as they provide a guaranteed income stream. However, account-based pensions, term deposits and bonds can also be used to manage longevity risk and deliver relatively stable and secure incomes streams.

More sophisticated investors can manage longevity risk by investing in assets that provide a level of income which takes into account inflation. However National Seniors is aware that not all investors will be able to achieve such a positive outcome from their investments in retirement.

National Seniors is concerned that the lack of retirement income stream-based investment options is resulting in many Australians being unnecessarily exposed to higher risk levels in the superannuation retirement phase.

Many Australians simply do not understand the true level of risk to which they are exposed within many retirement phase investment options, including account-based pensions. National Seniors' research indicates that 51 per cent of seniors do not understand the relationship between asset classes and risk. [1]

The risk profile of many retirement phase account-based pensions does not take account of the inability of retired members to recover any losses which may occur. As an example, the average default pension option has a 57 per cent exposure to growth assets. [2] Retirees have little capacity to generate additional income to recover losses suffered as a result of investments made within the traditionally more risky growth assets class. Therefore it is essential that they understand the implications of such exposure for the longevity of their account-based pension.

Current regulatory barriers including less favorable taxation treatment, lack of awareness of risk, limited product options and the potential mismatch with retirees' desire to spend more in early retirement[3] is keeping the uptake of income stream products with a lower risk profile artificially low, resulting in only about five per cent of retirement savings allocated to annuities[4] .

Self-managed superannuation funds are the fastest-growing segment of the Australian superannuation industry. [5] One of the main drivers cited for the growth of self-managed super funds is the desire of members to have more control over their investments. [6] Annuities do not allow for a

[1] Productive Ageing Centre (2012) *Financial Wellbeing: Concerns and choices among older Australians* National Seniors Australia.

[2] Mercer (2014) *Post Retirement Market Trends in Australia* Marsh & McLennan Companies.

[3] Reserve Bank of Australia (2014) *Submission to the Financial System Inquiry* Australian Government.

[4] Mercer (2014) *Post Retirement Market Trends in Australia* Marsh & McLennan Companies.

[5] Reserve Bank of Australia (2013) *Self-managed Superannuation Funds* Australian Government.

[6] Professor Rodney Maddock (2014) *Superannuation asset allocations and growth projections* Monash University.

high level of control and may be unpopular with investors without some form of incentive for their uptake.

National Seniors believes that deferred lifetime annuities (DLAs) are not a silver bullet to manage longevity risk, however investors should have the option to purchase DLAs and benefit from the same favorable taxation treatment as provided to other retirement investment options.

National Seniors supports the requirement to have some level of minimum drawdowns to avoid account-based pensions becoming a taxation haven. However some retirees report that they have suffered financial losses to their investments as a result of the prescribed minimum drawdowns on account-based income streams which do not provide flexibility to respond with lower drawdowns in periods of declining market returns. This can have the unintended consequence of reducing their balance at a rate which puts them at risk of running out of money and having to rely on Government pensions later in their retirement.

Consultation Questions

National Seniors has provided responses to the consultation questions which are of greatest importance to our members. In some cases responses to related individual questions have been combined.

Question 1: What types of income stream products would enable retirees to better manage risk in the retirement phase (in particular longevity risk and investment risk)?

Annuities including DLAs can be used to manage longevity and investment risks. However, as returns on annuities are usually linked to interest rates, Australia's current low interest rates result in low annuity returns.

Low returns, lack of control over their investments, uncertainty surrounding death benefits and limited flexibility regarding drawdowns are reasons which make annuities unattractive to many investors. In such a climate, any requirement to invest in annuities may act as a disincentive to save for retirement. These negative aspects of annuities have been used by the government of the United Kingdom (UK) to support the recent scrapping of the requirement to purchase annuities in retirement within the UK[7].

If the Australian market for annuities was to grow substantially, **National Seniors believes** that the Government should review the prescribed minimum capital and solvency requirements to ensure that all annuities providers have sufficient capital to reduce counterparty risk.

A low risk account based pension can also be used to manage investment and longevity risk, although to a lesser extent than annuities which can provide a guaranteed lifetime income. However, current account based pensions' default options have a 57 per cent exposure to growth assets and a similar investment risk profile to that of investments in the accumulation phase of

[7] Hon George Osborne MP (2014) *Pension freedom for 400,000 hardworking people from today* HM Treasury.

superannuation.[8] Therefore without a significant shift in investment choices, at this stage account based pensions do not appear to be effectively managing investment or longevity risk for many investors.

