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SUPERANNUATION IS FOR SPENDING

Nick Callil

It is remarkable that, more than 25 years after the key planks of today's superannuation system were put in place, we still have not defined the purpose of superannuation, despite recent (to date) unsuccessful attempts to legislate an objective.

Indeed, a better aim for our politicians might be to establish an objective for the overall retirement income system, encompassing age pension and related benefits, and compulsory and voluntary superannuation. Looking at the whole system, rather than just superannuation (or any other component) would help to promote better integration of the various components over time. Achieving an overall objective would allow more specific goals for the individual components, including superannuation, to be developed. We hope to see this matter addressed by the upcoming Retirement Incomes Review, announced by the Federal Treasurer in September.

In the meantime, it should not be contentious to assert that superannuation savings accumulated during working years should be spent down (ideally, as a regular income) in the years after employment ends. But too often even this limited purpose is not reflected in public discussion of superannuation and the retirement system. Often there is an assumption (generally unspoken) that assets individuals have accumulated for retirement are not to be drawn down during the retirement years. Under this thinking, the amount taken into retirement acts as a 'capital base' to generate investment earnings which can be spent but otherwise should remain untouched.

This sort of thinking was evident in the public discussion of the impact on retirees of the policy taken by Labor to the May federal election to discontinue refunding of excess franking credits. It was clear that many retirees or their advisers considered their 'retirement income' to be the dividend stream (including franking credits) generated on their share portfolio. The same mindset also underpinned some of the commentary on deeming rates for age pension means testing before the announcement that these would be reduced from 1 July 2019.

An unrealistic strategy

We should be wary of allowing a 'spend the income' mindset in retirement to take root for a good reason—for most retirees, it is simply unrealistic. Living off the interest income from term deposits or the dividend income emanating from a share portfolio sounds attractive, but for most retirees (who have little in the way of income-producing assets outside superannuation) this sort of strategy is unlikely to produce an income that they might regard as adequate.

As shown in Table 1, to achieve an 'ASFA Comfortable' income a couple adopting a 'spend the income' strategy would need to have a retirement balance of $3.9 million if investing in term deposits, or a lower amount of around $1 million if invested in a higher yielding (but riskier) Australian share portfolio.

Table 1. Achieving a target retirement level using a 'spend the income' strategy

	Required balance if invested in:	
Target retirement level (ASFA Comfortable)	Term deposit	Australian share portfolio
Single ($43,601)	$2,777,000	$703,000
Couple ($61,522)	$3,919,000	$992,000

Notes:
1. Term deposit rate: 1.57% p.a. (average of advertised rates for 12-month term deposit on $100,000+ for the four major banks in September 2019).
2. Dividend yield: 6.2% p.a. (average gross dividend yield on ASX200 over 12 months to September 2019, including franking credits).

Source: Willis Towers Watson, 2019.

These amounts are well above the median superannuation balances by Australians of retirement age, as shown in Table 2. For those hoping to achieve a reasonable income in the retirement years, this strategy makes sense only for the relatively wealthy few.

Table 2. Median superannuation balances in retirement

Age	Males	Females
65-69 years	$172,914	$165,857
70-74 years	$182,272	$170,885
75+ years	$132,324	$131,061

Source: ATO Taxation Statistics 2016-17.

Minimum drawdown rules

Of course, 'spend the income' is not generally a feasible strategy for retirees. The minimum drawdown rules (MDRs) that apply within the superannuation environment are designed to ensure account balances (including capital) are spent down over the pension phase.

While MDRs only specify a minimum amount to be drawn down, many funds still offer little guidance on drawdown strategy in retirement beyond disclosing the relevant percentages. Concern about regulatory constraints on providing advice and limited information about their retirees can constrain funds from offering more tailored drawdown guidance.

In the absence of such guidance, it is not surprising that many retirees commence drawing down their account at the MDR. Indeed, studies we have conducted of drawdown behaviour in funds show that a high proportion of members draw down at minimum rates throughout the pension phase, particularly for members with balances at or below the median.

While minimum drawdown throughout retirement may be an appropriate strategy for some retirees, it is reasonable to ask whether such a strategy is actually too conservative; deferring spending that could contribute to the quality of life in early retirement and increasing the chance of leaving unnecessarily large amounts behind on death.

Drawing down well

While longevity protection solutions (more on these later) can address underspending more directly, it's possible to improve things with careful design of the drawdown strategy used by members.

Consider the following three strategies to drawing down from an account-based pension:

- in line with the MDRs (minimum drawdown strategy)
- a constant drawdown each year, set at a level expected to last until age 90 (i.e. life expectancy plus three years) (constant drawdown strategy)
- in line with a modified set of drawdown factors based on life expectancy at each age + three years, but with a limit on the amount by which the drawdown reduces over any year (LE+3 strategy).

Figure 1 illustrates the pattern of income expected to emerge under each strategy, though in reality the actual drawdown level will vary depending on actual returns rather than the constant return used in this illustration. We observe that an MDR strategy provides lower income early in retirement, but lasts longer than the other strategies.

While ensuring income is available in advanced old age is a desirable feature, many retirees may prefer strategies that bring more income forward to the earlier, more active years of retirement.

