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Ms Karen Chester
Deputy Chair
Productivity Commission
Locked Bag 2, Collins Street East
MELBOURNE VIC 8003

Dear Deputy Chair

Re: Draft Report – Superannuation: Assessing Efficiency and Competitiveness

Challenger Limited welcomes the opportunity to make a submission to the Productivity Commission (the Commission) draft report into the competitiveness and efficiency of the superannuation system.

Challenger is a top-100 ASX listed company and the leading provider of annuities in Australia, delivering on our vision to provide our customers with financial security for retirement. We provide more than 60,000 Australians with a secure and reliable income in their retirement.

The focus of the industry has been predominantly on the accumulation of assets. Retiree superannuation balances are now reaching meaningful amounts at the household level and the system must turn its attention to how start paying the money back to retirees in the form of regulator income payments. Our submission addresses issues which have resulted from insufficient industry focus on retirement and provides suggestions for how this could be rectified.

If you have any questions or would like further information in relation to this submission, please do not hesitate to contact me

Yours sincerely

Carla Hoorweg
National Manager, Government and Industry Relations

Appendix A– response to draft report

Moving from an accumulation view to a retirement view

There has been an historical belief that the superannuation balances of people starting retirement are too low to be a major point of focus for the industry. Instead attention has been largely directed to superannuation's accumulation phase at the expense of how this money should be paid back to members in retirement. The heavy focus on accumulation was needed to build up member balances from scratch, but the tipping point has now been reached.

It is now time for the system to start giving money back to the retirees for whom it was created. At June 2017, there was $760billion already in the retirement phase. Australian superannuation savings are expected to double in size from $2.6trillion to around $5trillion by 2030[1] and around $1.3trillion will move into retirement phase over the same period.[2] Approximately 700 Australians are retiring every day and 51% of national wealth is owned by the 45-64-year-old cohort.[3]

The growth in the system is reflected in analysis of average balances of retiring members from 'top performing funds', which are now close to $300,000.[4] Extrapolating this to a newly retired couple household shows that superannuation delivers roughly $500,000 on top of other savings and the family home.[5]

The ultimate purpose of the superannuation system is to provide income in retirement. Accumulating a larger balance is important for retirement but does not in itself guarantee a good income throughout retirement. The process to achieve this by giving the money back to the member must also work well.

Transitioning to the payment phase of super

We believe the final report should have a greater focus on the "payment phase" of superannuation. Until now the superannuation system has not focussed enough on how to give members their money back in regular payments over the whole of their retirement, however long that might be. This is a significant challenge that must be overcome for the Australian system to complete the move from a defined benefit system to a defined contribution system. Funds and retirees will need to begin conceiving of retirement in terms of retirement pay cheques, or monthly income for life.[6]

This transition will also require the industry to move away from an 'endowment' view of retirement, where capital preservation is prioritised, to an understanding that safe consumption of savings over retirement is the real objective. Currently, the industry does not manage this pool of savings efficiently, as many retirees are under-spending their savings and thereby suffering a lower standard of living during retirement than they need to. This is reflected in the latest National Seniors Australia (NSA) Survey which found that most senior Australians are concerned about running out of money in retirement, and regular and constant income is seen as the most important priority.[7] The transition to a consumption mentality will not be straightforward though, as retirement presents different challenges from the accumulation of assets during working life.

Longevity is another key issue. When former Prime Minister Paul Keating established Australia's superannuation system in the 1990s, it was conceived for 55-75-year-olds.[8] Today's retirees are typically living into their late 80s, more than 9 years longer than when the system was established.[9] Safe spending across increasing life spans requires careful management of longevity risk.

Further, for an increasing proportion of retirees, superannuation is transitioning from merely supplementing the age pension to replacing it. At June 2017, only 42% of the over-65 age cohort were receiving a full

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[1] Rice Warner Superannuation Market Projections Report 2017
[2] Ibid, sum of flows June 2018 to June 2030 (in 2017 dollars)
[3] ABS (13 September 2017) 6523.0 Survey Household Income and Wealth 2015-16
[4] Based on APRA Superannuation Fund Level data, 2017
[5] Based on ATO data of aggregated balances using tax file numbers (age 60-64)
[6] See for example the arguments in Merton, R. 2014, 'The crisis in retirement planning', *Harvard Business Review*
[7] National Seniors and Challenger. (2018). Once bitten twice shy: GFC concerns linger for Australian seniors. Brisbane: National Seniors.
[8] Opening address at the 50th Anniversary ASFA Conference in Sydney on 28 November 2012.
[9] For example, a sixty-five-year-old woman today can expect to live to 90 on average, with one-in-five to live to 98, based on ALT2010-12 with 25-year mortality improvements from the Australian Government Actuary

pension, with a further 28% on a part age pension.[10] Six out of 10 over-65s are now partly or fully funding their own retirement. The system is becoming more mature, with greater numbers of people retiring who have had the benefit of a higher superannuation guarantee for much of their working life. This is contributing to the overall growth of superannuation assets and will also continue to contribute to the increasing number of retirees who rely less on the age pension, as a proportion of their total retirement income.