National Seniors believes that hybrid products could also be utilized to effectively manage investment and longevity risk. These include products which pool funds into a trust system to secure the lump sum and distribute returns to individual investors in a similar manner to that used by Retirement Income Solution[9] and some self-managed super funds.

National Seniors believes that the lack of consumer understanding of risk associated with popular post-retirement investments options prevents the benefit of annuities, low risk account based pensions and similar products being fully appreciated by many investors. However many pre- and post-retirees feel significant pressure to invest in investments which offer high returns and have higher levels of risk with the aim to ultimately avoid longevity risk.

This investment strategy can also be a result of a perception that their investments must grow to keep pace with government prescribed minimum drawdowns on account based pensions and the reality that many retirees are not generating sufficient savings in the accumulation phase of superannuation.

The insufficient superannuation savings is highlighted by the average superannuation balances at retirement of approximately $200,000 for males and $100,000 for females[10] well below the estimated lump sum required of $370,000 for a single person to live even a modest lifestyle in retirement[11].

Question 5: Should people only be able to purchase a DLA with superannuation money?

National Seniors believes that individuals in the retirement phase of superannuation should be allowed to purchase DLAs with superannuation money. The current restrictions on DLAs prevent individuals from protecting themselves from risk and restrict their ability to self-fund their retirement.

National Seniors members report that they can receive unexpected payments such as inheritance or redundancy payments (as non-superannuation money) within the pre and post retirement phase of superannuation which they wish to use to purchase an annuity. **National Seniors believes** that individuals should be able to purchase DLAs and be granted the same favorable taxation exemptions with non-superannuation money regardless of the original source of the money for example savings, inheritance, redundancy or employment termination payments.

In addition **National Seniors believes** that individuals should be able to purchase DLAs in the accumulation phase of superannuation (with superannuation money) for example by using pre-

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[8] Mercer (2014) *Post Retirement Market Trends in Australia* Marsh & McLennan Companies.

[9] Michael Rice (2014) *Australia's retirement income bulge requires urgent, comprehensive fix* Rice Warner.

[10] Ross Clare Director of Research (2014) *An update on the level and distribution of retirement savings* The Association of Superannuation Funds of Australia.

[11] A Deloitte Point of View (2014) *Adequacy and the Australian Superannuation System* Deloittes.

payment options provided that there are limits on the amount of dollars an individual can invest within DLAs.

Question 6: Should people only be able to purchase a DLA for an up-front premium or should other purchase options also be allowed?

To be attractive to a broad range of investors **National Seniors believes** that DLAs should be able to be purchased up-front and through the use of payment options for example monthly installment payments.

Question 7,8,9: Restrictions on DLAs

National Seniors believes there should be a upper limit on the amount invested in a DLA. The limit should be based on an estimation of the lump sum required with expected annuity payment rates that would be needed to provide up to a comfortable standard of living for the time period of the DLA. The Association of Superannuation Funds Australia retirement standard[12] could be used as a guide to determine what annual income stream is required to live a "comfortable" standard of living.

The maximum amount invested in a DLA could be balanced against an individual's other investments to ward against inflation in later years of retirement. **National Seniors believes** that a 5 year minimum deferral period with a upper age limit based on an individual's life expectancy estimated from the life expectancy tables[13] is appropriate. For example if an individual's life expectancy is 82 they would have to purchase a DLA no later than age 77.

These restrictions would limit the ability of investors to use DLAs to preserve wealth.

Question 11: Should providers of DLAs be able to offer a death benefit? If so, should there be restrictions on the size of the death benefit that could be offered? If so, what restrictions?

National Seniors believes that no additional restriction on death benefits should be applied to DLAs than what are applied to standard annuities and account based pensions. Any additional restrictions on DLAs death benefits would reduce the demand for DLAs.

National Seniors supports the ability of providers of DLAs to offer a range of death benefits which will provide the market with options. Noting that the restrictions proposed in our response to questions 7-9 will significantly limit the use of DLAs as a wealth retention mechanism which is the main risk associated with allowing DLAs to offer death benefits.

