FSC Retirement Income Products Conference

Keynote Address

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Retirement is different

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1. Fit for purpose question

This might come as a shock to some, but there is a serious question whether a defined contribution (DC) system like ours is fit for purpose in retirement. That was the fundamental conclusion that motivated the Financial System Inquiry (FSI) recommendation for CIPRs. The FSI realised that a 'pre-selected' combination of products would simplify decisions at retirement and, most importantly, deliver better outcomes for retirees. The FSI envisaged a regular and stable income stream, longevity risk management and flexibility (among other features). The FSI even suggested that the design should consider the possibility of cognitive impairment at older ages. In aggregate, the FSI pointed to a lot of things super is not doing for current day retirees.

There is a serious question whether a defined contribution system is fit for purpose in retirement.

This is an inconvenient truth, but even Paul Keating conceded some years ago that the super system was not designed for people who were going to live over the age of 80. The system he conceived was for the 55-75-year-olds.[1] People are now typically living into their late 80s, more than 9 years longer than they did in the 1990s. We need to enhance the model, which is what the MyRetirement reforms are asking us to do.

In the DC model, there is no structure to the drawdown phase. Flexibility is prioritised at the expense of risk management and income certainty and sustainability. This is the source of our current 'growing pains'. We are trying to bolt a more DB-like solution onto our DC system, while maintaining choice and flexibility.

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We are also shifting from the world of merely **supplementing** the Age Pension to a world of **substituting** or supplementing it.

1 Opening address at the 50th Anniversary ASFA Conference in Sydney on 28 November 2012.

2. Spending is different from saving

When a member of a super fund retires, the 'financial dynamics' of their long savings program are reversed. Instead of their employer making regular SG contributions on their behalf and their fund being a large scale 'wholesale' investor, the retired member becomes a 'retail' customer, but also a spender, rather than a saver. For the first time, there is a direct financial lifeline from the fund to the member. The fund becomes the source of the retired member's retirement pay cheque. This is a fundamentally different business from accumulating savings.

The super fund becomes the source of the retired member's retirement pay cheque.

And yet, in Australia, we seem to have one way of thinking about, talking about, and measuring, the success of superannuation – and it has little to do with providing regular, spendable cash flows in retirement.

3. Retirement income products

This quickly leads to a discussion of retirement income products; the subject of this conference. Products are undoubtedly important because they ultimately deliver the outcomes retirees are looking for when it comes to their financial security in retirement. It follows that a substantial part of the MyRetirement reform discussions have centred around those products.

But, products are downstream from some even more important considerations in getting the right financial outcomes for retirees:

a) **Philosophy:** If super is to produce income in retirement to substitute or supplement the Age Pension, what should that retirement income look like and what investment beliefs do the trustees follow in generating that income?

b) **Trustee director duties:** what does the system require of trustee directors when it comes to providing income to retired members?

c) **Supervision and accountability:** how is compliance with those duties going to be supervised and enforced?

d) **Advice:** what should retirement planning advice look like and what skills and training should financial advisers have?

Let's look at each of those in turn.

4. Retirement income philosophy

A super fund needs a retirement income philosophy. You will not be surprised to hear that I don't think this amounts to: "being great investors". The return of a member's money in the form of regular income and better managing their risks in retirement is not the same as the time-weighted returns achieved by the fund as whole.

A super fund needs a retirement income philosophy.

Not all things can be addressed by asset allocation. Fund trustees should have a clear view of where they sit on the spectrum between entirely probability-based outcomes and a risk-free retirement: one backed entirely by the Age Pension and Commonwealth government bonds, for example. Once they have worked out this retirement income philosophy, they can work on the delivery.

Let's use an aircraft analogy that I must attribute to UK pensions academic and expert, Professor David Blake.[2] When an aircraft takes off, it has a very specific flight path to its destination and constantly risk manages its ability to reach it using navigational waypoints and myriad other technologies. The crew constantly check fuel and other variables. If you think about the MyRetirement reforms, they are aimed at more retirees having a smoother flight; consuming their retirement savings more evenly over the course of their retirement.

5. Trustee director duties

Most activities or outcomes that call for improvement in superannuation are connected to governance. It's extraordinary to think that the *Superannuation Industry (Supervision) Act 1993 Cth* (SIS Act) is silent when it comes to trustee director duties in favour of retired members.

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The relevant part of the SIS Act which itemises trustee director duties (s 52) is cast in an accumulation paradigm, referring to 'investment options' (among other things). It makes no mention of 'retirement income' or any of the issues to which the MyRetirement reforms are directed.

The SIS Act could be amended to refer specifically to duties to retired members and their different income and risk management needs. That way, it wouldn't matter which fund a member belonged to, they would still be entitled to the same level of care and diligence when it came to the fund's MyRetirement offering.

Without going into too much detail, the covenants could deal with the need to formulate a plan that suits the demographic composition, account balances and retirement income needs of most retiring members. The trustees would also need to consider things like the pooling of longevity risk, protection from market risk and inflation, the sustainability of the income and even how the income needs of retirees with cognitive decline could be met more effectively.

