The Dialogue

Leading the conversation

Developing the retirement income framework

Retirement Incomes Working Group

Actuaries Institute

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Anthony Asher is the Convenor of the Actuaries Institute Retirement Incomes Working Group. The Group has been working since 2012 on addressing obstacles to the development of appropriate advice and retirement income product offerings. It has produced a range of research papers and articles on the spending habits of retirees in order to determine needs; the products potentially available; the advice given to members, and regulatory obstacles to the development of solutions. Last year it produced an Information Note to alert members of the Institute to some of the technical issues related to the development of the innovative income stream products that are now permitted by regulation. This Dialogue paper focuses on the proposed retirement covenant that trustees are being asked by government to provide appropriate products and advice to their retiring members.

This paper has been prepared by the Retirement Incomes Working Group of the Actuaries Institute as a contribution to the way forward – to fulfil the objectives suggested by the Position Paper. It does not necessarily represent the views of the Institute. Responses can be made to the Convenor, Anthony Asher at a.asher@unsw.edu.au.

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Executive summary

The Treasury is in the process of developing a retirement income framework for Superannuation to "enable individuals to increase their standard of living in retirement through increased availability and take-up of products that more efficiently manage longevity risk"[1]. We agree that such a framework should encourage the increased take up of longevity products and should include a requirement that all trustees adopt a retirement income covenant that requires them to offer longevity products to their members. We think however that it may be premature to "mass customise" combinations of retirement product to suit the needs and preferences of very large groups of retirees without advice. Such advice needs to address members' needs explicitly and without bias – noting that every option offered to members creates a 'nudge'.

This paper sets out considerations for the advice that we believe to be required by members, suggesting how it can be provided affordably, and the products that should be offered. Obstacles to the development of an appropriate framework include some reluctance to change, the risks that trustees will be blamed when some members are worse off, and the possibility of lack of take-up and being left with loss making products. We offer suggestions for how regulation, advice and product design can address these issues.

1 https://treasury.gov.au/sites/default/files/2019-03/c2018-t285219-position-paper-1.pdf

1. Introduction

The Treasury issued a Retirement Income Covenant Position Paper (Position Paper) in May 2018[2]. It explained:

> *As part of the Government's More Choices for a Longer Life Package in the 2018-19 Budget, the Government has committed to introducing a retirement income covenant as a critical first stage to the Government's proposed retirement income framework. This will codify the requirements and obligations for superannuation trustees to improve retirement outcomes for individuals*

2. Objectives

The Position Paper discussed a retirement income framework intended to:

- enable individuals to increase their standard of living in retirement through increased availability and take-up of products that more efficiently manage longevity risk, and in doing so increase the efficiency of the superannuation system and better align the system with its objective; and
- enable trustees to provide individuals with an easier transition into retirement by offering retirement income products that balance competing objectives of high income, flexibility and risk management.

The framework will include the incorporation of a "retirement income covenant' into section 52 ff of the SIS Act to go alongside the investment, insurance and general covenants requiring trustees to look after members' best interests. This will "codify the requirements and obligations for superannuation trustees to improve retirement outcomes for individuals."

We strongly support these objectives and agree that having products that more efficiently manage longevity risk will result in higher standards of living in retirement and will better align the superannuation system with its objective.

However, we do not believe that increasing product offerings alone will lead to changes in behaviour. We suggest a third objective may be needed: to enable trustees to provide an increased range of personalised decision-making support for their members as they transition into retirement.

Alternatively, there may be a case for some compulsion – to avoid decision paralysis given Australia's lack of familiarity with longevity products. We note that the Superannuation Guarantee system relies on compulsion rather than encouraging members and superannuation trustees to choose their own minimum contribution rate

2 https://treasury.gov.au/sites/default/files/2019-03/c2018-t285219-position-paper-1.pdf

3 The industry's response

On 1 July 2017 legislation was changed to allow super funds to offer a wide range of retirement income products. On 1 July 2019 further legislation was enacted to offer means testing incentives to the use of lifetime income streams. While a number of super funds have been working to develop new products, we are not aware yet of any actual new product launches.

