On many counts, Australia’s superannuation system is one of the best pension systems in the world. By garnering 9 percent of the national payroll (a rate set to increase incrementally to 12 percent by fiscal 2020), we have amassed a US$1.4-trillion store of retirement savings, our stock market is bigger than our gross domestic product would suggest, and we have a vibrant funds management industry—the fourth largest pool of funds under management globally (Australian Trade Commission 2011). Our superannuation system also was able to play a key role in recapitalizing our banks and major companies following the Lehmann collapse in 2008, with a total of US$90 billion raised in the 2009 fiscal year.

In 2009, Australia began a major review of its pension system (Australian Treasury 2010b). The major reforms that flowed from the Australian government’s response to the review, labeled “Stronger Super,” included a modernization of the administration of pension funds, a new style of simpler, more cost-efficient default fund called “MySuper,” and a range of changes to governance, transparency of outcomes, and disclosure of risk and return objectives.1

While these reforms are significant and represent the largest changes since the introduction of compulsory superannuation in 1992, one area experienced few explicit changes: the retirement or decumulation phase. On reaching retirement, the majority of Australians withdraw their pension balance, a minority of them commit the sum to income-stream products, and a very small number opt for a guaranteed income for life in the form of an annuity (both of which are tax-free).

Indeed, Nick Sherry, a former superannuation minister, recently said: “We don’t have a pension system. We have a lump sum payment system” (Sherry 2012).

This represents the next major challenge for policymakers and private sector participants in Australia’s superannuation industry alike: the transformation of our accumulation-focused, lump sum system into one that provides our 3.2 million retirees a guaranteed, inflation-adjusted lifetime income stream.

Australia’s superannuation industry has tended to regard retirement as just another phase in the lifetime pursuit of wealth maximization in which retirees maintain their status as investors. Of course, as those from nations with more-developed pension systems will understand, this sits at odds with the mathematics of portfolios in decumulation as well as the overarching objectives of many retirees.

Australia’s equivalent of AARP, the National Seniors Association, recently surveyed a sizeable sample of its members (National Seniors Association 2012). The survey found that more than two-thirds of respondents, both retired and working, said their greatest concern was that inflation might erode the value of their savings.

The survey also found that a majority of workers also is concerned that they won’t maintain a reasonable standard of living in retirement or might outlive their savings, and that respondents placed a very low value on funds received in the future. Participants were asked what reward they would need in order to delay the receipt of the sum of $10,000 for a year. The median response was $5,000 (i.e., receiving $15,000 a year later), showing that respondents applied an annual discount rate of 50 percent to the value of future cash flows (exceeding the current market-based Australian discount rate by a factor of more than 10 times).

The survey results seem to show a mismatch between what the industry is delivering and what retirees say they want.

Moving Beyond One-Size-Fits-All Thinking

Australia’s most-popular retirement income product is the account-based pension, which is essentially a “balanced” managed fund in phased-withdrawal mode (in Australian industry parlance, “balanced” usually means around 60–70 percent invested in growth assets).

While retirees have a degree of underlying investment choice, very little of the product is tailored to suit their needs and the asset allocation remains consistent with default balanced funds in accumulation. It is very much a one-size-fits-all approach.

The word “pension” here is a misnomer because whether the product actually produces sustainable retirement income is at the risk of the retiree. The majority of products have no guarantees, structured protections, or any explicit inflation or longevity hedging.

Account-based pensions are designed to run out. Much like in the United States, minimum drawdown requirements increase with age so that tax-advantaged savings are ultimately depleted. In fiscal 2013, for the fifth consecutive year, the Australian government reduced the required drawdown.
rate to give some relief to retirees who have experienced the serial depletion of retirement capital since 2008. While this has been welcomed by retirees and the industry alike, it is a poor reflection on the suitability of Australia’s core retirement product. Retirees should not be so universally exposed to market volatility.

Anecdotally, many holders of these products mistakenly believe them to be annuities, probably because they’ve continued to draw the same income stream even when the account balance has fallen considerably.

The term and lifetime annuity markets in Australia remain nascent, but are growing rapidly with some product and distribution innovation taking place. A growing chorus of voices from academia, the actuarial profession, and industry is calling for the removal of unintended legislative impediments to the issuance of deferred lifetime annuities.

Into the future, better retirement solutions are likely to combine existing products to provide both a level of certainty (e.g., through an annuity) and the opportunity to benefit from market upside (e.g., through an account-based pension or phased withdrawal product).

Combining retirement products in different ways allows the retirement problem to be separated into different parts according to a retiree’s requirements. Some retirees might want certainty of cash flows throughout retirement. Others might be willing to accept a degree of market risk in order to capture potential market upside. Whatever the case, having a suite of retirement products available will allow advisors to tailor retirement to individual retirees.

Innovation Required in Dominant Distribution Mechanism

Investment platforms or wraps are a major distributor of superannuation and retirement products in Australia, but innovation in the platform industry during its 25-year lifespan seems to have slowed recently (Beaman 2012). The significant cost of building and expanding a platform is likely to limit innovation, particularly in light of current market conditions.

However, there are a number of challenges to offering suitable retirement products in a platform environment. Retirement solutions historically have been individually focused, e.g., a lifetime annuity, which has a rate based on an individual’s age and gender, so these solutions do not naturally fit with platforms, which consolidate investors into single holders, typically via unitization. Innovation and collaboration at both the product and platform levels are required before annuity-style retirement solutions are more readily available via platforms.

Longevity Risk

Australians are living longer and improvements in mortality are expected to continue. A 25-year retirement now is considered the norm, and retirees face a real danger of outliving their savings if they fail to address longevity risk.