Retirement is different

The Commission has viewed superannuation largely through an accumulation lens, however delivering income in retirement is a very different paradigm, due to the following retirement-specific factors:

- **There is usually no regular or lifetime income other than an age pension entitlement:** the 'financial dynamics' of accumulation are reversed. There is generally no regular wage or salary or lifetime income (other than an age pension entitlement) and the retiree starts drawing down on their savings to fund consumption. This makes it a fundamentally different proposition from accumulating savings and introduces new risks;[11]

- **Retirees have specific goals:** the goal of most accumulators is simply to build up the maximum amount of retirement savings for a given risk appetite; time horizon and contribution rate (they may or may not be targeting a level of retirement income from those savings). This explains the risk-profiling approach used by most advisers. In retirement, most retirees will have a range of goals that will include an income goal for spending; access to capital for emergency spending; growth; peace of mind and leaving a bequest. These goals create a very different dimension from the accumulation phase;[12]

- **Retirees are exposed to longevity risk:** the risk that they outlive their savings because of increasing life expectancies. Longevity risk also has another dimension: the uncertainty of how long people will live. There is a wide distribution of actual lifespans around the mean (i.e. life expectancies of retirees). A 65-year old female only has a 5% chance of dying in the year of her life expectancy (currently 90). This makes planning around retirement income needs all the more complicated;

- **Sustainability of retirement savings:** becomes a new and important concept. This has two elements: the probability of success of the retirement plan (expressed as a percentage of likelihood of reaching a particular age with savings still intact) and the range of potential outcomes based on market returns that deviate from long term averages;

- **An understanding of life expectancies is critical:** to advise on the sustainability of a retirement portfolio and the rate of safe spending from that portfolio, advisers need a strong understanding of life expectancies, including concepts like mortality rates, mortality improvements and, most importantly, the deviation of actual lifespans from the mean;

- **Market risk takes on a new dimension - sequencing risk:** when drawing on a portfolio, the sequence of returns matters. Negative market movements early in retirement have can have an adverse impact on the sustainability of cash flows.[13] A retiree's ability to recover from poor investment returns (or take advantage of lower market prices) is generally limited because strategies

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[10] Calculated from full pension recipient data from DSS 2017 Annual Report and DVA Pension statistics as at June 2017 and ABS estimates of population for June 2017 (Cat #3101.0)
[11] For example, dollar cost averaging works in reverse. See Challenger Retirement top tips: *What works in accumulation works against you in retirement,* January 2012
[12] This is usefully summarised in a 2013 white paper by Lonsec and Milliman entitled *Boomers, Herding, Denial and Zeitgeist: Who will be First to Grasp the Post-Retirement Advice Opportunity?*
[13] Challenger Retirement Income Research, *The ABC of sequencing risk, August 2012* <https://www.finsia.com/docs/default-source/Retirement-Risk-Zone/the-bca-cab-bac-abc-of-sequencing-risk.pdf?sfvrsn=2>

available in the accumulation phase (take more risk; keep working and contribute more) are generally not available;

- **Household expenditure is funded by individual savings:** yet the predominant way people approach the financial challenges of retirement is by sharing them with another person. Around 70% of people start retirement in a couple household. We accumulate retirement savings individually, but generally spend it jointly. As a result, retirement income advice is generally best framed to align with this reality;

- **Inflation becomes a significant risk:** inflation takes on a new dimension because the retiree's capital is disconnected from wage rises and retirees can generally only be confident of maintaining purchasing power via the age pension and explicitly inflation-linked investments. Recent low inflation rates, following an extended period of inflation at 'average' rates, does not make it any less likely that inflation could deviate strongly from the mean during a lengthy retirement;

- **Long-term investing is no longer a panacea:** plans based solely on notions like 'investing for the long term' are generally less relevant in retirement, although growth assets will play a material role in most portfolios. Due to spending needs, approximately half of a typical retiree's savings are consumed in the first 10 years and a smaller proportion of savings can be set aside for 'the long-term'. Later retirement spending is funded from dollars created by compounding returns during retirement;

- **Diversification does not mitigate all risks:** by itself, diversification of asset risks is much less able to deal with retirement income challenges than is widely thought. For example, for most retirees, longevity risk cannot be ameliorated solely by exposure to growth assets. It is not just about having money later, but it is the ability to spend confidently, and not run out;

- **Importance of cash flows:** retirees say that they want a 'retirement pay cheque'[14] and yet most retirement plans are based on investment returns and capital accretion, rather than regular, stable income;