Industry has raised several concerns about implementing the principles proposed in the Position Paper.

Industry has since raised several concerns about implementing the principles proposed in the Position Paper. From reading over several of the submissions made by other organisations, we have identified the following themes and suggest how they might be addressed

3.1 Concerns about a lack of demand from members for new products – resulting in scale risk for funds.

This concern is grounded in the failure of several lifetime income streams that have been developed recently (so called variable annuities with guarantees) to attract much business, and which have probably led to losses for those companies that introduced them. The losses will be significant given their administrative complexity. These types of products are however complex partly because of the need to fit into the previous legislation, and difficult to explain. It is even more difficult to understand whether they give value for money, which perhaps explains why they have not been enthusiastically accepted by advisors or funds.

We believe that there are simpler products that can be shown to offer real value for money. Research by the Behavioural Economics Team of the Australian Government (BETA) shows that around half of members would choose a CIPR that includes a lifetime income stream once properly explained to them[3]. This is consistent with much other research.

The Position Paper recognises the issue of reducing legacy costs, and some consideration could be given to the ideas in Appendix 2 to this note.

3.2 A perception that, given the diverse range of retiree needs, preferences and financial circumstances, retirement is too complex for super funds to mass customise.

We agree that the range of retiree needs is wide, but they do tend to fall into a finite number of common objectives – as noted in various consultations including the FSI final report. These are:

- High income
- Income that lasts for life (including the life of a spouse)
- Stable income each year (that keeps pace with living costs)
- Enough access to capital
- Desire to leave a bequest

3 https://www.pmc.gov.au/sites/default/files/publications/supporting-retirees-in-retirement-income-planning_1.pdf

Different retirees may weight these objectives differently according to their own personal circumstances. However, it is still possible to categorise members of funds into a smaller number of groups which have relatively homogenous objectives. At the very least, the member segmentation process can be based on members' demographics and financial circumstances within the funds, while allowing member to disclose additional information if they want.

For each group, member testing may be required to identify the main objectives and the relative importance between different objectives. This would allow Trustees to provide retirement solutions or products with features meeting the objectives. The distribution channels for these group-specific solutions could also be different, including offering as the default solution (the Trustee's choice) through scaled advice through to opportunities for more comprehensive financial advice. An option to opt out should be allowed for the default solution.

For solutions offered through any advice process where there is member engagement, flexibility should be built in the product or solution design to allow members to choose the features that best meet their individual circumstances.

Both scaled and comprehensive advice require information on members' demographics, financial circumstances and non-financial circumstances. The Financial Services Inquiry suggested that the ATO should be able to provide information on members' demographics and financial circumstances. At the very least, the ATO should be able to provide the details of members' financial balance sheets in a format that could facilitate the giving of scaled or digital advice.

The provision of this detail would be adequate for some people and would significantly reduce the cost of advice for those who want personal reassurance or have more complex needs. For non-financial circumstances such as preferences (e.g. risk tolerance) and health, online questionnaire may be a useful tool to collect information. Medicare history may also be a possible source to assess the health status of members.

3.3 Concern that longevity products are irrevocable – resulting in risks for trustees or members who make poor decisions but cannot then change their mind.

This is tied to a perception that members need access to a large proportion of their capital to provide flexibility (e.g. for aged care or other major capital expenditure such as home maintenance or a significant health cost).

Retaining a lump sum certainly provides an option to use it for alternative purposes, but failure to decide will necessarily mean loss of other benefits which may be worse. Most income streams allow for lengthy cooling off periods and a significant return of capital in the early years, so the irrevocability of the decision is less than sometimes thought.

There is also considerable confusion about the needs for liquidity and access to capital in retirement. Capital can only be used as a buffer if it can be replenished, which requires an income stream to do so. Amounts required for flexibility would normally be no more than one year's expenditure leaving most of the retirement lump sum available for income streams. In this calculation, we exclude money set aside for specific spending such as travel.

