CEPAR Submission Number 3 to the Financial System Inquiry:

Drawdown defaults

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About CEPAR

The ARC Centre of Excellence in Population Ageing Research (CEPAR) is a collaboration between academia, government and industry.

The Centre is based at the University of New South Wales with nodes at the Australian National University and the University of Sydney. It aims to establish Australia as a world leader in the field of population ageing research through a unique combination of high level, cross-disciplinary expertise drawn from Economics, Psychology, Sociology, Epidemiology, Actuarial Science, and Demography.

CEPAR is actively engaged with a range of influential government and industry partners to cooperatively deliver outcomes to meet the challenges of population ageing. It is building a new generation of researchers to global standard with an appreciation of the multidisciplinary nature of population ageing.

Mission

CEPAR's mission is to produce research of the highest quality to transform thinking about population ageing, inform product and service development and provision (private practice) and public policy, and improve people's wellbeing throughout their lives.

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Drawdown defaults[1]

Introduction

This submission focuses on the use of defaults in superannuation drawdowns at retirement. It has been written in response to a request to CEPAR by the FSI to provide input on this issue. It builds on earlier CEPAR submissions, dated March 31 (Submission 1) and June 12 2014 (Submission 2). It should therefore be read in conjunction with those submissions, which discuss the context and much of the evidence underpinning the recommendations in this submission.

Defaults have been shown to be powerful in determining choices and outcomes in a variety of settings. Understanding how they have this impact requires a grasp of a range of behavioural issues. These have been canvassed in both CEPAR's previous submissions.

Specifying retirement income drawdowns is challenging. People approaching retirement differ in numerous ways, including by age of retirement, level of savings, home ownership, family circumstances, health status, and consumption. So they face different types and levels of risk and resources to deal with retirement. As a result, a single mandated retirement income strategy will not suit everyone's circumstances. Defaults may be a more appealing policy option: while providing appropriate guidance for the majority, they offer an opt-out. This allows those with preferences and facing circumstances for which the default is inappropriate to make alternative decisions.

The June 12 submission explicitly raised the possibility of setting defaults for superannuation decumulation. The present submission considers more explicitly the nature of decumulation defaults. It falls into two substantive parts. First, we consider the various design elements of a decumulation default. Second, we expand on recommendations S1 and S2 in our June 12 submission. S1 and S2 recommend consideration of default drawdowns and consideration of mandating a Deferred Life Annuity (DLA) at a later pre-determined age.

Preliminaries

Objectives of Retirement Policy

It is helpful to begin by reinforcing the purpose of retirement policy. Recommendation 1 of Submission 1 reads:

> Government should formulate and pursue a coherent plan that will allow superannuation to provide a stream of resources in retirement. This is an overarching recommendation from which other, specific recommendations and comments follow.

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[1] This submission draws on and extends a working paper prepared by CEPAR for the Actuaries Institute Working Group on Retirement Incomes, which has been set up to assist the FSI with its deliberations. John Piggott was a member of the Working Group. The same individuals were involved in preparing both documents.

A default retirement income structure, over and above the Age Pension, should deliver consumption smoothing and provide some coverage against a standard list of risks, in a configuration suitable for a majority of the retiring population. These risks include: longevity (and the opposite under-consumption risk), inflation, investment (including sequencing risk), timing of purchase, replacement rate (including price risk), and counter-party (or provider) risk.

There are some tradeoffs between managing different risks. For example, since formal insurance (investment, inflation, longevity) incurs a cost, it is possible to think about payout structures as trading off the expected consumption stream, or replacement risk against insuring the various other risks listed. Similarly, while products such as annuities may cover longevity risk, the individual may instead face risks related to liquidity or timing of purchase.

Broadly speaking, potential defaults should be assessed on how well they trade off these various risks, including replacement rate risk – that is, how well they deliver consumption smoothing between working life and retirement.[2]

Because needs and circumstances vary greatly through retirement life, the default could be dynamic, offering different kinds of benefits at different stages of retirement. Of special importance is the onset of cognitive decline. Currently, the incidence of dementia (more serious than cognitive decline) reaches as many as 20% of the population aged 85-89, and increases further in the 90s.[3] This raises questions of decision-making competence, of consumer protection, and of family negotiations and decision-making. The present submission, consistent with CEPAR recommendations S1 and S2, envisages two separate stages in retirement – one covering active and cognitively competent retirement life, and a second period where frailty and cognitive compromise are more common.

Limitations

The Age Pension offers longevity insurance at a low (poverty-alleviating) level. Longevity risk therefore relates here to running out of superannuation savings over and above the protection provided by the Age Pension.

Other retirement fund management goals, in particular aged care and bequests, should be ignored in analysing retirement income defaults. For many people, the owner occupied home will provide the wealth basis for financing both. But in any event we do not consider that superannuation should have as its purpose provision of bequests and there is already in place a structure for aged care.

