RETIREMENT INCOME

MYTHS AND REALITIES

June 2015

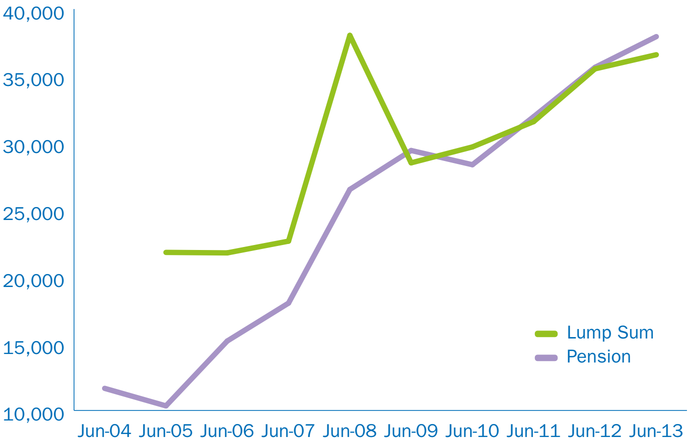
How much do we really know about what retirees are doing with their superannuation once they can access their funds? Colonial First State recently commissioned Rice Warner to launch the Income Stream Index to examine some of the common myths about retirement and present a current view of the superannuation industry.

Myth 1: Around 50% of retirement assets are paid out as lump sums

There's a widely-held belief that many Australians, once they retire and finally get their hands on their super, will take their retirement assets as a lump sum.

Annual statistics published by APRA add weight to this belief. Despite an evident increase in the popularity of account-based pensions over recent years, the split between super assets taken as a pension compared to assets taken as a lump sum, is slowly trending towards pensions.[1]

BENEFIT PAYMENTS TAKEN AS LUMP SUM VS PENSION



Source: APRA Annual Superannuation Bulletin, June 2013

The flaw in these statistics lies in the definition of 'lump sum' and 'pension'. In addition to retirement benefits, lump sum figures reported by APRA include:

- death payments
- insurance payments.

The benefit payment total for pensions is also misleading. The figure only shows payments from existing pensions, not the rollover of benefits at retirement into a pension product. The data has been widely misinterpreted as indicating that the lump sum and income stream figures are of equal value, however they only take into account the income that is being drawn down from a pension, not the remaining capital.

We commissioned research company Rice Warner to look into these figures and present us with a more accurate view of how Australians take their retirement savings. The research looked at the exit behaviour for 18 super funds, representing 10 million superannuation accounts, to determine the behaviour of members at the point of retirement. The results were surprising.

The results contrast markedly with APRA's 2013 statistics. We found over 80% of retirement assets were converted to a pension rather than taken as a lump sum.[2] However, when you look at the split by number of accounts, the majority were taken as lump sums (59% compared to 41%).

We also found that by 2025 an estimated 96% of superannuation assets will be rolled over to an account-based pension as the superannuation system matures, average account balances grow and concessional taxation incentivises retirees to keep their savings in super.

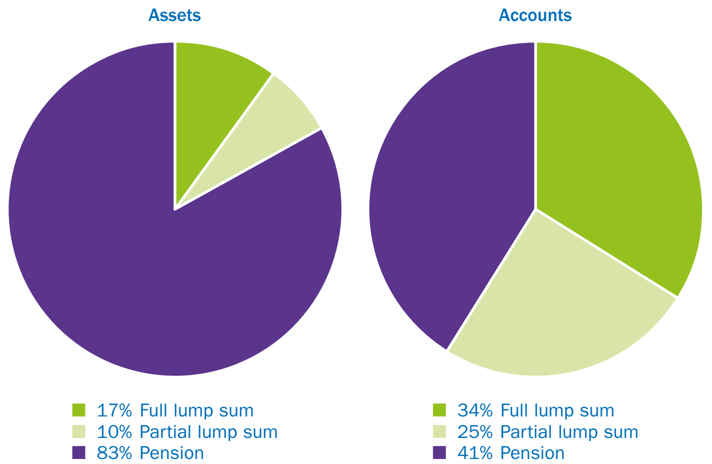
RETIREMENT ROLLOVERS AND BENEFIT PAYMENTS – ESTIMATED SPLIT

	Assets (%)	Accounts (%)
Lump sum	**17**	**59**
Full lump sum	10	34
Partial lump sum	7	25
Pension	**83**	**41**
Total	**100**	**100**

Source: Rice Warner, data for the year to 30 June 2014

1 APRA Annual Superannuation Bulletin, June 2013

2 Rice Warner, data for the year to 30 June 2014



Source: Rice Warner, data for the year to 30 June 2014

Excluding SMSFs, the majority of retirement assets taken as a lump sum have account balances of $50,000 or less (80% by assets and 86% by number of accounts). The higher the account balance, the higher the percentage of retirement benefits taken as a pension rather than a lump sum.