The Actuaries Institute's Green Paper 'Options for an Improved and Integrated System of Retirement' has suggested that Refundable Accommodation Deposits (that currently can be used to fund aged care) are undesirable as they create anxiety for retirees who become concerned that they might need to find significant lump sums at short notice. The paper suggests that these are undesirable and should be phased out.[4]

4 "The Refundable Accommodation Deposits (RADs) that can currently be used to fund aged care are undesirable from the perspective of the residents. Their existence creates anxiety in that retirees become concerned that they might need to find significant lump sums at short notice. This also contributes to a reluctance to invest in life annuities or pensions. Whether to withdraw a lump from superannuation is a stressful and complex decision because it cannot be recontributed later.

It is also debatable whether RADs are in the best long-term interests of aged care providers. Arguably, providers should not be funding long term property assets with short term loans from particularly vulnerable residents. To the extent that debt is are required, long term investments should be funded by long term loans from informed lenders who would impose appropriate financial standards on the borrowers."

A minimum requirement should be for super funds to offer members an appropriate longevity protection product and carefully and fairly set out the advantages and disadvantages of different choices, before paying any benefits at retirement.

3.4 Concerns that the AFS licensing rules prevent funds from being able to help members make decisions in an efficient way (given that retirement is much broader than a single superannuation account) and that trustees may be taking on significant risk in giving any guidance.

The current AFS licensing rules make giving guidance or advice to individuals difficult and expensive. Recent media articles have highlighted that only the wealthy can afford financial advice as the minimum fee is several thousand dollars.

The AFS rules and requirements apply when the Corporations Act definition of 'financial product advice' is triggered[5]. This definition focuses on whether a recommendation was made but it also captures any statement of opinion intended to influence a person about a particular financial product – especially if that person's objectives, situation or needs were considered in the process. As a result, it risks capturing any sort of assistance that super funds provide to individual members when making decisions.

As a result, members are poorly served by the absence of advice.

Allowing superannuation funds to safely provide a wider range of personalised support is important.

Allowing superannuation funds to safely provide a wider range of personalised support is important. This could include personalised education. Research shows that superannuation funds are a trusted source of information and help.

Indeed, thought should be given as to ways in which the current position should be reversed. Members and their beneficiaries are prejudiced by the absence of options to obtain a suitable income stream product, and trustees should be at risk if they fail to make such an option salient.

Modelling shows a 15% - 30% increase in retirement income[6] by using an appropriate allocation to suitable lifetime income streams. Without such products, retirees will either leave significant bequests or run out of money in later life. We note that there is a particular need to protect longer living partners with lower personal balances.

It seems clear that more direct Government Intervention may be required – just like the introduction of the Superannuation Guarantee, MySuper and even Account-Based Pensions. While not likely to be popular, there is potentially a case for compulsory allocation of some of members' superannuation to lifetime income streams in retirement.

A minimum requirement should be that super funds offer members an appropriate longevity protection product for all or part of their balances, and carefully and fairly set out the advantages and disadvantages of different choices, before paying any benefits at retirement.

4. Addressing the concerns

It appears, therefore, that markets are not proving efficient. Despite CIPRs delivering a better retirement outcome for many Australians, the lack of members' knowledge results in a perceived lack of demand in the eyes of Trustees. There is also a view that many in the financial sector (financial advisors, investment managers and banks) oppose the introduction of lifetime income products because they require less ongoing servicing (i.e. fees) than other investments and hence a loss of revenue.[7] This all creates a lack of confidence in superannuation trustees to move forward.

Until innovative longevity products become more mainstream most people won't understand how the products work and the benefits they offer.

5 https://download.asic.gov.au/media/3889417/rg36-published-8-june-2016.pdf
6 Financial System Inquiry Report page 92
7 Asher, A and E Rajadurai (2018) Investing Superannuation for the Public Good: Creating new markets to benefit members & fund necessary investments, The McKell Institute. https://mckellinstitute.org.au/app/uploads/FINAL_Superannuation_2018_WEB.pdf

Overseas, a common concern is that annuities discriminate against lower socio-economic groups and individuals in poor health. The technology to make these distinctions is already available in Australia.