6. Supervision and accountability

With such duties clearly spelt out in the SIS Act, APRA would then have a clear mandate and some signposts for building out a retirement income prudential standard. A close analogy would be the way APRA consulted with the industry in 2012/13 when it released a draft of, and then finalised, SPS 250 on insurance in super.

7. Seniors rely on financial advisers

National Seniors Australia (NSA) and Challenger recently released a research report[3] on the behaviour and attitudes of senior Australians regarding their retirement finances.

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What the report shows is that six out of ten Australian seniors are turning to financial advisers for advice and information about retirement finances.

This proportion is significantly higher than for superannuation member population overall, where only one in five seek advice.[4]

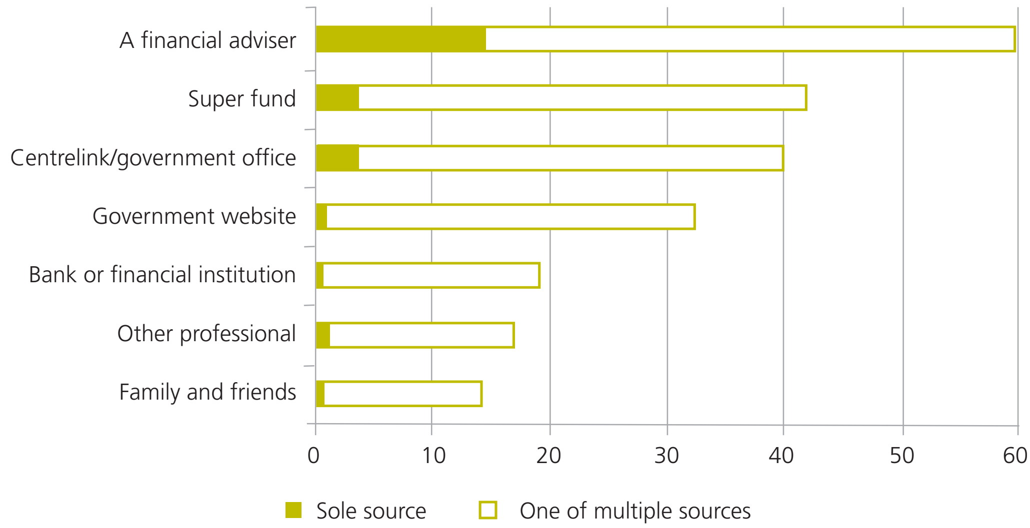
2 Blake D, Andrew Cairns and Kevin Dowd: Turning Pension Plans into Pension Planes (2008) https://www.pensions-institute.org/workingpapers/wp0806.pdf.

3 <https://nationalseniors.com.au/retirement-income> There were over 5,500 respondents who were over 50; 55% female and the average age was 68.

4 MLC Quarterly Wealth Behavioural Survey Q1:2017.

The most common sources of advice and financial information about retirement are: financial advisers (59 per cent); super funds (42 per cent); and, Centrelink and government offices (40 per cent). Contrary to widespread belief, family and friends are not highly rated as a source of financial information at only 14 per cent.

Who seniors turn to for financial information on retirement



8. Advice standards

The Financial Advice Standards and Ethics Authority (FASEA)[5] is a Coalition government reform seeking to improve the education, training and ethical standards of the financial advice industry. It is a commendable and important reform, but it is vitally important that FASEA realises that retirement is different.

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FASEA needs to move the industry away from the accumulation-centric view of advice. It needs to ensure that educational courses and ongoing training focus on the retirement income aspects of advice, as well as the predominant wealth creation aspects.

What would this look like? Factors that need to be considered include: age pension entitlements; life expectancies; cash flow projections; spending rates; sustainability of the portfolio; longevity risk (and other risks specific to retirement); potential cognitive decline and aged care.

This is borne out by the NSA report, which gives some pointers about the key goals for retirees. Beyond the timing of the next overseas trip, seniors' key goals are:

- Generate a regular stream of income to meet essential spending;
- Have income that will always be there; and
- Meet health and aged care costs later in life.

Those goals sound simple, but a high degree of skill and training is required to address those three goals in a clear, concise and effective way. We seem well on the way to delivering this for all retirees.

5 https://treasury.gov.au/programs-and-initiatives-banking-and-finance/financial-adviser-standards-and-ethics-authority-limited-fasea/

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9. Household view

The predominant goal of super is to create a retirement pay cheque; a regular flow of income to live on in retirement. In practice, consumption or spending happens at a household level. This another big challenge: we save up super individually because it's employment-based, but most of us spend it jointly in retirement. Sharing a roof is the most basic element of shared consumption of retirees. In the 2016 Census, nearly 70 per cent[6] of people aged 60-64 were married or partnered and less than 20 per cent were living alone.

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While it is important not to forget the minority of singles and the extra burden they often face, the majority engage in, and benefit from, pooled household consumption. The payment rates for the Age Pension also recognise this with singles receiving proportionately more than each member of a couple (i.e. circa $23,000 for a single full age pension with supplements, versus around $17,500 for each member of a couple).