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[2] One question specifically asked in the interim report relates to whether "income efficiency" is a metric for choosing between alternative retirement income products. In the present context, should this metric be used to compare defaults? CEPAR believes this is not an appropriate measure. First, the income efficiency measure takes no account of bequests (intended or unintended) when in fact such bequests are often a determinant of family care in later life. Second, it appears not to take account of capital reserve requirements which are designed to meet counterparty risk. But most importantly, it provides no guidance as to how well the objectives laid out above are met. For example, a lump sum is 100% efficient, but meets none of these objectives.

[3] Anstey, K. J., Burns, R. A., Birrell, C. L., Steel, D., Kiely, K. M., & Luszcz, M. A. (2010). Estimates of probable dementia prevalence from population-based surveys compared with dementia prevalence estimates based on meta-analyses. BMC Neurology, 10, 62.

We also abstract from the question of what action or circumstance might trigger the default. In the June 12 submission, we referred to "some point corresponding to substantial scale-down of labour force participation in later life, at or after superannuation access age (retirement)". There is a genuine difficulty in defining a set point at which drawdowns should commence by default, or for that matter, through mandating. To the extent the first phase of retirement includes some form of income drawdown product this should allow for some flexibility in the early stages of retirement when an individual may be continuing to perform some paid work. There is also an important consideration of whether superannuation access aligns to the pension access age.

Default Design features

Phasing

The default can be tailored to phases of retirement so that products will be appropriate for a greater proportion of people and the changing circumstances that they face moving through retirement. For example, individuals in early retirement are more concerned with liquidity while in later retirement longevity risk becomes prominent. Viewed from the retirement window, circumstances in late age can be captured within a tighter distribution of circumstance than immediate conditions – something that the default design should reflect. They should also reflect the very real potential for cognitive impairment at some stage in retirement. The dividing line between phases can be drawn in different ways, including:

- arbitrarily at age 85, possibly indexed with life expectancy;
- at average life expectancy, capturing the bulk of longevity risk; or
- at a certain proportion of expected life in retirement.

There should be a provision for earlier change between phases where serious cognitive impairment is present. This is consistent with Submission 2, Recommendation S2. The income streams available in each of these phases should be consistent with each other and reasonably expected needs of each phase.

Product

A number of products or combinations of products could be considered, mindful of the possible phasing. Some of the products include sub-types which could be part of the evaluation. For example, annuities could be joint or single life and could be standard or underwritten to allow impaired life annuities that would suit greater numbers of people and address equity concerns. The latter could act as a form of customisation, by, for example, gender and occupation as proxies for life expectancy, and would in fact be essential if mandating a DLA were considered. An alternative might be a deferred GSA (Group Self-Annuatisation), where idiosyncratic risk pooling is facilitated, but where the member pool shares systematic longevity risk. Some default products, such as phased withdrawals, may also require investment mix defaults along the lines of MySuper, but better suited to individuals' age profiles. In particular, age-phasing the investment mix through retirement for products with high income and/or capital volatility, for instance equity exposure, should be considered. Consideration should also be given

to allowing reallocation between spouses of their superannuation savings to achieve better risk management.

Coverage

The default is likely not to apply to all classes of workers. For example it's not obvious that the default would apply in the same way to self-employed workers, who could instead actively opt-in. Consideration also needs to be given to grandfathering of existing arrangements to those about to retire and/or the phased introduction of the new regime.

Account

It may be that the trigger would only operate for certain accounts. For example:

- MySuper (i.e. for people who have already been defaulted);
- MySuper + Active choice accounts;
- MySuper + Active choice accounts + SMSF;
- an account which at opening time at an earlier age has been nominated to go into default pension once at retirement; or
- more preferably all accounts with certain exceptions (e.g., defined benefit).

Opt-out

There needs to be clarity about the opt-out. This would require the following:

- Time period (e.g. 6 months, which would require structuring that doesn't lock in the purchase of an insurance product until the opt-out period is over)
- Method of notification pre-and post-default becoming operable

Thresholds

How much of the retirement accumulation is defaulted to which type of product would depend on thresholds:

- There may be a minimum accumulation below which the income stream is not the default (e.g., $100,000); and
- There may be a maximum (e.g., $2 million), to be defaulted, with excess funds requiring some active decision for high accumulations.

Deciding the level of thresholds should be done regardless of other savings to avoid changes in behaviour (e.g., not encouraging debt build-up pre-retirement that would be paid off from taking lump sums). The thresholds could be set based on replacement rate targeting for workers at different points in the earnings distribution, which would be consistent with the principle that superannuation is designed for the purpose of consumption smoothing. Importantly, such thresholds should be indexed.

In considering thresholds, a natural question is whether these apply to individuals or income units (which may include couples), and what the thresholds might be in the latter case. This suggests that some mechanism for combining individual superannuation accumulations across income units (couples) to take account of income unit thresholds may be appropriate.

The provider

This is an important question in terms of efficiency of the system. Provider options include:

- license holders + nomination from trustees;
- funds vs insurers;
- government; or
- prudentially managed winner of semi-regular auction (in line with the FSI inquiry's discussion around MySuper tendering).