RETIREMENT BENEFITS/ROLLOVERS (EXCLUDING SMSFS)

	Assets (%)		Accounts (%)	
	Lump sums	Pension rollovers	Lump sums	Pension rollovers
$0–$50,000	80	20	86	14
$50,000–$100,000	57	44	58	42
$100,000–$200,000	35	65	38	62
$200,000–$300,000	21	79	24	76
Over $300,000	10	91	16	84
All balances	**32**	**69**	**73**	**27**

Source: Rice Warner, data for the year to 30 June 2014

Myth: Around 50% of retirement assets are paid out as lump sums.

Reality: While it's true that around 50% of accounts are paid out as full or partial lump sums, if we look at the volume of assets, less than 17% of benefits are paid out as lump sums.

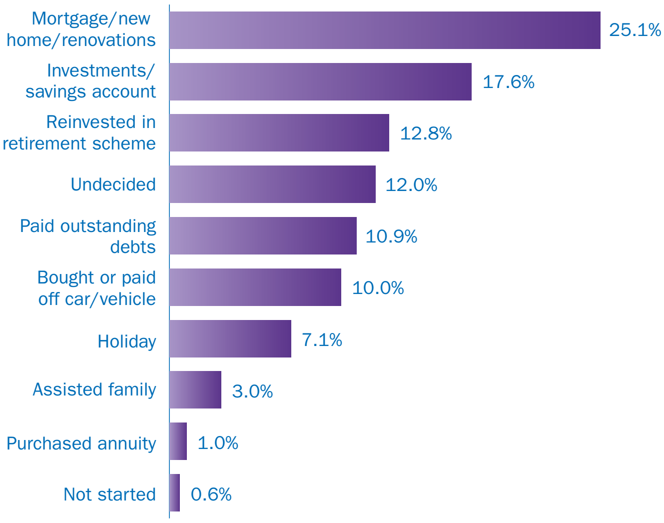
Myth 2: Many retirees aren't careful with their retirement savings

Another view often held about retirees is that they're frivolous with their retirement savings. Of those who take their retirement savings as a lump sum, the assumption is that many will spend a decent chunk of it on large expenses such as an overseas holidays, or buying a holiday house. If this assumption is true, the reasons for this behaviour are likely to be two-fold:

1. Unawareness about how much money is needed to sustain a reasonable standard of living during retirement (currently cited as $58,444 per year for a 65-year-old couple desiring a comfortable lifestyle[3]).
2. Belief that cashing out and spending their super will help the retiree to qualify for the government Age Pension (or a full pension if they are currently receiving a part payment).

Analysis of data from the Australian Bureau of Statistics[4] shows that, for the most part, retirement assets are being used sensibly and in many cases have been invested in an annuity or retirement scheme, or used to pay off debt.

USE OF LUMP SUMS



Source: Australian Bureau of Statistics, 2013

Myth: Many retirees aren't careful with their retirement savings.

Reality: Retirement savings taken as a lump sum are generally reinvested or used to pay off debt.

Myth 3: Most retirees depend on the Age Pension

The shift in demographics caused by the Baby Boomer generation retiring has raised concerns about social security entitlements. The number of people retiring each year will soon double the historical average of 142,000 per year[5], and many of these retirees won't have adequate superannuation to fund their own retirement without government assistance. So how will the government – and our budget deficit – fund the retirement of our ageing population?

The recent Financial Systems Inquiry[6] into the retirement income system noted:

> "The lack of effective risk management, particularly longevity risk management, is a major weakness of Australia's retirement income system."

The report went on to recommend that the government should agree on the following objective with regards to the super system: "To provide income in retirement to substitute or supplement the Age Pension."

3 ASFA Retirement Standard, March 2015

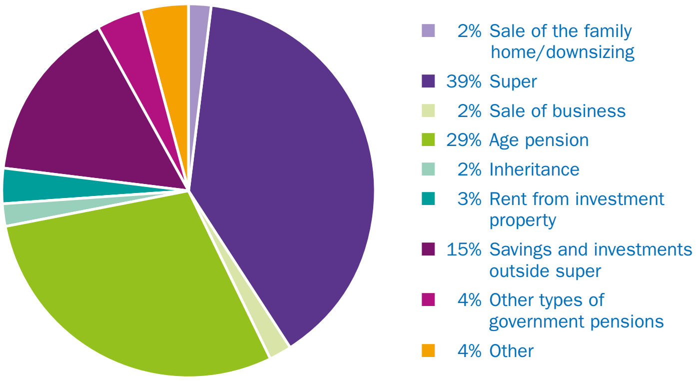
4 Australian Bureau of Statistics (Cat 6238.0), Retirement and Retirement Intentions, Australia, July 2012 to June 2013

5 ABS, Australian Demographic Statistics 2012 and Population Projections 2010. Values after 2012 are projected

6 Financial Systems Inquiry Final Report, 2014

According to the Investment Trends Retirement Income Report 2015, the main source of income for retirees is their own superannuation savings. Only 29% of total retirement income is from the Age Pension, and with cuts to the asset threshold proposed in the 2015–16 Federal Budget (a reduction from $1.15 million to $823,000 for assets excluding the family home)[7], it's reasonable to assume that this percentage will decrease over the coming years.