- **Pooling benefits can be realised:** pooled retirement income products produce a distinct form of income known as a 'mortality credit': effectively the yield from capital belonging to those who predecease the projected life expectancy of the pool. This form of retirement income is uncorrelated to market assets like equities or bonds and can be distributed from the start of retirement, based on actuarial assumptions. It is unique to pooled retirement income products and significantly enhances the rate of return to surviving members of the pool;

- **Cognitive decline:** sound retirement income planning and advice involves the recognition that there is a high likelihood that at some point along the way, one or both members of a retired couple will suffer cognitive impairment or dementia. Many strategies involve more complexity and decision-making than is suitable for late stage retirees;

- **Elder financial abuse:** older Australians are exposed to financial abuse, often at the hands of family and carers. An increase in online and card-based services means that older people are even more vulnerable to such exploitation. Those giving retirement income advice need to be attuned to this problem; and

- **Each retiree's needs tend to be distinct:** there are no universal solutions to funding a retirement and the individual circumstances of retirees' (such as their health; intended consumption patterns; financial literacy; marital status and their likely longevity) play a much bigger role in the advice and

[14] Above n 11

planning process than in accumulation. This is largely because accumulation does not involve any element of spending.

Choice in retirement

The lack of a retirement focus has resulted in a lack of choice in the market. This lack of choice has been identified by the Commission in the draft report, however there are several issues which we believe should also be highlighted. We outline these below.

Current product choice is lacking

The draft report recognises that decumulation is more complex than accumulation due to multiple and conflicting objectives, interactions with the needs of a spouse/partner, age pension, health and aged care needs and assets held outside superannuation. We agree that retirement is complex and that different considerations emerge in retirement however we note that the retirement phase may be even more complex than the Commission has identified due to reasons that we have outlined earlier.[15]

The draft report considers whether enough product variety is available in the maturing superannuation system. We believe retirees need more choice in how to spend down their retirement savings with confidence. The system currently does not provide structure in the drawdown phase, with flexibility prioritised at the expense of risk management, income certainty and sustainability.

We are concerned that retiree perspectives do not match what is currently being provided by the system. The NSA Survey found that 7 out of 10 over 50s remain concerned about another potential market collapse from a global financial crisis style event, with only 1 in 14 believing they would be able to tolerate a loss of 20% or higher, and 1 in 4 saying they could not tolerate any annual loss on their portfolio.[16] These findings show that retirees are concerned about exposure to equity market risk, yet the NSA Survey findings also show that despite this intolerance to loss, the great majority of older Australians hold a proportion of their savings in market-linked investments; products that do not adequately manage exposure to market risk.

The government's proposal to introduce a requirement for funds to offer comprehensive income products for retirement (CIPR) will add to the options available for retirees. The combination of longevity protection through an annuity or other pooled lifetime income stream will enable a larger number of retirees to more adequately balance the risks to which they are exposed.

Account-based pensions

Currently account based pensions (ABPs) are the predominant product available in retirement. Many superannuation funds now manage assets for their retired members that run into tens of billions of dollars. These savings are in ABPs, which are invested little differently from the assets of those still working, even though retirees face very different risks. Specifically, many ABPs provide similar levels of equity exposure in retirement as in accumulation.

Further, there is little recognition in the market or the Commission's draft report that retirees are largely 'defaulted' into ABPs. The CIPR proposal has received criticism for being a 'soft default' yet ABPs proliferate, are offered to members without advice, and are offered with an implicit assumption that they are suitable for all retiring members. We argue that an ABP alone does not adequately cater for the unique risks that retirees face and that a different approach in retirement in required.

Whilst we agree, in part, with the Commission's draft finding[17] that it is not desirable to default members into a CIPR, we believe ensuring that every member has access to a product that is designed to pay them back in retirement is a necessary step to ensure that member needs are met. Choice in retirement necessitates retirees being able to choose from a selection of products at retirement, instead of the current approach of solely offering an ABP. The government's CIPR proposal will go some way to introducing a wider range of retirement products.

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[15] See section entitled *Retirement is Different*
[16] Above n 7
[17] Productivity Commission Draft Finding 4.4

Advice issues

We do not agree with the comments in draft finding 4.4 suggesting that improving the quality of financial advice given to members is the most important task remaining. While the provision of quality retirement-focused advice is very important, we would suggest that this is just as important as the industry placing a greater focus on retirement.

We have reservations regarding the provision of financial advice in retirement. Consistent with the general focus of the industry, training for financial advisers is heavily skewed toward accumulation issues. The content in those courses that do have a retirement component is weighted toward tax strategies and estate planning, with little focus on the unique aspects of providing advice to members who are approaching, or in, retirement such as life expectancies, sustainability of savings to different confidence intervals, and cognitive decline. We note there are leading advice businesses which do provide comprehensive retirement advice, however there are opportunities for this to be improved across the rest of the market. We also have reservations regarding the pathways that are currently being developed by FASEA[18] and are concerned that these will not sufficiently train new advisers in the unique needs of retirees unless there are significant changes to existing course structures.