There should be a clear and easily accessed comparison base for default products offered by different providers, to facilitate choice of provider by consumers.

Price/fees

Related to the question about providers, prices and fees could be determined by:

- the retail market;
- the wholesale market;
- regulated levels (e.g. NEST in UK requires min fees to be part of accumulation default); or
- regulated structures (types of implicit/explicit fees allowed/disallowed, e.g., opt out fees)

Incentives

Ensuring that tax and means test incentives are structured to favour the default could include:

- taxing lump-sums or withdrawals below min and above max; and/or
- changing means test treatment, particularly in relation to the age pension and other seniors' government provided benefits.

Generalising this point, it is important that policy incentives are aligned with the chosen default.

Choosing the default

The default specification should be as simple as is feasible, consistent with the objectives laid out above. We refer to Submission 2, Recommendation S3:

Recommendation S3: Retirement income products should be simplified. A possibility is to require that financial service providers offering retirement income products offer *at least* a small menu of standardised products, with clear protocols around pricing, charges, and benefits. If a default or mandate has been specified, it should be included in this menu, and should be simple.

The default could be either universal, or could come from a small and comparable menu if it is decided to leave default specification in the discretion of the superannuation fund. That is, the funds could choose between two or three default specifications, to best match the default to their membership characteristics.

Government support for the default market

In addition to facilitating the infrastructure related to the processing of defaults (e.g. super-stream infrastructure changes and tendering process) government can assist in the risk management issues that will make it easier for the private sector to provide products that cover a range of risks. For example, issuing long term related financial instruments that help to manage longevity, market and asset liability mismatch risk. These could take the form of long term bonds, longevity, infrastructure, and inflation linked bonds, allowing the private sector to better deal with the risk accumulating on the balance sheets of reinsurers and lower the cost of risk capital.

The provision of such instruments can provide capital for current infrastructure needs, are a natural match for infrastructure investments (without creating a balance sheet issue for government), while also making longevity products cheaper to provide for the financial system. The outcome would be welfare improving since it would allow the private sector to do what it does best (insure the idiosyncratic risk) while government takes on the more difficult stop-gap longevity risk, in a transparent market context.

In addition, in the event that the default involves products requiring a capital reserve, the Inquiry should investigate the appropriate levels of such reserves. This is especially true of DLAs and GSAs, both of which products would seem to be strong candidates for default targeting. Appropriately priced deferred longevity insurance products issued by a government entity, akin to Medibank Private, may have much to recommend it, at least until the market is firmly established (Submission 1, Recommendation 10). (Submission 1, Recommendation 10). .

Conclusion and Recommendations

In conclusion, CEPAR is inclined to the view, based on evidence offered in earlier submissions, that financing the first stage of retirement may be assisted by an appropriately designed default, providing liquidity, flexibility and discretionary capital. The later "frail" stage of retirement may be better served by a longevity insurance product, either defaulted or mandated, which would in turn require both government support and customized pricing.

Defaults will work most effectively if they are integrated and aligned with more general policy settings. Framing superannuation as an income stream (Submission 1, Recommendation 14) along with coordinated policy incentives and education initiatives (Submission 1, Recommendation 12) will support the default strategy.

With this context, the recommendations from this submission are:

Recommendation D1: At some point corresponding to substantial scale-down of labour force participation in later life, at or after superannuation access age (retirement), individuals should have most of their superannuation accumulations defaulted[4] into an income stream. The default should allow individuals to have flexibility through the first, active, segment of retirement, to allow them to cope with unexpected (and largely uninsurable) contingencies, while at the same time setting a standard for an affordable stream of consumption through to late life. Some equity exposure is appropriate, possibly declining with age. The structure of an account based pension is consistent with this default. The default should be designed to be consistent with the Age Pension, and Age Pension means test rules should be modified where necessary to be consistent with the support of such a default. Defaults should operate on accumulations of between a low sum below which income streams may be trivially commuted and an upper bound, beyond which defaulted retirement stream become irrelevant.

Recommendation D2: At some late age, for example 85, a survivor-contingent income stream should be defaulted or mandated. This could take the form of a conventional DLA, or a deferred GSA income stream. Again, taxation and means test rules should be modified where appropriate to support this default. Earlier drawdown should be facilitated where serious cognitive impairment is present. (Submission 2, Recommendation S2). The value of capital reserves should be considered, with a view to taking account of other hedges by the issuer which might dictate a lower requirement than currently stipulated, thus improving the moneys worth of the income stream. Heterogeneous circumstances concerning survival probabilities should be reflected in customized pricing of the deferred income stream.

Recommendation D3: The default products offered by different providers should be easily comparable across price and characteristics, possibly through a government website. If it is decided that superannuation funds should have discretion to choose a default, the default menu should be small and simple, with 'just in time information' about products – superannuation funds should not have discretion to invent their own default. Individuals should also be able to readily assess the impact of their decisions on tax, access to age pension and other benefit entitlements.

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[4] The wording so far is identical to Recommendation S1 in the June 12 CEPAR submission.