Super: no magic bullet

Financial Planning recently gathered representatives of the financial planning community to discuss the key issues around superannuation adequacy and longevity risk, including how the changes announced in the Government's response to the Henry review and the 2010 Federal Budget might address the system's shortcomings.

Superannuation adequacy

Freya Purnell: What are the main issues currently with superannuation adequacy?

Deen Sanders: The current model doesn't lead to adequacy, so what can we do about that? Do we talk about structure, as is the Government's preference? Do we talk about encouraging additional savings as is arguably economically intended? Or do we talk about how we engage Australians in their superannuation? There are three important but distinct conversations.

Nick Economidis: Adequacy is Chris Bowen's favourite word, but from my point of view, a lot of the discussion as part of the reviews has not actually dealt with adequacy. It's been principally a focus on structure and costing rather than engagement. Without member engagement, you can't have adequacy, so the problems I have with the reviews are that a) we assume people are disengaged when they're not; b) we assume that because they're disengaged, we have to be paternalistic and take care of them; and c) why will taking decisions away from people make them more engaged? So I think we should look at how we get Australians more engaged with their superannuation.

Claire Mackay: You would be surprised at the number of people in their late 20s coming to us who are saying, "This money is not working for me, I know it's only a small amount but it's going to grow and eventually I'm going to need it". I think it's great that people are recognising that it's not just an amount that disappears each month out of their pay cheque.

Jim DeCarlo: I suspect it's only happening now though, as a result of 2008 and the beginning of the wave of baby boomers coming over the hill. I think we'll see more investigative analysis by the consumer, more awareness, more transparency, more ownership and it will drive manufacturers to develop better technology to allow you to pay more attention and be engaged with your super account. I think we don't do that right now.

FP: What is driving that increased awareness?

CM: There's been an awful lot of spectacular failures. People have seen others lose everything, and think, "Will I work hard for the next 20 years and will it all be for nothing?" That has reinforced the need to think about it, particularly for people towards the end of their working life who are very concerned about whether they will have enough money to get through retirement. On the other side, I think younger people have been brought up to question everything.

DS: I think that's fair in terms of those people who are already engaged. But when you're talking about the concept of adequacy, there is a whole pool of people who aren't receiving advice. That's where I slightly disagree with the idea that we don't need to do much more regarding adequacy. Still for a large portion of

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the population, the pension is their aspiration because of a whole raft of reasons – they might not be engaged in long-term work, they might have broken work patterns. The question in terms of longevity and superannuation retirement incomes policy is how do we engage those people in better savings and superannuation patterns as well?

We also need to recognise that right now, there are still clients who are planning to balance their superannuation with the pension. That's a choice available to them now which I suspect will not be available in five or 10 years' time. These are the issues the superannuation system needs to be focusing on – not just the accumulation phase, but how do we rework and improve the retirement phase. That's where there is a complete absence of good thinking at the moment.

NE: My concern is also that we're now moving to an environment where people could say, "Not only has the government decided what level I should contribute, they have also decided what kind of fund I should have, what investment option I should have – they have set the parameters, so I don't actually need to do anything". Psychologically, it could exacerbate the disengagement, because people will assume they will be covered.

The bottom line for me is still this, if you want to talk about adequacy for most people in the current Australian workforce, they've got to put more money in now. We'd love to get every 20-year-old to put the cost of a cup a coffee a day into superannuation – that's a good start.

CM: That's what we say to clients – when you're looking at retirement, you'll never regret putting in the $4 for a coffee 20 years ago. You've got to address psychological and structural issues as well as the tax system. It all comes together – because I think that very few people aged less than 40 now believe that they are going to be relying on the Age Pension.

Rob Thomas: That's absolutely spot on. There are many surveys that show people do understand they have to take more responsibility and accountability, even in older groups they understand that.

JD: So are we saying that while we don't necessarily have complete engagement, we have a platform for engagement?

RT: I think it's improving, yes.

FP: What needs to be done to encourage people to contribute more to their super?

