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RETHINKING RETIREMENT

Challenger's Jeremy Cooper talks to *FS Super* about retirement income, challenging some dearly-held beliefs about the drawdown phase of superannuation.

As one-time chair of the Cooper Review, Jeremy Cooper knows Australia's superannuation system as well as anyone. His recommendations led to the Labor government's Stronger Super reforms, which radically changed the way the system operates. Many in the industry, still struggling to comply with the new standards, may be praying that that's it for a while.

But as deep as the Stronger Super reforms went, they did not really tackle the problem of transforming accumulated funds into retirement income. Now, as chairman of retirement income at Challenger, Cooper is turning his mind to this problem. And as he tells *FS Super,* there is a lot that needs to be done.

Until now governments and the industry have focused most of their attention on the accumulation phase of superannuation, at the expense of the retirement phase. Why is that?

Part of the reason is that we actually only built an accumulation system. So a little bit like the 401K schemes in the US, all they really do is build up savings and give them to you at the end. Now we're trying to convert that into a retirement system. Most defined contribution (DC) countries – the US, us, the UK – are struggling with this back end. It's not a fatal problem but it's a serious problem. Just handing people a pot of money at the end doesn't actually give them retirement income at all.

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What's happening to people's super when they retire?

At its crudest it just gets resprayed and retuned a little bit, and then you're able to draw down on it in retirement. Now, there are good aspects to that. It gives you lots of flexibility and emergency liquidity, and all the rest of it. But you can certainly over-consume, and it obviously doesn't deal with inflation risk or longevity risk.

The proposition we're putting is, if you're not a former politician and you haven't got a big fat inflation-adjusted defined benefit pension, you need something else to cover off on longevity and inflation. You need that stable income. And that's where the annuity comes into it.

Retirement is a lot harder than accumulation. We're not advocating that we've got a silver bullet solution. You've got a bunch of things that you need to get right.

At the moment, when you hit 65 you can choose to do whatever you want with your super. Is this level of choice appropriate?

Well, you are incentivised to leave your money in the super system because it's tax free. If you just pull out a lump sum and put it in the bank you're denying yourself the tax free status. Apart from that incentive structure, there's no barrier.

The issues that people are making choices about are very, very difficult. We're just looking at the results of a survey that shows that people are quite dramatically underestimating their own life expectancies due to a combination of investment behaviour problems. People don't like thinking about their own death, and also information about life expectancy is quite out of date, flawed, difficult to understand.

So, I believe in people being able to make their own choices, but the things they have to get right in retirement are actually a lot more complicated than they are in accumulation.

The idea of putting a cap on lump sum withdrawals, or at least introducing tax disincentives, would clearly solve a lot of problems. However it always meets with fierce opposition. Why is that?

It's a genie back in the bottle problem. Since day one in Australian superannuation, people have been told it's their money. Now that's not the case in the UK. The UK have actually got a much more nuanced and clever way of doing it. So in their new environment they're saying it's a three-way split. Some of it's yours, some of it comes from your employer, and actually some of it comes from the government by way of our incentives and tax breaks and that kind of thing. So if you drill that message into the community it's quite a different outcome from the one of, "It's your money."

The quote

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So in terms of putting gates on lump sum access, certainly Challenger is not an advocate of that. Politically trying to harness that and doing something with it would be extremely difficult.

Why do we love our lump sum payouts so much?

There's some fantastic research on this where you'll say, "Well, what would you rather: $100,000 or $10,000 a year for the rest of your life?" Now, actuarially, let's say you're 65 years old. So you can have a hundred grand now, or we'll give you a triple-A rated promise to give you $10,000 a year for the rest of your life. The ten grand is infinitely a better deal, but people nearly always take the $100,000.

It's partly about being incapable of figuring out the life expectancy, but there's also just an element of, "Gimme the hundred thousand."

There's another interesting article where, just as a dinner party conversation, this leading pension academic says, "Say you've got a hundred grand, what sort of income do you think you could reliably year-to-year kick out of that 100,000?" A lot of people say $15,000, which is an absolutely ludicrous amount. That's hedge fund territory. They just don't know the answers to this stuff. So that's what I meant when I said that the choice environment asks you to compute all this stuff. So you get all this confusion. It is very hard stuff.

Given people are not good at figuring it out on their own, does that mean the government has to get involved?

Look, yes. I guess that was the idea of the MySuper default – it was supposed to go all the way into retirement. But it doesn't.

What stopped the government from extending MySuper into retirement?

I think there was some fairly strong industry resistance, based on the fact that some funds until relatively recently had no retirement offerings. So once you retired they'd just give you the money. So the industry said, "Whoa, too much change, this is happening too quickly, we don't even have internal advisers."

One of the issues has been, oddly, super funds have been very resistant to having their own advisers. They just felt it was all too complicated, this whole concept of licensing, and where were they going to get these people anyway? If you're going to do retirement, you need advice. It doesn't matter, you know, it can be external, third party advisers, internal ones. For the reasons that we've been discussing it's actually the time when you do need advice.

Do you think MySuper will eventually be extended to retirement?

Yes I do. You see people bringing it back to the table and saying, "In the absence of anything else, it would be sensible to have some sort of default going on."

Are there any lessons we can learn from overseas about how to design the retirement phase?