MyRetirement and CIPRs

The government's proposal to introduce a mass-market CIPR does go some way in addressing our concerns regarding financial advice. Currently only retirees seeking advice are receiving solutions to manage retirement specific issues. A mass-market CIPR could provide access to solutions that are currently only available under advice. A well-designed CIPR has the potential to increase product choices for unadvised retirees and provide them with a simple package that can address many retirement concerns. Like all products, it would need to be offered with the standard option to seek advice for a personally tailored solution. We note that ABPs are currently offered to unadvised clients, so mechanisms already exist in the system to deliver retirement products to unadvised clients.

Pre-retirees

We agree with the intention of draft recommendation 11. It is essential for pre-retirees to receive guidance on their options and to arm themselves with good quality information. We question whether this recommendation goes far enough. We would like to see financial guidance available for pre-retirees who seek it, however we note the issues we raised earlier regarding the current limited training for advisers in the unique needs of retirees. Training will need to improve if pre-retirees are to benefit from this recommendation.

Older Australians are making plans for living longer and are planning across a wide range of activities, with the most common being keeping the brain active, staying fit and healthy, making medical plans and staying positive. Just over half (56%) have made a financial plan. We believe this proportion should be higher.[19]

"Simple is wrong"

It is true that the concept of accumulating savings is more straightforward than managing the risks that emerge in retirement. To say that "simple is wrong" in retirement[20] however ignores what the system should be providing retirees. From the perspective of a retiree, their superannuation should very simply provide them with a reliable source of income for the duration of their life in the same way that a defined benefit scheme or government pension does. Significant complexity might be required in managing this outcome for retirees but if managers and trustees are doing their job, the retiree experience should be one of relative simplicity.

The draft report suggests that sufficient product variety already exists in the market, and the fact that most people choose ABPs is evidence of the unattractiveness of non-ABP products. This is not the case. The

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[18] Financial Adviser Standards and Ethics Authority ("FASEA")
[19] Above n 7
[20] Productivity Commission Draft Report p 198

system is currently set up in a way which promotes the use of ABPs, with superannuation funds effectively offering ABPs as the only alternative to a lump sum.

If it is true that “most retirees value the need for a regular income but that pension accounts by themselves are imperfectly constructed to achieve that goal, when people face early sequencing risk, withdraw at high rates or there is any protracted period of poor returns”[21] we must ask whether the products on offer are suitable. Where retirees are choosing products that might not deliver the outcomes they are seeking there must be confusion. We would argue that the limited take-up of other retirement income products is more a reflection of the inability of retirees to predict their lifespan or spending needs on their own, rather than a result of products being unattractive.

We believe it is too early to tell exactly how the market will respond to changes to the tax and regulatory settings for retirement income stream products. Changes to promote innovative retirement income products came into effect just on a year ago[22] and the market is still working through the technical implications. New pension means testing rules will take effect from 1 July 2019 but have not yet been introduced into parliament. There is still enough regulatory uncertainty to inhibit new products from being brought to market until all changes are fully implemented and understood.

Fallacies regarding annuities

In some places, the draft report refers to ideas that repeat fallacies or are based on false assumptions regarding lifetime annuities. In this section we address these issues.

“Irreversible”

Longevity products are positioned as irreversible with an implication that people should avoid longevity products because they are irreversible. For example, on page 39, there is a suggestion that guidance is required before a member commits “to mostly irreversible longevity risk products”, however almost all longevity risk products sold in Australia have in-built flexibility and are not irreversible. Prior to the rejuvenation of the lifetime annuity market in 2010 most products were irreversible, but market testing highlighted the benefit to retirees of secure regular income for life. As a result, Challenger launched the Liquid Lifetime annuity which provided both a death benefit and access to capital for up to 15 years. This concept has been further developed in recent years and the capital access schedule that was part of the 2017 changes for innovative retirement income streams means that reversibility will continue to be an important element of longevity products in Australia. Currently, of the $422million in lifetime annuity sales in the 6 months to December 2017, a significant majority had access to capital and death benefits for many years after purchase. It is now well-recognised that these lifetime annuities are far from irreversible. In practice there is a greater fear of needing flexibility than an actual need. There is a cost, in that payments will be lower due to the flexibility features, but indicative pricing as at 2 July 2018 for a 65-year-old male shows a flexible annuity can provide payments of $5,239 per annum for life, indexed to CPI inflation from a $100,000 investment compared to an indexed payment of $5,612 per annum for a lifetime annuity with no flexibility after purchase.

Most importantly, for most retirees, the allocation to the annuity is only a small proportion of their total savings, often around 20%. This is a critical point because it means that the remaining 80% is available at any time to cover unforeseen circumstances. The allocation to the annuity can be held intact to manage the longevity risks as intended.