5. International experience

It is worth noting that the retirement systems in most countries provide greater use of lifetime income streams than is typical in Australia.

5.1 Chilean experience

Chile provides an example to an active annuity market. In Chile, over 60% of eligible retirees purchase annuities from the private market through the Chilean electronic market for annuities (SCOMP), with prices on average being 3% less generous than an actuarially fair annuity (Illanes and Padi, 2018)[8]. The SCOMP was instituted in 2004 as an innovative government-run exchange. Similar to a stock exchange, SCOMP transmits consumer information and preferences to all annuity providers, elicits offers from annuity providers willing to sell to that consumer, and then ranks the offers by generosity to facilitate the consumer's decision process. All retirees must use SCOMP to access their retirement savings, even if they would like to cash out the benefits through phased withdrawals. SCOMP allows information between firms and consumers to be transmitted, without limiting price discrimination or constraining consumer and firm choice.

5.2 UK experience

Of the countries that have moved away from compulsory lifetime incomes, the UK allows encashment of a person's superannuation at retirement, but retirees face a significant disincentive in that any lump sum payment in excess of 25% of the balance is taxed at the person's marginal rate. There is state funded free 'guidance' available.[9] By 2019, only 11% of retirees were buying annuities,[10] but 55% took a lump sum, 90% whom were withdrawing less than £30,000. The rest bought the equivalent of account-based pensions (ABPs). For those not taking lump sums, 14% of those who took professional advice bought an annuity, but this rises to 54% of those receiving the independent state funded guidance (and 42% with no apparent advice or guidance). Receiving professional advice appears to reduce the likelihood of choosing an annuity over a drawdown arrangement by 70% to 75% – the impact being higher for those larger balances. While there may be a selection effect, it seems possible that advisors are biased against annuities. A potential explanation is the income they and their employers expect to receive for future advice from those who choose drawdown arrangements.

The FCA's review into the pension freedoms found that "around half of our full encashment cases might have followed a different path as a result of seeing our examples". As they put it:

> *Many respondents had a 'penny drop' moment during these discussions, which made them start to question whether they had acted too hastily, without understanding all the facts.*[11]

5.3 South Africa approach

South African retirement income products are compulsory with a ceiling on the amounts that can be drawn from account-based pensions. The regulators, however, also require funds to have an 'annuity strategy' and require funds to offer retirement benefits counselling and a default income stream.

It can be noted that enhanced annuities are offered in both UK and South Africa for retirees with lower life expectancies. This addresses a common concern that annuities – especially when compulsory – discriminate against lower socio-economic groups and individuals in poor health. The technology to make these distinctions is already available in Australia.

8 https://www.ftc.gov/system/files/documents/public_events/1349883/illanespadi_1.pdf
9 https://www.pensionwise.gov.uk/en/appointments
10 https://www.fca.org.uk/data/retirement-income-market-data
11 https://www.fca.org.uk/publication/market-studies/retirement-outcomes-review-interim-report-annex3.pdf
12 The regulation is a masterful exercise in brevity – just one page effectively. http://www.treasury.gov.za/publications/RetirementReform/Final%20Default%20Regulations%20Gazetted%2025August2017.pdf

6. The way forward

Australia has its own unique retirement system that the retirement covenant needs to operate within. As we implement the Position Paper and super funds design Retirement Income Strategies, trustees will need to shift their focus from achieving high balances to focusing on how those balances get used in retirement. Funds need more 'needs based' thinking around how savings get used to produce retirement income.

We note there are several other regulatory initiatives pushing in a similar direction to the Retirement Covenant including ASIC's Design and Distribution powers[13], APRA's Member Outcomes Assessment[14] and the FASEA standards and education requirements for advisers.[15]

In our view implementing the first two of the proposed Retirement Covenant operative principles (from May 2018) is critical to improve retirement outcomes for Australian retirees. The current practice of using Account-Based Pensions in isolation can only deliver the best outcome for those retirees who have shorter lifespans. We also largely agree with the other principles.