The longevity assumptions underlying the Intergenerational Report produced by the Australian Treasury (2010a) were that half of 65-year-old Australian men can be expected to live until age 87, and one in five can be expected to live to age 94.

The account-based pension, while part of a retirement solution, does not offer adequate longevity protection or any explicit hedge of inflation risk.

Sequencing Risk

Sequencing risk occurs when cash flow is being drawn from a market-linked portfolio. In retirement, market volatility increases the risk that assets will need to be liquidated when prices are depressed. In this case, more units of capital need to be sold to meet spending needs which, of course, present themselves in dollars rather than units. When the market rebounds from the lows, less capital is invested, and so the actual return received ends up below the average return.

This is a problem with many online retirement calculators available for public use in Australia. Using fixed, “average” long-term returns is common in Australian retirement planning and often is labeled as a “typical” outcome. However, sequencing risk means that even if the average return is achieved, when returns are volatile the average outcome (in terms of income or capital) is less than that projected by assuming average returns. It is not the case that beating the average is a 50-50 coin toss. The coin is loaded and the more volatile the investment, the more likely the result will actually be below the projected “average” outcome.

Ultimately the system will recognize these differences in retirement, but presently the approach of seeking to increase returns by investing in more risky assets is applied to retirement, similar to the accumulation phase.

Income Streams

Income streams have re-entered the Australian policy debate. Before 2004, lifetime income-stream products were encouraged by policy with the objective that retirees had access to a secure income stream other than the Government Age Pension. In 2007, at the height of the equity market boom, the policy changed to better accommodate equities-heavy account-based pensions. The impact on retiree incomes from the past five years of poor equity markets has been part of the reason that retirement income products are now under review by a Superannuation Roundtable.

Deferred Lifetime Annuities

Deferred annuities do not currently exist in Australia due to various taxation, social security, and other regulatory blockages that led to them being phased out in the early 1990s. However, the Superannuation Roundtable is exploring the feasibility of deferred...
annuities and other retirement income-stream products.

The reintroduction of the deferred annuity is an exciting potential development for the Australian industry because it will open up two very interesting opportunities:

- The ability to buy pure longevity insurance under which policyholders will get the dual benefit of pooling of premiums (i.e., mortality credits) and the time value of money inherent in the contract (i.e., the long deferral period between retirement and the annuity coming into distribution);
- The concept of a “bounded retirement”: a known period between retirement and the deferred annuity moving into distribution during which retirement savings can be invested and consumed in the knowledge that a backstop of inflation-adjusted cash flow exists in the form of the deferred annuity. In this way, deferred annuities might help solve the greatest dilemma faced by retirees and their advisors: “How do I make a finite amount of money last an unknown length of time?”

“Preservation Age” at 60 or 62?

Australia recently has begun debate over whether the age at which people can retire and access their supers should be increased. This “preservation age” is now 55 and will increase to 60 by July 1, 2024. This question has arisen because the age at which people can access the first pillar of Australian pensions is moving to age 67 by 2024. Although this will be a smaller gap than currently exists (i.e., males currently can retire at 55 and access their supers), it still gives rise to the risk of inducing people to retire too early, deplete retirement savings, and increase longevity risk. Australia’s Financial Services Council (2012) estimates that adding two years to the preservation age (to 62) would almost halve its estimated “superannuation savings gap” of US$830 billion.

Asset Allocation in Australia’s Pension System

Another Australian debate is running about the style of asset allocation typically adopted by super funds, particularly whether our equities-centric approach is suitable for retirement.

Australian super funds are out of alignment in terms of their allocations to fixed income investment, which, according to the Organisation for Economic Cooperation and Development (OECD), sits at 11 percent. This is:

- the lowest allocation of any OECD retirement system,
- one-half of the next lowest OECD member, and
- about one-quarter of the OECD average.

This is made more pronounced by a triple whammy of three other factors: our relatively high allocation to equities, the high preponderance of defined contribution (DC) funds in our system, and the absence of guarantees for members. It is not uncommon in DC systems for there to be guarantees (e.g., Germany and Switzerland). Now, even the U.K. Minister for Pensions is asking the pensions industry whether DC pension members should be offered so-called “money-safe” pensions where their contributions are guaranteed (Cumbo 2012).

Australia’s super system is relatively immature and has been largely an accumulation system. It has been rational to have a high allocation to equities and a low allocation to bonds in a predominately accumulation-focused system. But this will have to change quite quickly.

Super fund members age 45 to 65 own roughly 61 percent of the assets in the system. More than US$900 billion is on the verge of, or moving toward, retirement over the next 20 years. More than US$500 billion of this is owned by people age 55 and older. This has profound implications for a retirement system that has so far seen itself as an accumulation system. The weight of all this money moving to the decumulation phase will create irresistible pressure on the asset allocation of the system to shift to more-secure and less-volatile assets.

Life-Cycling in MySuper

The MySuper reforms will force the Australian superannuation industry—and all of its intermediaries, investment managers, and consultants—to revisit the current static asset allocation model to deal with age-related exposures to risk. This will become more obvious when the industry starts to engage with MySuper. It cannot possibly be the case that the traditional Australian 70/30 model is the 21st-century standard where the 20-year-old and 64-year-old (and in some cases 74-year-old) have the same asset and risk allocations. This will have profound, but largely positive, implications for Australia’s retirement savings system.

Conclusion

Economist Joseph Schumpeter once said: “Pessimistic visions about almost anything usually strike the public as more erudite than optimistic ones” (McCraw 2007). And so it is that this article has concentrated primarily on our weaknesses. However, Australia is well-placed to be able to round out its pension system by focusing more on secure lifetime income while maintaining the existing range of other wealth management options to the benefit of Australia’s savers and the macro-economy alike.

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Endnotes


References


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