“Expensive” (value of annuities)

Annuities are relatively expensive/have poor reputation/represent poor value – p169, p201, p203

There are several references to the perceived poor value of annuities in the draft report but limited description of the basis for the assessment. Academic studies in Australia were conducted in a time when

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[21] Productivity Commission Draft Report p 199

[22] *Treasury Laws Amendment (2017 Measures No. 1) Regulations 2017*

annuities provided limited flexibility and were sold with relatively high commission payments. This is not representative of Australian annuities in 2018.

There are two main reasons for this misrepresentation. The first is comparing the annuity to growth assets such as shares, which is an appropriate comparison. The annuity should be compared to defensive asset in the portfolio such as bank deposits or bonds. Calculating a net present value using a discount factor that incorporates the equity risk premium leads to an incorrect valuation.

The second mistake is to value the lifetime annuity payments without reference to time or only to life expectancy. Even when an appropriate life expectancy number is used, this ignores the insurance value of the annuity, and will always undervalue the annuity. The point of a lifetime annuity is that it provides payments throughout life even when that is for longer than average life expectancy. An annuity is like a bond, the coupons from which are linked to, and expire at, an individual's lifespan (whatever that turns out to be).

An appropriate comparison is to calculate the internal rate of return or net present value of the annuity using a risk-free discount rate and appropriate estimates of life expectancy. This will show that annuities currently sold in Australia are providing good value and are fit for their intended purpose. They offer a premium to government bonds appropriate to the nature of the regulated guarantee that annuities provide. The premium is explained in **Appendix B – understanding annuity rates** which provides details the factors driving annuity rates.

The increasing sale of lifetime annuities in Australia is following an improved understanding of their appropriate role in a retirement income portfolio. As this continues, historical reputation issues will continue to dissipate.

"100% annuitisation" (full annuitisation)

There are very limited circumstances where it would be appropriate for a retiree to fully annuitise their retirement savings. While this has been the assumption in economic literature dating back to Yaari[23], it is not a necessary requirement for a retiree to consider. The ability to secure some income through a lifetime annuity (or other form of lifetime income stream) while maintaining flexibility in the bulk of the portfolio of a retiree is likely to result in the best outcome for most retirees. This is recognised in the Government's CIPR proposals.[24] Typically, annuities tend to be used for 25-30% of a retirement portfolio.

"Changes in the UK annuity market"

The draft report suggests the UK experience provides evidence that annuities will not be a suitable solution for most Australian retirees. It notes the April 2015 'UK pension freedom' changes to enable UK retirees to access their pension pots without a requirement to take all their money as an annuity and suggests these resulted in a dramatic decline in the number of annuities sold and an increase in retirees using a flexible drawdown approach. In overall market terms, the UK market went from total lifetime annuity sales of £11.9billion in 2013, bottoming at £4.2billion in 2015, increasing to sales of £4.3billion in 2016 and an estimated £4.5billion in 2017.[25] This suggests a market that has re-based and is now growing modestly. It is not evidence of any failure or unsuitability of lifetime annuities.

The recently released final report on the effect of the pension freedoms, issued by the UK Financial Conduct Authority sheds more light on the outcome of choice.[26] Of the 594,339 consumers who accessed their DC pension pots in the year to September 2017, 54% withdrew their savings in full. Almost all of these (88% of the 54%) were for total savings of less than £30,000 and most (94%) of these report other sources of

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[23] Yaari, M. "Uncertain Lifetime, Life Insurance, and the Theory of the Consumer." The Review of Economic Studies, Vol. 32, No. 2 (1965), pp. 137-150.

[24] It is also recognised by NEST in the UK with their flexible lifelong retirement income proposal see https://www.nestpensions.org.uk/schemeweb/NestWeb/includes/public/docs/NEST-Flexible-Lifelong-Retirement-Income,PDF.pdf

[25] Association of British Insurers and UK industry estimates

[26] Financial Conduct Authority (UK) 2018, Retirement Outcomes Review: Final Report, MS16/1.3 June, London

income. The most common main source of other income for these consumers was a defined benefit pension scheme, so they had no need for additional annuity income.[27]

In total, almost half of these consumers had limited savings in their DC pot and simply took the money out. Annuities were taken up by 12% of retirees. This number increased to approximately one in four UK retirees choosing an annuity with their retirement savings when those with small balances are removed. This is a significant proportion of the population choosing to secure income in retirement.

The existence of defined benefit pensions is also evident in ABS statistics on income for older Australians.[28] Of note is that 17% of people aged 65-74 in receipt of regular income from superannuation have a defined benefit pension. Of those aged over 75, 31% receive a defined benefit pension. The availability of a defined benefit pension reduces any need for an annuity to secure income in retirement.