6.1 Retirement Income Strategy

The first operative principle in the Position Paper is:

> **Trustees should assist members to meet their retirement income objectives throughout retirement by developing a retirement income strategy for members.**

A retirement income strategy requires a profound change in the scope of what a trustee must consider compared to each member having individual accounts. The thinking requires understanding the preferences of different retirees, typical personal circumstances and a solid understanding of the growing range of products that can be used to align member's circumstances with their objectives.

Trustees require significantly more prescriptive guidelines on what a retirement income strategy must look like for different cohorts of member.

In our view superannuation trustees require significantly more prescriptive guidelines on what a retirement income strategy must look like for different cohorts of member, perhaps even going so far as providing examples or a safe harbour design. For example, in a similar way to how ASIC RG 90 provides example Statements of Advice for financial advisers to refer to.

6.2 Engagement

The second operative principle suggested in the Position Paper is:

> **Trustees should assist members to meet their retirement income objectives by providing guidance to help members understand and make choices about the retirement income products offered by the fund.**

In addition to simply being guided as to how retirement income product options work, members will require significant assistance to articulate their "retirement income objectives" and to understand how different products help in achieving those objectives.

13 https://hallandwilcox.com.au/design-and-distribution-obligations-and-product-intervention-powers-legislation-has-been-passed/
14 https://www.apra.gov.au/media-centre/media-releases/apra-consults-updated-member-outcomes-assessment
15 https://www.fasea.gov.au/standards/

Any decision about retirement should take into account:

- The need to maintain a basic minimum standard of living (the household's 'needs') before and after retirement.
- The household's eligibility and means testing for the Age Pension, which remains the main source of income in retirement for over half the population.
- Cash flow planning over the lifetime of each household including career salary profiles, the impact of raising children, buying a home and phased retirement.
- Risks, including investment risk, inflation and health risks. Health risks include loss of earnings due to illness or injury but also includes longevity risk – the risk of outliving your assets.
- Other objectives such as particular lump sum goals or the desire to leave a bequest on death.

6.3 Definition of a Comprehensive Income Product for Retirement

A CIPR is a retirement income product which is designed to provide:

- **(income for life);**
- **some access to efficient, broadly constant income, in expectation; and**
- **longevity risk management capital.**

A 100 per cent allocation to an ABP alone would not meet the definition of a CIPR.

All funds should offer the components of a CIPR.

It may not yet be practical to offer a mass customised CIPR(s) for all retirees, but we agree that all funds should offer the components of a CIPR as defined here and that a 100 per cent allocation to an ABP does not meet the objectives of the Position Paper.

6.4 Offering a flagship CIPR

All trustees should offer a flagship CIPR to members at retirement, subject to limited exceptions (see principles 7 and 8).

Until members have more experience in understanding different retirement income products, it may be difficult for Trustees to be confident to lock down a specific CIPR configuration that will meet the preferences and needs of large groups of members.

In the meantime, Trustees should still be required to offer a flagship lifetime income stream option for members to choose for some of their superannuation at retirement.

There is potentially a case for compulsory allocation of some of a members' superannuation to lifetime income stream in retirement – in order to address the market inefficiency issues discussed in this paper. There could be exceptions for very small balances or those in hardship or ill health.

6.5 Third party products

Trustees can fulfil their obligation in part or in full by using a third party.

We agree, not least as this provides some protection against legacy products, which life insurers have the capital and potentially the scale to manage more appropriately.

6.6 Consent

Consent should be required for a CIPR to commence.

It is already necessary for members to request any benefit payment and (at least) provide their bank details for payment.

Products should carry clear 'red flag' warnings so that those who aren't suited to them are less likely to proceed with the wrong product.

If longevity products are optional then it is important to provide balanced advice as to the advantages and disadvantages of the products offered. Products should carry clear 'red flag' warnings so that those who aren't suited to them are less likely to proceed with the wrong product.