You have to be really careful about this, because each system is an intricate web of history and politics and culture. So it's all very easy to get a big shopping basket, and say, "Oh, I love the Swedish premium pension model, so we'll put that in the basket. And I think the way the Danes do ATP is wonderful." But you end up with a mishmash of things.

They [Sweden and Denmark] are countries that have got a very strong notion of solidarity, a notion of intergenerational sharing and collectivism, things that are really embedded in their societies. It's like going overseas and coming back with a whole lot of souvenirs, and thinking, "My God, why did I buy that? It doesn't work in Australia!" We follow largely the American model, where, "This is my account, I don't give a stuff what so-and-so has got in his account. It's my money."

You win and you lose there, because you're not pooling investment risk and longevity risk and intergenerational risk. But that's who we are. So to come back and go, "Righto fellas, we're going to have a collective system where a bunch of wise owls are going to decide that, to help longevity at the back end of the age distribution, we're going to be doing things to cohorts along the way," we would just freak out in Australia. We wouldn't even know how to regulate that.

So, how do you envisage a functional retirement phase in Australia?

It's really about the two models [account based pensions and annuity-style products] coming together. The intellectual foundation of accumulation is a sort of a wealth management one – it's about building up wealth. Currently we're applying that mentality all the way through. We're thinking that asset allocation can actually work both in accumulation and in retirement.

We need more of an insurance mindset. So you don't necessarily need to use the word 'annuity', although annuity is the for example of it – but you've got the deferred annuity, you've got ideas of pooling, the mortality credit, the idea that premiums paid by people who die early are a unique source of income that's not correlated to what the capital markets are doing. It's about the mathematics of creating a pool of lives. So that concept is really missing in retirement in this country. Now, if you want to call it an annuity, well, that's a way to describe it. Pooling and insuring – that's what's missing.

And it's not a matter of saying we need to detonate the account-based pension and put everybody into these things. But the suite of ideas and the suite of products has got to be broader than it is now. It's about bringing in solutions and saying that there are some risks that, in the individualised world, you can't really bear. So what I'm saying is, the average Australian at the moment is effectively being asked to be their own little life insurance company. They're given, say, $311,000 to retire on, and told: "There you go, that's your little account." And then you've got to manage that for an unknown lifetime, unknown sort of spending patterns etc. "Oh, by the way you've got the age pension to support you, but I'm sad to say it's only 27% of AWOTE [Average weekly ordinary time earnings] which is no way near enough to live on. So, knock yourselves out."

Currently all annuities providers operate in the for-profit sector. But some of the bigger industry funds are increasingly branching out into other financial services fields, either on their own with in-house investment management teams, or through joint ventures such as ME Bank, Super Partners and IFM Investors. Could the not-for-profit super funds also provide their own longevity risk products?

The quote

The average Australian at the moment is effectively being asked to be their own little life insurance company.

They've thought about it. There are what they call 'pooled self-annuitisation schemes'. But there's no such thing as a free lunch. At the moment, super funds if they wanted to could do their own life insurance. But these are not part-time businesses. Yes, conceptually it's possible, but really, they'd have to set up their own life company and devote the sort of skill and attention that we [Challenger] do.

It's also about having the capital. The fact is the DC model and the industry fund model is one that really doesn't have shareholder capital backing it. And to make concrete promises in retirement, you need capital.

However, the system is definitely evolving, and it could well be that we get life insurance companies popping up in various quarters. And you'd imagine that as more and more people retire, there will be more demand for this kind of stuff. And we would certainly want to keep participating in that kind of market.

At the moment Challenger dominates the annuities market. Assuming the rules change to accommodate deferred lifetime annuities (DLAs), will there be enough annuities providers to keep the market competitive?

Well, we've got MetLife, and don't forget CommInsure and Westpac have got life insurance companies. They don't do much at the moment but they are there. And a legislative move like DLAs or perhaps even something that we don't know about yet could create the impetus.

The government is planning a review into the retirement phase of superannuation sometime this year. What is the main area this review should deal with?

The combination of a lifetime annuity and a deferred lifetime annuity are really the two key ideas. The DLA is an exquisite mixture of the concept of pooling risk to diversify away the idiosyncratic risk that you're going to live to 101. If you get a big enough pool then that risk is diversified away. You then have the time value of money, where the premium might go in at 65 and sit with the life insurance company for 20 years. You can do a lot with that.

And then there's the mortality credit idea that by the time you're getting your premium, we're dead. The life insurer can anticipate roughly, based on life expectancies, that that money is going to be available at a particular time. So when you get quoted your original rate, it will have in it a much higher lift. And you can see that in life tables now – the actual rate of return or payout rate which you're going to be promised right through your life is actually going to be quite a bit higher than what you'd expect based just on an interest rate. And that extra is the mortality credit up front because it can be anticipated down the track. I don't think many people, even in the industry, really understand that.

Is APRA ready to regulate DLAs?

Absolutely, yes. DLAs are not exactly the same, but they are very, very similar to lifetime annuities. In fact in one respect they are slightly less onerous, because if I buy a deferred lifetime annuity and you buy a lifetime annuity, the life company has got to start paying you next month, so it's got to have cash flows and liquidity immediately. With me, it will be 20 years. But essentially it's the same product. So APRA are more than capable of dealing with that. **FS**