"Little future impact on age pension"

The draft report refers to a statement in the 2015 Inter-Generational Report that with superannuation, the "proportion of retirees receiving any pension is not expected to decline".[29] This projection is out of date in that it did not incorporate subsequent changes to means testing arrangements that have resulted in households with more than $1m in assets outside the family home no longer receiving any age pension. A report by ASFA notes that the proportion of the population receiving any age pension (including Veteran Pensions) has fallen from 75% in 2007, to 70% in 2016 and is expected to decline to 60% by 2025.[30]

Bequest intentions and the preservation of capital

References to the bequest motive in Box 4.3 of the draft report seem inconsistent with an assessment of the efficiency of superannuation. Figure 4.9 highlights that only around half the population place any importance on a financial bequest for the next generation. Importantly, this is the option ranked lowest for retirement finances by senior Australians. The latest NSA report reaffirms that the most important goals relate to income.[31] Having income that lasts for life was seen as one of the most important financial goals, with 80% of older Australians rating it very important. The only goal given a higher "very important" rating was the desire for regular and constant income, rated very important by 84% of respondents.

This aligns with a goal of superannuation to deliver income in retirement by deferring wages. In measuring any efficiency of the superannuation system, it seems appropriate to measure efficiency by reference to the amount of money given back to the member (and their spouse) rather than the allocation to future generations, who will have their own opportunity to accumulate through the superannuation system. There should be no requirement to preserve capital through retirement, but rather the objective is to have the income (cashflow) available to meet expenditures as required.

Further, the government has made clear statements regarding its view that the use of superannuation as a tax-incentivised estate planning vehicle is not appropriate.[32]

'Best in show'

If the best in show is progressed by government, there will need to be careful consideration and consultation on how it should operate for retirement, otherwise the best in show concept will only assist the first half of the retirement journey. Superannuation funds will need to meet different criteria in the retirement phase. We note that past performance is not necessarily a guide to future performance and careful consideration will need to be given to how this is framed, given existing disclosure requirements for both superannuation and investment funds, in relation to retirement. At a minimum, a fund's ability to address the points we outlined

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[27] Financial Conduct Authority (UK) 2017, Retirement Outcomes Review: Interim Report, MS16/1.2 July, London annex 4
[28] ABS Cat No 6523.0 Household Income and Wealth: Australian Table 15.6
[29] Treasury 2015, Intergenerational Report, Canberra p 67
[30] ASFA (2017) *Mythbusters Myths that super will come up short*, November, ASFA Research and Resource Centre
[31] National Seniors and Challenger (2018). Once bitten twice shy: GFC concerns linger for Australian seniors. Brisbane: National Seniors.
[32] Scott Morrison, M.P. *Address to the SMSF 2016 National Conference, Adelaide*, 18 February 2016

earlier in this submission should be included in any consideration of suitability for inclusion on a best in show list.

Issues for the system to overcome

Members not being moved to retirement phase

There is evidence that the current system is not producing the best results for members. A clear example of this is that as at June 2017, there was $92billion in superannuation accounts of APRA-regulated funds held by the 65+ age group still in the accumulation phase.[33] This means that the member is paying tax on investment earnings when they could be in the tax-free drawdown phase. Some of this could be intentional, or a consequence of the transfer balance cap. However, data provided at the fund level indicates that many funds have member accounts with small balances in the tax-paid phase, despite meeting a condition of release. Many of these retirees are likely to also be receiving some age pension and wouldn't be subject to tax if the funds were invested outside superannuation. Paying unnecessary tax is unlikely to be in the member's best interest.

Fund governance

Where funds adopt a 'representation model' of choosing board directors or appoints independent directors, we query who would represent retirees at board level. The view of workers and the issues that they face are different in nature and consequence from the issues faced by retirees and future retirees. We are concerned that the perspective of retirees has not yet been given adequate consideration in the ongoing discussions regarding fund governance. Given the weight of money entering retirement phase and being managed by funds, we believe retirees should have stronger representation at board level.

Lifecycle funds

A lifecycle fund approach is and should be allowed as part of MySuper. Ideally, the lifecycle fund would target income through retirement rather than a balance at retirement. This would improve the outcome for members. The problems identified in the draft report relate to a poor proxy for a lifecycle fund, rather than the lifecycle concept itself. One key element that was missed in the draft report (and is present in most MySuper lifecycle options) is that the exposure to growth in the early stages is higher than it would be in a balanced fund. It could be argued that a balanced fund is poorly allocated for younger members as it is reducing exposure to growth at an age when compounding is highest and the potential time to recover from any loss is the longest.