6.7 Offering an alternative retirement income product through advice

Trustees may offer an alternate CIPR or another retirement income product to a particular person or cohort of people through any form of personal financial advice, including scaled personal advice, intra-fund advice or full financial planning.

We think this is essential but note the UK experience and the risk that advisors may be biased against annuities because they offer less potential for offering recurrent advice. We also note that their employers and even the superannuation trustees may be biased if the purchase of an annuity will lead to a reduction in Funds under Management and therefore of future revenue and profits.

This bias could be addressed by a strict review to ensure that all advice is unbiased or to require funds to make once-off advice available at retirement.

6.8 Exception for individuals for whom CIPRs are unsuitable

Trustees may choose not to offer a CIPR at all to a particular person if the trustee has reliable information that a CIPR would not suit that person.

Generally, we see no grounds for exemption on grounds of poorer than average health. As is prevalent in some other countries, members can be underwritten when they purchase a lifetime income product. The exception may be for life threatening and terminal illnesses.

As to smaller balances, we suggest that members need at most one- or two-year's income as 'buffer capital' and that the small balance exemption could be fairly low.

7. Helping members select the right strategy

In Appendix 1 we set out detailed thoughts on why households require advice, what decisions they need to make and what must be considered in order to make the best decisions.

In our view it is important the word 'advice' be broken down further to acknowledge the range of different levels of assistance that retirees might need from their superannuation fund and could help to them make informed retirement decisions. These levels of support include things like:

Superannuation funds should first help members decide whether they need detailed personal recommendations or whether they could be provided with simpler information about their options.

If all of these levels of support are swept under the same regulatory regime as a 'personal financial product recommendation' then it creates significant inefficiency and results in many retirees not getting any help at all. Anecdotal evidence is that it costs a minimum of $3,000 to produce a piece of financial product advice for a new client under current rules. A major part of this cost is in creating up to 100 pages of paperwork once you include the Client Fact Find, file notes, research papers, Statement of Advice and Authority to proceed.

Ideally, superannuation funds should first help members decide whether they need personal recommendations or whether they could be provided with simpler information about the choices they have and appropriate education/guidance to help them achieve their retirement objectives.

Appendices

Appendix 1 – Considerations when making retirement decisions

We believe that standard advice should be available to all members at retirement – at minimal cost. Costs can be limited if the collection of data is appropriately automated, using what has already been collected by government. Expressed as a percentage of the balance, we do not think it should exceed 1%.

The FPA website lists the following examples of concerns people have as they approach then enter retirement :

i. debt elimination
ii. family healthcare
iii. helping your children
iv. retirement planning
v. wills and trusts
vi. business exit strategy
vii. protecting your assets
viii. aged care planning
ix. travelling
x. a large lump sum expenditure
xi. inheritance tax mitigation
xii. gifting to family
xiii. preserving your capital; and
xiv. estate planning.

It is likely that many Australian employees will take a similar journey to each other with their financial lives. It is therefore possible that some of the above issues could be managed using highly streamlined advice tools.

Most could be incorporated into a sensible automated retirement plan. Reasons for a household to need more sophisticated or customised advice than others could include:

- Significant (more than 20% of total) assets outside of superannuation, including business ownership, investment properties or lifetime income sources such as overseas pension incomes or royalties.
- Uncertain future earnings profiles, including potential of a significant future inheritance.
- Unusual tax arrangements such as royalties, living overseas.
- Complex family arrangements, such as paying support for ex-partners or disabled children and known plans to marry, divorce or re-marry.
- Disability or significant health concerns for themselves or immediate family members, including future aged care needs, but see below.

1. Standard advice before retirement

For those with most of their savings in superannuation accounts, there are effectively three decisions: how much to save, where to invest and when to retire. Buying a house comes into both of the first two.

16 If this does not apply to balances of $25,000 or less, this allows for at least $250 for very simple questions, and could be capped at say $2000 for balances over $200,000. The regulatory model for delivering advice may need to change to make these amounts feasible. Not all members will want a formal written recommendation.