National Seniors believes that applying the same death benefit provisions to account based pensions, annuities and DLAs will promote consistency and competition in the post- retirement market.

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[12] Association of Superannuation Funds Australia (2014) *Retirement Standard* The Association of Superannuation Funds of Australia Limited.

[13] There are a number of life expectancy estimates that could be utilised including World Health Organisation, Australian Bureau of Statistics of Australian and the Australia Government Actuary.

Question 12: Are the current minimum payment amounts for account-based products appropriate to achieve the objectives outlined above, given financial conditions can change?

The current minimum payment amounts appear to be achieving the policy objectives, however some National Seniors members indicate that the current payment amounts are too high when compared to the current returns available in the market and therefore put seniors at risk of running out of money in later years of their retirement.

National Seniors is concerned that applying the assumed nominal investment returns of six per cent and inflation rate of 2.5 per cent as the basis for setting the current minimum payment amounts does not encourage adoption of lower risk investments.

National Seniors believes that a lower assumed rate of return linked to lower risk investment such as term deposits, government bonds and annuities would result in a lower percentage minimum drawdowns. Lower percentage drawdowns would be more appropriate as they would align with the more secure lower risk investment strategy for the retirement phase of superannuation which is promoted as a way to manage longevity risk. This would encourage individuals to take a more conservative investment strategy thereby reducing longevity and investment risk.

Question 13,14,15,16: Automatic mechanism for adjusting the minimum drawdown amounts in response to significant movements in the investment market performance?

National Seniors believes that there should not be an automatic adjustment of the minimum drawdown amounts. The difficulties in determining what factors would trigger an automatic adjustment and what level of adjustment is appropriate to make are too complex and variable to be reliant on a fixed automatic adjustment mechanism linked to an underlying index.

National Seniors believes a more appropriate approach would be for the government to determine a number of key variables which would trigger a government or ministerial review of the assumed available rate of nominal investment return, inflation rate and subsequent current minimum drawdown rate.

The key variables which could trigger a government/ ministerial review could be relatively high level such as a percentage drop in the ASX, a sharp increase in inflation or a rapid drop in the interest rates. However, the more in depth review undertaken by the government/ minister should then also consider the actual assets and risk exposures of investments held in account based pensions.

National Seniors believes that any changes to the minimum drawdowns based on the above methodology should be left in place for a minimum of three months. Any adjustments after that time should be in response to significant and sustained shifts in the variables which the government utilised to determine the change. This approach would also reduce the potential to make ad hoc changes to the minimum drawdowns.

National Seniors does not believe that the minimum drawdowns should be adjusted up in response to strong market performance alone as the markets performance does not reflect returns available from lower risk investments which are preferred by many retirees. In addition as superannuation savings have been taxed within the accumulation phases, increasing the minimum drawdowns could be seen as forcing the release of funds into the economy and increasing the exposure of retirees' savings to further taxation.

Further any link to increase the minimum drawdowns to strong market performance also put significant pressure on retirees to invest in high risk investments to ensure that they can achieve a return equivalent to any perceived losses from higher minimum drawdown requirements, thereby increasing the investment and longevity risk.

Conclusion

National Seniors believes that the current regulatory environment, the lack of understanding of risk, desire for control over investments and a limited market of innovative, post-retirement investment products is resulting in many seniors having unnecessary exposure to investment and longevity risk.

Providing the same favorable taxation treatment to DLAs and ensuring that the minimum drawdown requirements reflect the actual returns available in the market, including those from low risk investments will encourage investors to develop more conservative investment strategies within the retirement phase of superannuation and reduce their exposure to investment and longevity risk.

Investors should be able to purchase DLAs within limits which allow investors to self-fund up to a comfortable life in retirement by accessing a deferred guaranteed income stream.

National Seniors believes that it is the government's role to ensure that there are a range of post-retirement investment options available which consider the inability of retirees to recover from any losses suffered as a result of a decline in the market, such as occurred during the Global Financial Crisis. If more investors take up annuities, DLAs and low risk account-based pensions, the exposure to investment and longevity risk will fall and the need for adjustment to the minimum drawdowns in times of crises will be reduced.

National Seniors appreciates the opportunity to comment on these issues and will continue to work collaboratively with government to ensure Australians have adequate options for their post retirement investment needs.