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[33] APRA 2017 Annual Superannuation Bulletin

Appendix B - Understanding annuity rates

Lifetime annuity payment rates are often compared inappropriately to rates of return on other investments. There is confusion at three levels:

1. Each payment includes: interest, a return of capital and mortality credits, rather than just a reward like interest on a bank deposit, which is entirely separate from the capital deposited;
2. There is a temporal component arising out of the longevity protection feature. You do not know in advance how many payments you will get. What this means is that today's rate does not tell the whole story; and
3. Annuities are part of the defensive component of a retirement income portfolio and are not a substitute for growth assets. In a retirement income portfolio, such as a CIPR, an annuity should replace the bonds in the portfolio and so an annuity rate should only be compared to the rate available on other defensive assets (having regard to the differences explained in paragraph 1 above).

Current annuity rate

Consider a live example from an annuity for a 65-year-old male bought from Challenger on 15 June 2018. The annuity option with flexible access to capital and payments fully indexed to the consumer price index (CPI) would begin at $5,297 in the first year for each $100,000 invested. This option also provides for a death benefit of 100% of the original investment if the purchaser dies before age 74.

The rate offered each week changes with market movements (which affect the return earned on the underlying investments). It is also based on an actuarial assessment of the purchaser's probability of survival, given their age and gender.

Let's compare annuities and bonds

For comparative purposes, the example below assumes an initial annuity payment rate of $5,297 per $100,000 invested. This is consistent with an underlying net investment return on the assets backing the annuity of approximately 5.0% pa in nominal terms. The examples below compare the payments from the annuity with the payments from a bond portfolio earning the same (5.0%) net investment return. Payments are assumed to increase at 2.25% pa to match inflation in all cases, in line with current market-based expectations of average inflation for the next 25 years.[34]

Each annuity payment consists of interest, a return of capital and mortality credits. The relative proportions of these components change over time as the annuitant ages. Consider two people: someone who lives to age 90 and someone who lives to age 95.

Total annuity payments to age 90 would be (assuming 2.25% pa inflation) $175,189 comprising 57% interest payments; 23% from capital returns; and 21% from mortality credits.[35] Total annuity payments to age 95 would be (assuming 2.25% pa inflation) $223,508 comprising 50% interest payments, 22% from capital returns and 28% from mortality credits. The longer someone with an annuity lives, the more they receive from mortality credits. This is illustrated in **Figure 1**. The first chart highlights the increasing contribution from mortality credits over time. The second chart shows the composition of payments (from the three sources) from age 65 to 95.

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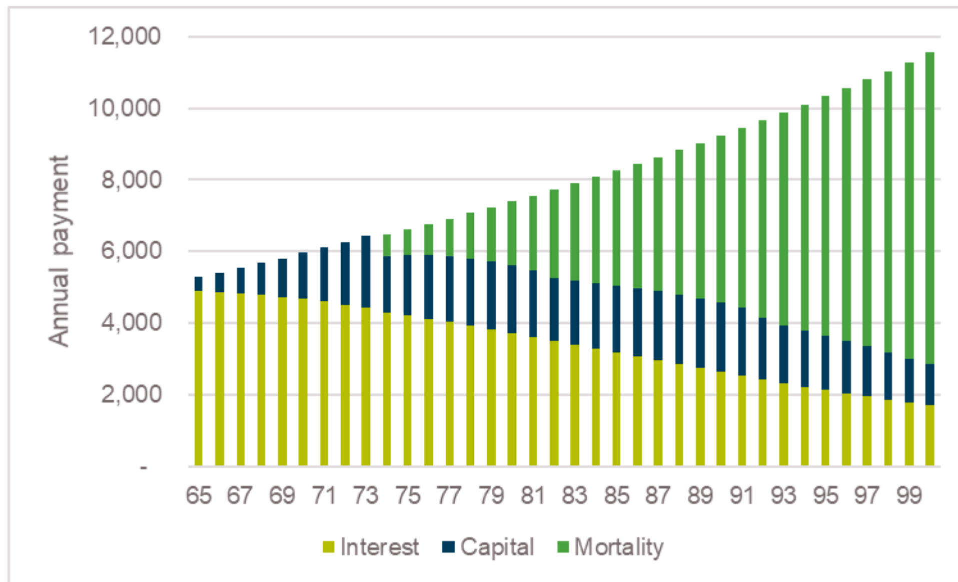
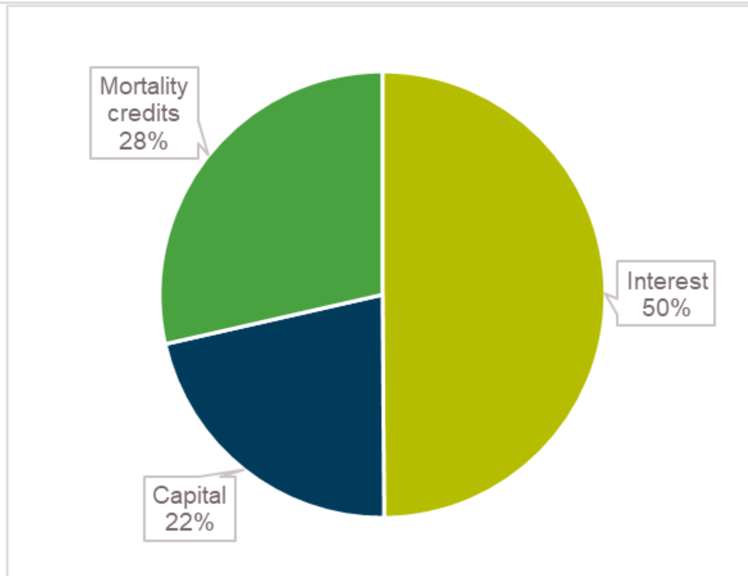
[34] The underlying risk to the investor in this hypothetical example would differ materially between a bond portfolio and an annuity. In the case of the former, the investor would be directly exposed to the credit risk in the portfolio. An annuitant, on the other hand, is protected by the risk-weighted capital held by the life company.