Of course, there is a trade-off here: a faster spending strategy means retirees can enjoy more of their savings, but equally increases the chance that they will be left without retirement assets if they live longer than expected. Setting an appropriate drawdown strategy can

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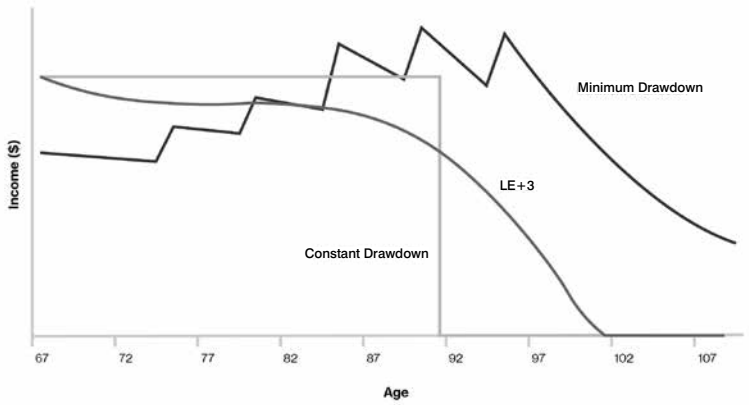
Figure 1. Patterns of income under three drawdown strategies

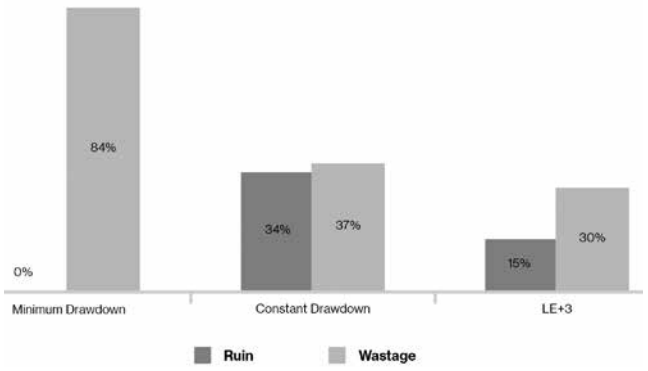


Source: Willis Towers Watson, 2019.

be seen as an exercise in balancing two risks to the retiree—running out of money before death, or 'ruin', and leaving amounts behind on death that might be regarded as excessive, or 'wastage'.

These risks are shown in Figure 2, for each of the three drawdown strategies considered.

Figure 2. Likelihood of 'ruin' and 'wastage' under different drawdown strategies



Notes:
1. 'Wastage' defined as 50% or more of initial balance remaining on death.
2. 55% growth investment strategy: mean return 5.9% p.a. over retirement period.
3. Mortality ALT10-12 (males), with 25 year improvements.

Source: Willis Towers Watson, 2019.

A minimum drawdown strategy, while having a zero risk of ruin, arguably has an unacceptably high risk of wastage, whereas under a constant drawdown strategy, ruin risk becomes the concern—many funds would still baulk at endorsing a strategy with a one-third risk of running out before death. This suggests a middle ground, like the LE+3 strategy shown, can provide a better balance of these risks. Research we have conducted in this area shows that this strategy can be further improved by additional modifications to the drawdown algorithm (such as floors and ceilings to reduce large variations in year-on-year income).

Ultimately however, no spending strategy alone can ensure a stable income for life. Ideally, as well as developing a default spending policy for retirees, funds would offer a complementary longevity product (such as a deferred annuity) to provide ongoing income where a retiree outlives their savings.

But while those more complex products are in development, a well-designed drawdown strategy can yield significantly improved outcomes for those retirees who prefer to be directed by their fund and hence would otherwise be likely to simply draw down at the minimum rates.

What can be done?

The drawdown or spending phase is ripe for greater attention and development by funds. More can be done, by funds and the industry generally, to promote spending down of balances smoothly during the retirement phase. Some ideas are:

A retirement income objective: As discussed above, developing an objective for the whole retirement system, as well as for the superannuation component within it, is a worthwhile aim. Developing an objective with substance will be contentious, as industry stakeholders and participants will have differing views; for instance, should our system aim to deliver poverty alleviation, age pension supplementation or a standard of living defined by reference to working life earnings? However one aspect that should not be controversial is that retirement provision should be in income form, and that capital balances should be spent down over retirement. An objective which is framed clearly in income terms will strengthen this focus.

Retirement income estimates: Providing estimates of projected retirement income during the accumulation phase (particularly as members approach retirement) promotes the primary aim of superannuation as spending in retirement, and should be encouraged.

These estimates are currently provided by many funds but are not universal. Ideally, income estimates should be made mandatory, with some sensible limited exceptions at the fund and individual member level. The ASIC Class Order under which many funds currently provide such estimates could also be modified to allow potentially worthwhile extensions, such as showing the uncertainty associated with an income estimate. Better still, the Class Order relief framework (which presupposes income estimates are financial product advice—a questionable assumption) could be revisited altogether.

Careful use of the term 'income': Language matters. In communicating with retirees we often see 'income' used to denote both investment earnings (such as dividends, rent, interest etc.), and the income received from a fund during retirement phase. This dual usage can cause confusion and promote the 'spend the earnings' concept described above. It's often better to use 'drawdown' or similar terms to refer to amounts paid to retirees in pension phase.

Well-designed drawdown rules: As discussed, while a conservative approach to spending down retirement accounts is appropriate in the absence of longevity protection, funds should review their default drawdown offerings to ensure they are not too conservative and do not promote inappropriately low spending by retirees.

Better retirement products: Ultimately, most retirees with meaningful balances will spend their savings more confidently earlier in retirement only if they are sufficiently comfortable that they will not run out of money in advanced old age. The continued development and promotion of longevity protection products that can provide this comfort remains a high priority for the industry. **FS**