17 https://fpa.com.au/about-financial-planning/identifying-your-goals/

18 See also https://www.actuaries.asn.au/Library/Events/FSF/2016/HenningtonLangtonRetirement.pdf for more discussion.

1.1 How much to save

This question can be addressed automatically – see www.draftfinplancalc.com or www.10E24.com. Such advice needs to consider future cash flow issues including the additional costs of raising children and buying a house – as well as weighing up standards of living before and after retirement. This calculation should include the repayment of debt, accumulation of a buffer for unforeseen cost and provision for bequests. If people cannot use a calculator like this, then they will know they need personalised help from an adviser. We expect that almost everyone will at least require initial explanations.

1.2 Where to invest

There should be a strong default to well-designed lifestyle options here. Most modelling shows that retaining equity exposure until relatively late ages is likely to give better risk adjusted long term outcomes than using defensive assets. Given that mistakes that can be made (and were made by the Productivity Commission in their interim report on Superannuation), there is perhaps a place for relatively detailed regulation on this matter.

1.3 When to retire

This needs to include the possibility of phased retirement (working part time) and cover both members of a couple.

2. Standard advice at and after retirement

Here the decision is dividing assets between:

- Short term objectives such as repaying debt, or 'bucket lists' such as expensive travel. Assets for these objectives can be held in an ABP or outside superannuation, and investments will depend on short term risk aversion.
- A regular income for the household's lifetime (including both partners). There is really no alternative to a lifetime income stream (conventional or pooled) – but see the section below on planning for aged care.
- Members then need a choice of income producing products, and at least generic advice as to how they should choose between them. They should at least be offered one product that offers some investment and longevity guarantees and one that does not.
- A buffer for unforeseen costs that can be topped up by the regular income and should probably be equal to between 6 to 24 months of expenditure. It should also be liquid and possibly outside superannuation.

The choice of investments and guarantees will depend on aversion to changes in income and investment volatility. For homeowners, consideration can be given to releasing capital later by downsizing or equity release products.

3. Pre-planning for Aged Care at 65 – or not

In many respects, one cannot pre-plan for Aged Care at the point of retirement, because there are too many unknowns.

In many respects, one cannot pre-plan for Aged Care at the point of retirement, because there are too many unknowns. Issues that are not predictable about Aged Care needs at the start of retirement include:

- Where the retiree will want to be:
  - Will they have a partner?
  - Where they will be living?
  - Where will significant family, friends and carers be living?

- What the retiree will need:
  - Home or residential aged care?
  - Care for one or more of a variety of dementia and physical ailments?
  - Will they be a carer looking after their own partner?

- When the retiree will need care:
  - At what age will care be required?
  - How long will they require care?

- Who will be able to provide care:
  - Available places (in different locations and for different needs) depend on variable supply and demand.
  - Will family members or friends be available to assist with care?

- How much will care cost:
  - What level of assets and income will the retiree have at the time they need care?
  - Can they afford the cost of the care they want?
  - What subsidies will the Government offer at the time care is needed?

What is relatively predictable about aged care is that under the means testing rules people who do not have the means can access care (albeit with potentially long waitlists).

Despite the uncertainties around a retiree's future aged care needs at the start of retirement, a choice of retirement income products can ensure income and/or a lump sum would be available to pay for fees should the need arise. This choice would be imprecise but could go some way for preparing the retiree for meeting future aged care fees and home support.

Further work needs to be done to find solutions which assist retirees in planning for aged care at the start of retirement (including whether they need to hold back assets to fund their future aged care needs), but we would suggest that the requirement to think about a retiree's ability to meet future aged care fees should be part of the member's retirement income objectives considered as part of the retirement covenant. We refer to the previous Section 3.3 (p7) in our paper.

A choice of retirement income products can ensure income and/or a lump sum would be available to pay for fees should the need arise.