[35] This is equal to $132,425 adjusted for inflation, being 25 annual payments of $5,297 each.

Figure 1: Payments from a lifetime annuity from age 65 to 95



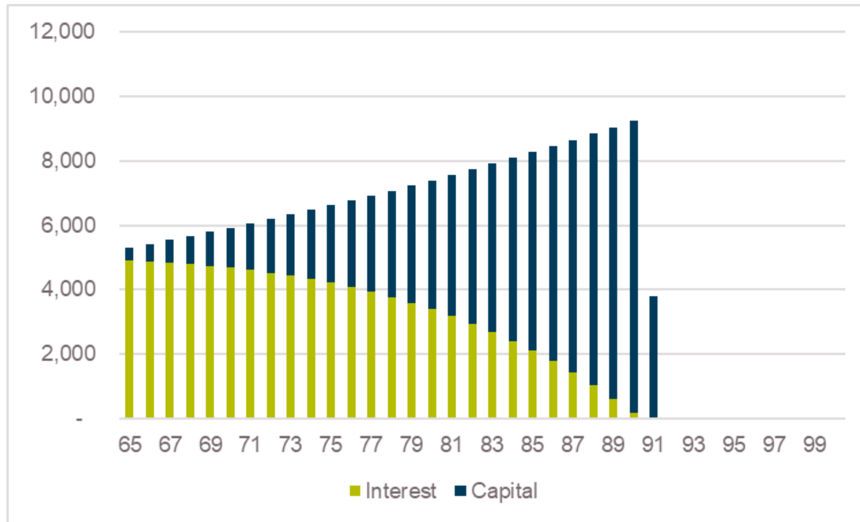


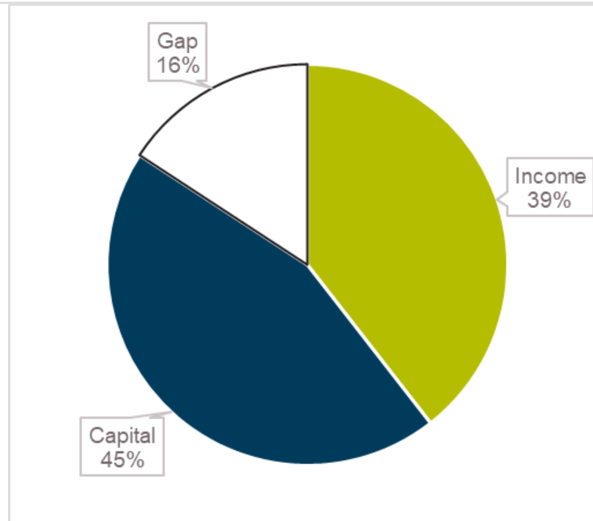
The bond portfolio alternative

The annuity payments can be contrasted to a bond portfolio that was achieving the same 5.0% nominal net investment return. If you wanted the bond payments to last to age 90 exactly, the initial payment could be $5,352 pa (indexed to inflation). To get the payments to last to age 95 exactly, the initial payment would have to be reduced to $4,772 pa to last the distance. This is, of course, an unrealistic example. A retiree does not know in advance exactly how much they can draw from their investment each year, because they don't know how long they are going to live.

Another way to compare the bond and the annuity is to consider what happens if exactly the same payments as the annuity were made from a bond portfolio. To age 90, the total payments would all be made, but at a greater capital cost (that is, a greater depletion of the original capital). The payments from a bond portfolio would not last to age 95, but would be exhausted in the 92nd year (ie aged 91), leaving the retiree short a total of $35,285 in payments not received. This is shown as the gap in the charts below in **Figure 2**.

Figure 2: Payments from a bond portfolio from age 65 to 95





Explanation for the difference

We have created two portfolios with an identical underlying rate of return. The reason for the difference in outcome is that the annuity has cash flows boosted by mortality credits, while the bond portfolio does not. The other potential difference is in the amount left to the estate, depending on the age of death. This illustrates the key trade-offs involved.