CM: I think there has to be confidence in the superannuation system. A lot of people come to us concerned about the superannuation rules changing constantly. There also has to be confidence in the financial services sector – they are concerned about whether it will be safe in various investments or whether it is safer to keep it in a bank account. That confidence in the whole system is another element that needs to be addressed as well.

DS: We use the language of the three Cs – confidence, certainty and control. It is confidence in the security of those savings; certainty that you can start making real, engaged decisions now that will have an impact on your future, and the rules are not going to change tomorrow; and control of your money. People should have more control, they should be able to make informed decisions with the support of expert advice. Others who don't want to shouldn't be forced to make risky and difficult decisions in the absence of professional advice, and therefore there should be safety nets and default structures for them – but let's not assume that's for everybody.

RT: I think there needs to be a level of simplification because when people have too much

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choice or information, their behaviour is to not make a decision at all. So the simpler things are, and the more certainty you can create, that will encourage engagement and people taking responsibility.

NE: Engagement comes over a period of time and one of the best ways to do that is to have workplace programs. If corporate super advisers come into the workplace to provide those progams, you'll see over a period of time contributions going up, engagement going up, and insurance levels go up. Now under these new reforms, we don't know whether corporate superannuation as an industry can survive. That would take away one of the things corporate super does – it acts as an instigator for engagement. To say intra-fund advice can replace that – that waits for someone to get to the point where they think they need advice. It's too late. You need something that's going to start the fire.

The Henry review and the SGC

FP: One of the recommendations of the Henry review that has been adopted by the Government is an increase of the superannuation guarantee (SG) contribution to 12 per cent. Is this going to make a significant difference to adequacy, or does more need to be done in terms of policy?

RT: It's an improvement. Could more be done? Yes, but you've also got to look at the various trade-offs they have to make.

DN: There's not a single magic bullet here. I think there's a suite of things that have to be addressed. I think Nick's right – particularly in terms of SG contributions, it takes a long time for people to get engaged in terms of understanding what it is. Young people have small contributions going in, and it's not until much later on that they understand what it's all about. Increasing the contribution level is a good start because we know the 9 per cent is not adequate, but we know that going to 12 per cent over 10 years is still going to be short.

CM: When the SG was first brought in back in the '90s, Paul Keating had a vision that it would go to 15 per cent. Why not challenge the discussion and say, let's push it eventually to 15 per cent? Why stop at 12?

DN: I agree. We also run the risk of dumbing it down to the extent that you only look at cost and push everyone into a single default fund. I'm not sure that's the answer at all. And it's not so much the size of the contribution, but it's what you do in terms of portfolio construction, tax management, cost management and real performance in a fund. I'd like to see a lot more done there.

FP: The increase in the SG contribution rate to 12 per cent is going to be phased in over the period to 2019/2020. What is your view on that timeframe?

DN: It's too long. These are all good things in terms of direction but it's just not happening fast enough.

CM: To be fair, it is being phased in for a very real reason – businesses need to factor this into their costings and to change it overnight is not fair on the economy.

DN: But the Government needs to support businesses more appropriately in that transition,

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"Confidence in the system is lost through too much change" – Nick Economidis

and I'm not sure that they're doing enough.

RT: I partly agree – the burden isn't just on employers, you can also say the burden is on the employee because they're expecting an inflation-led wage rise. Then of course there's tax coming out of that, we've got SG coming out of that and they're thinking, "I'm actually going backwards". It would be great if it was sooner, but we understand that it's challenging to do things quickly. At the same time, we've got to be very positive because there is engagement – we are actually quite progressed relative to many other economies in the world. You just have to look at the European situation and the liability they have because they didn't address this 20 years ago.

DS: I think there's a delicate balance here – it is an economic and employment issue. But the thing we need to be cautious about is that a lot of positive rhetoric around it will not actually be delivered in the end, because the changes are so subtle over such a long period of time that they are essentially not going to substantially impact the superannuation of people with 20 years of work left.