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Where possible, all participants in the retirement income system need to be more accustomed to distinguishing between the solo retirement and the pooled retirement. They are very different experiences and need different treatment. We are often not making this distinction.

10. Measuring success in the retirement phase

One of the problems facing the industry is determining measures of success, at the fund level, in providing income in retirement.

An overall measure of success needs to capture key quantitative and qualitative factors around the financial outcomes provided to a retiree through retirement. This is harder than it sounds.

Measuring success in accumulation is relatively straightforward. It revolves around performance league tables. It is having a strategy with the highest net after-tax, risk adjusted returns over say a rolling 7 to 10-year period or longer. The trouble is that the sort of portfolios that are producing these returns are all built on ideas related to modern portfolio theory (MPT). The problem is that MPT doesn't work in retirement; it doesn't factor in the cash flows in retirement and effectively assumes an endless investment horizon. Most retirees will need to consume some or all of their savings along the way.

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There are numerous other challenges in retirement: sequencing risk, inflation, longevity risk, drawdown rate and the bequest motive to name some. These factors all need to be managed to deliver a stream of retirement income for the retired member to live on. A higher accumulated balance alone will not guarantee success.

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We therefore need new measures of success in retirement so that funds can better manage towards them. This needs a balanced scorecard approach, based around something like these key parameters:

- The probability of meeting the cash flows needed to support the retiree's desired spending. This would need:
  a) An ex ante measure, an actuarially-based assessment of the payments that can likely be made; and
  b) An ex post measure to look at payments made through a person's retirement;

6 The exact figure was 69 per cent.

- An estimate of the expected estate balance (where zero is the optimal outcome for any unintended bequest);
- Member satisfaction with the level of liquidity (e.g. for unexpected spending needs) afforded by the plan;
- The path and variability of income, and the impact on the member's peace of mind (e.g. loss aversion); and
- An overall retirement plan satisfaction score.

11. The Future Fund and wholesale investing

Peter Costello recently suggested that the Future Fund could take over the management of the default sector of super; that is the more than $600 billion sitting in MySuper products. This was quickly rejected by the super industry, but he had a point. The Future Fund could **theoretically** do this because it has a good handle on asset allocation and has access to the same asset managers as super funds. Another government agency like Medicare or the ATO could handle the cash flows. But, let's be clear **I am not advocating for this**. The point I'm getting around to making is about retirement income.

MySuper was excluded from the retirement phase by legislation. It can only operate in accumulation. The point I think Costello was making is that accumulation investing is a generic activity that could be outsourced elsewhere.

What this suggestion does is remind super funds where they have a natural advantage: their connection to their customers; their members, in meeting their needs in retirement. They have much less of a natural advantage when it comes to generating investment returns.

The Future Fund would not be able to service retired members with pensions because it does not have the necessary data on them and it doesn't know their financial needs and goals in retirement.

This deep knowledge of the characteristics and needs of millions of workers and retirees is the true advantage super funds have.

Funds who are lacking such information or are not focusing on it are in that same highly contestable and generic business of wholesale investing as the Future Fund. This is the take away for the super industry

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12. Recap of key points

Our pure DC system is not completely fit for purpose in retirement. Both the FSI and Paul Keating have said this and they were right.

Super is moving from merely supplementing the Age Pension to an increasing level of substitution. In this world, the Age Pension will become more clearly a safety net and super will increasingly have to provide the secure income that the Age Pension once did.

Retirement income is not just about products. You need an underlying philosophy and sharpening the duties of trustee directors towards providing income in retirement would greatly assist funds in developing these.

Retirement income is not just about products.

The super system needs to be able to measure success in the retirement phase and it's not just a matter of using our accumulation measures.

Measuring success by just being good investors is a dangerous game. There is a big wide world of asset managers out there and it is a highly fungible process. Serving customers, particularly retired customers, is the point of distinction for super funds.

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13. Call to action

The super industry is under pressure. There are existential threats all around. Thought leaders are calling for radical changes, including even nationalisation. Pressure emanates from the Productivity Commission; digital disruptors and the community at large. There are even calls to extend the proposed Bank Executives Accountability Regime beyond the banking sector to institutions, including super funds. In July this year, the Financial Conduct Authority in the UK put forward a proposal to extend its equivalent regime to all regulated firms.[7]

What is the solution? A focus on better meeting the needs of the customers. Who are those customers? Accumulators and employers might oil the wheels, but it is a fund's retired members who are its true customers. They look to a fund to provide regular income and to manage risks that they cannot manage on their own. To deliver this, we need to accept an inconvenient truth. Our wholly individualised DC system is not up to the task for the vast bulk of retirees who cannot afford to manage those risks themselves. That is what the MyRetirement reforms are asking us to do. Burying our heads in the sand is not the solution.

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7 CP 17/25: Individual accountability - extending the Senior Managers and Certification Regime to all FCA firms https://www.fca.org.uk/publications/consultation-papers/cp17-25-individual-accountability-extending-smcr.