For those who want to fund their retirement solely from their superannuation, the question arises whether they should plan for a reduced or increased level of income when they need care. An ABP is likely to provide a reduced level of income at advanced ages if the person's balance starts to become exhausted in later life. An annuity will deliver a level or CPI linked income. Retaining assets out of superannuation will allow for more flexibility but at the expense of lower total income for those who live a long time. Those owning their home have a financial advantage. Should this decision be left to personal preferences or are there advantages in some compulsion to avoid decision paralysis?

Appendix 2 – Legacy issues

Legacy products are in no one's interest. Closed books may also need special reporting to APRA and thus incur further costs. Legacy products can result from a failure to provide for simple ways to address changes to circumstances.

Some consideration can be given to the following:

- Contracts can permit a range of arm's length insurance and administration outsourcing arrangements to provide flexibility and obtain access to economies of scale;
- Contracts can permit a wide range of changes to underlying investments to remain relevant to policyholders over time and as circumstances change for them personally;
- Policyholders should not be locked into closed products, but rather offered a fair option to transfer to a new product design if it is offered, or to another manufacturer's product if it is not. This would be subject to equity considerations and potentially proving their health.
- If possible, one should try to avoid being required to obtain expensive court approval for transfers or combining pools and instead be subject to less expensive independent actuarial or legal review.

'Fair' should be interpreted flexibly in the context of transferring and/or combining pools and could mean that the present value of the benefits (calculated at market rates and allowing for risk) are not reduced.

Increases in expense charges should be justified on the basis of increased costs, or otherwise dealt with as below.

Annuitants in a pooled product may be exposed to the risk of increasing expenses or charges for insurers or other service providers. Additional risk arises wherever policyholders or annuitants cannot respond by transferring their interest easily and without loss, as they may be exposed to higher charges than could be obtained in other competitor's pools. The following provisions could be considered:

- A product design where the provider of the product cannot change the charging structure and level of fees. This creates certainty for the policyholder and is similar to the guarantees inherent in guaranteed annuities. This introduces additional costs relating to the capital required to support the guarantees. However, the additional cost is known at purchase so products can be compared.
- A product design where the administrative charges (except for statutory imposts and tax) will not increase by more than the inflation rate. This design may impose additional cost to cover the guarantee.
- That charges will not increase unless it is justified by an increase in the costs that relate to the product as certified by an independent expert.
- The provider will not make a profit more than 20% of the charges – as is the case with participating life insurance contracts. This could also potentially require certification to ensure that the policies are allocated no more than their fair share of overhead expenses.

Appendix 3 – International experience

Rocha, Roberto, Dimitri Vittas, and Heinz P. Rudolph. 2011. *Annuities and Other Retirement Products: Designing the Payout Phase.* International Bank for Reconstruction and Development, World Bank, Washington, DC.

This volume is a product of the staff of the International Bank for Reconstruction and Development / The World Bank.

Summary of Policy Recommendations

1. Policy makers should target an adequate level of annuitisation, but not too much in order to give flexibility to variations in spending and legacy needs.

2. Allow several different rather than a single product, to give flexibility to different needs.

3. Don't mandate CPI indexed securities as these are expensive and risky due to the impossibility of exact asset-liability matching.

4. Support joint life annuities with minimum payment periods as this ensures a larger return on initial investment on the last death - also satisfying the bequest motive and being of benefit to impaired lives.

5. Account based pensions suffer from absence of longevity protection and are subject to investment and inflation risk but are portable and are attractive to impaired lives and for legacy needs.

6. Variable payout annuities appeal to pensioners who want to participate in the upside potential of investments in equities and real estate. But their offer requires a robust regulatory framework and a high level of transparency and integrity on the part of providers. Use them in combination with other products.

7. Deferred annuities (with or without refunds), which are purchased at the time of retirement and are payable 10, 15, or 20 years later, are an attractive option in most countries.

8. Countries need to define a default option for retirees who cannot decide.

9. The use of centralised electronic quotation systems (as in Chile) and offer of guidance and advice by regulatory agencies will also contribute to greater consumer protection.

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