2010 Federal Budget

FP: Turning to the Budget, do you think the continuation of the transitional $50,000 concessional contribution cap [for those over 50 with super balances up to $500,000] is sufficient to address the concerns of pre-retirees who felt the opportunity to top up their super was removed?

RT: It assists. Is it enough? I guess it depends on what each person's actual need is. It probably isn't really enough for most people if they're wanting to retire at 60 and can live until they're 90. But it all helps.

DN: As we said before, it's more evidence of a good start.

DS: It is also demographically relevant in that this audience over 50 has a desperate need to top those funds up because most of them aren't thinking about it today. Every piece of research we have says that the level of engagement with superannuation skyrockets about five years out from retirement, so there is certainly a need to tip a lot more into that space.

NE: When they brought the cap down to $25,000, there were a lot of people affected who were not rich, because they're playing catch-up.

RT: The other thing is for those people playing catch-up, the only other option for them to create wealth is gearing, and that's more risky, so this is a good thing.

NE: Confidence in the system is lost through too much change and I think Chris Bowen has actually said these reviews are about setting the policy goalposts and then not touching them again. But who's going to believe that?

JD: There is a correlation between disengagement and change – if we go back to one of the first points, consumers are concerned about the government continuing to tinker.

Managing longevity risk

FP: How conscious of longevity risk are clients when they reach retirement?

JD: We conducted focus groups this year with pre-retirees with household income streams of $100,000. It was jaw-dropping. Five years out from retirement, they were fearful, they had omnipresent anxieties about their longevity.

CM: We have clients who are five years from retirement, asking, "Will we have enough?". If you are going to retire at age 60 and live for 20 years or longer, those conversations are quite confronting. Because they have often just paid off the mortgage, the kids have left home, they think they can start enjoying themselves and then they're hit with this deadline. By the same token, these are people who have thought about it, and they have made the decision that they need to do something and they can't do it on their own. So I guess that confirms too that the earlier you get advice, the less anxiety there is, and a lot of what we do with our clients is to try to provide that education, as well as a plan and structure and putting the numbers around the unknown.

FP: What tools and strategies do you use to manage longevity risk at the moment?

CM: There are structures out there in the marketplace that are directed towards those concerns. I guess when you are sitting in front of a client, just like with any other product, we have

to explain what the product is, what the fees are, and the added confidence or protection those products are going to provide for that cost. And often they're very complicated. I think as product manufacturers move into this area, there will be more competition, and hopefully that will bring the fees down and reduce the complexity. Hopefully they can explain it better and engage with consumers, because our clients want something that is simple, understandable and low-cost, that will get them where they need to be.

RT: I think that one of the issues with clients is the ability to demonstrate volatility. Many products are demonstrated with these lovely straight lines on returns, and that's not necessarily the case. I think there is an awareness of that but there aren't the tools to educate people. Recent events might make them more aware of it, but that may be forgotten as time goes on, so that is one of the things we need to look at in the industry – how we visually show the effects of volatility.

DN: We spend a lot of time with clients educating them around volatility and how markets work.

NE: Every time we do a risk profile on a client, we touch on volatility, and modelling doesn't allow you to show volatility. Instead, we do a worst case scenario.

FP: Is there enough focus in the industry on the retirement phase?

DS: That's the part that worries me more – the focus on accumulation, when frankly the pension and annuity phase is going to be much longer for most people. You look at volatility in that environment, when you've got a finite pool of money for investment, and it's much more of a problem. The challenge is for the industry to get on with providing annuity products, because at the moment there is a remarkably poor pool of retirement income stream products, with less flexibility and control than most people want. That's absolutely the area of growth I think, to make sure there are good products, properly advised, in the market.

CM: It's an interesting thing, because that product is going to have a life of 25-30 years. I don't think culturally we have a view of 25-year investment plans.

NE: I think what's also hard is that product manufacturers need to manage the balance sheet and the yield curve, and look at what's on the other side that is going to have the timing matches.

JD: Anybody can go out today and buy a put option on a share portfolio. It might cost you somewhere between 17 and 22 per cent of capital, so your buck becomes 77 cents back after five years.

DS: But can they do it for 20 years? We're encouraging the product marketplace to come up with something, because clients want choice, they want confidence and certainty. This is the issue – with longevity there is an absolute uncertainty. I think people will probably bank on 77 cents in the dollar if it comes with certainty. The Government has now stepped away and said the market will provide, so we're keen to see the market provide.

JD: The AXA group surveys 17,000 pre-retirees and retirees every year from about 24 countries, and they said they will pay 4 to 5 per cent of the cost of capital return on their money over a 20- to 30-year period for certainty.

As an industry, we talk accumulation, but nowhere do we talk income, and that's the conversation we need to have, that's the cultural shift that needs to take place – how much

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income will I have and will it last? We have had an average of 30,000 post-retirees hitting the market every year for the last 15 years. Everyone has built their business on the accumulation and pre-retiree market. We will now have an average of 120,000 retirees hitting the market for the next 15 years, in a market where volatility is as high as it was 15 years ago. The maths doesn't add up. So we've got business challenges

"People want individual control, and it's difficult to manage longevity risk for one person" – Rob Thomas

that are coming at us, about how we are going to run our business and provide certainty of income streams, in a marketplace where post-retirees are smarter and more nervous.

RT: In the past, when corporate defined benefit funds were looking at asset and liability matching, we had this number of people reaching retirement age, and this number of people making contributions to a fund. In that situation, it's relatively easy to apply averages and pool the risk. But we're dealing with individuals here – people want individual control, and it's difficult to manage longevity risk for one person.

DS: Again, it comes back to the three Cs – confidence, certainty and control. Control over what you do with your life, and are you able to control your funds flow – whether it is a retirement income stream at 96 per cent of the guaranteed outcome, or 40 per cent plus the traditional pension plus working two days a week. It's the control that people want, and that's the anxiety that people are expressing now – that they won't be able to control that. Are you optimistic about the development of retirement income stream products?

JD: I'm absolutely confident they will be more and more validated in the market. I liken this to the platform industry 20 years ago – I think it will reshape our industry in the same way. Let me be really clear here – longevity products are not designed to capture the client's total portfolio. Longevity products are meant to provide certainty in a portfolio. If you say, "I'm going to put all my clients in a longevity product", you're missing the point. How they're sold globally is that the planner decides what proportion of the income the client needs to be sustainable.

NE: I don't think you could have a conversation with the client where you say we're putting your whole portfolio in a longevity product.

JD: The danger is that if you have volatility in the first two years of the client's post-retirement income withdrawal, they can't recover. So what we and other manufacturers are trying to do is give a client an allocated pension, and they can draw down as much as they'd like. If there's a lightning strike over the next 15 years, which there probably will be, when the allocated pension runs out of money, they will either be out of money at age 86 with nothing, or out of money at 83 because of the fee draw, and then have an income stream at x per cent. That's what these products are designed to do. We can put the current technology into an allocated pension that currently exists, and offer peace of mind at a portion of income. I think that could reshape the industry.

FP: For those with clients, what do you think about these longevity products – is it going to have that sort of impact? Are there barriers?

NE: I will reiterate the point: I think longevity products can only be part of the solution.

DN: It's about portfolio construction. There will be more appropriate products going forward because of the complexity – although I think complexity is not a bad thing, it's going to drive the industry into a professional area. It places demands on the planners and on the industry to lift our game, so bring it on.

CM: Obviously there is a counter-argument though. I should point out, the majority of our clients are self-funded retirees, and the majority are seeking control. They have had professional lives and they are smart, but they can't comprehend why they don't understand the structures that are being presented to them. I think there is inherent complexity with what we're talking about. But if I can't explain to my client what that complexity is, they cannot feel confident about whether it will actually work and if it will still work in 20 years' time, so I can't recommend in all honesty that they should invest in it. So while there are inherent complexities in these products, they have to be able to be easily understood. The other side is the value-add they provide as against the cost associated with it.

JD: That's the challenge for the industry.