SOURCES OF INCOME IN RETIREMENT



Source: Investment Trends Retirement Income Report 2015

If the proposed changes to the Age Pension eligibility requirements get passed it's estimated that by 2017 67.8% of retirees will receive a full or partial pension from the government. While that number may seem reasonable, many retirees will still need to rely on their own sources of income to partly or fully fund their retirement. The role of advisers, therefore, will be to ensure that their pre-retiree clients have the right strategies in place to help ensure that retirees will receive an adequate income in retirement.

Another proposed change in the 2015–16 Federal Budget is to change the relationship between assessable assets and Age Pension payments. Currently, for every $1,000 reduction in assessable assets over the lower threshold, asset-tested pensioners receive an additional $1.50 per fortnight. As a result of the change, for every $1,000 reduction in assessable assets over the lower threshold, pensioners will receive an additional $3.00 per fortnight. If this change is passed, strategies that reduce assessable assets will become more effective. These include:

- contributing to superannuation in the name of a spouse under Age Pension age
- improving the principal home
- gifting within allowable limits
- gifting five years prior to Age Pension age
- purchasing long term annuities with a depleting asset value.

Myth: Most retirees depend on the Age Pension.

Reality: Currently about 70% of retirees receive a full or part Age Pension, however given that the Age Pension accounts for only 29% of total retirement income, retirees need to supplement this with their own superannuation savings.

Myth 4: Inflation, longevity and investment risk can be fully managed in an account-based pension

As part of its analysis into the retirement income system, the Financial Systems Inquiry Report looked at the way superannuation assets are being converted into retirement income. The report noted:

> "Superannuation assets are not being efficiently converted into retirement incomes due to a lack of risk pooling and over-reliance on individual account-based pensions."

The report went on to examine the way two commonly-used retirement incomes streams – account-based pensions and lifetime annuities – compare in terms of income, flexibility and risk management.

FEATURES OF RETIREMENT INCOME PRODUCTS

		Account-based pension		Lifetime annuity
Income	✔	Difficult for retirees to decide how much to withdraw. Payments cease when balance is exhausted.	✔	Payments continue for life. Purchase price includes margins, some of which are for servicing capital.
Flexibility	✔	Complete flexibility of withdrawals (subject to statutory minimum). Residual balance at death available for bequests.	✘	Non-commutable. Generally no residual balance at death.
Risk management	✘	Individual exposed to longevity, inflation and investment risks.	✔	Provides complete longevity risk protection. Indexed annuities also provide inflation risk protection.

Source: Financial Systems Inquiry Report 2014

94% of pension assets in Australia are held in account-based pensions.[8] While they provide a regular source of income and the flexibility to adjust payments for each retiree's specific needs, account-based pensions are subject to longevity, inflation and investment risks.

With 50% of retiring white-collar workers expected to live to at least age 91 (women) or at least age 88 (for men)[9], longevity risk in particular is a concern that needs to be addressed. Especially when coupled with the decreasing likelihood of receiving a part or full Age Pension to help supplement retirees' income needs.

After conducting its analysis of retirement income products, the Financial Systems Inquiry Report noted:

> "A combination of underlying products would likely be required to provide these features, for example, an account-based pension paired with a pooled product that provides longevity risk protection."

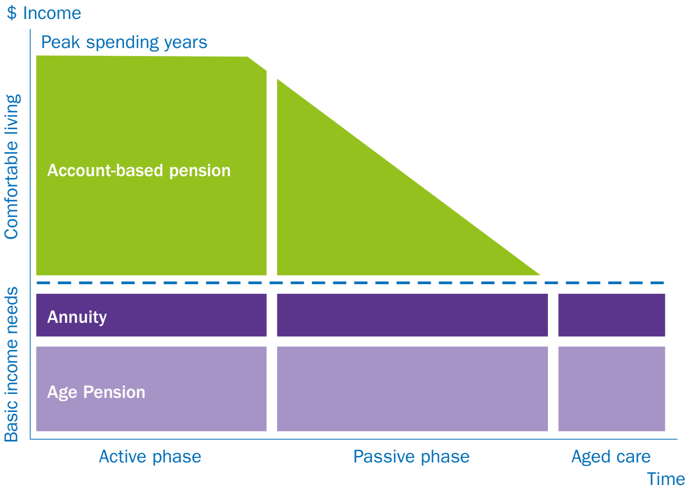
7 FirstTech Federal Budget Briefing 2015/16

8 Financial Systems Inquiry Final Report, 2014

9 Mercer: White collar workers killing average life expectancies, 2014

An income layering approach, as shown in the diagram below, can provide retirees with a dependable source of income with reduced investment, longevity and inflation risk. In this example, a lifetime annuity is used to supplement Age Pension entitlements. Part of the retirement income is structured to provide for ‘essentials’ such as food, clothing, utilities and health expenses without being exposed to investment risk. The remaining savings are invested into an account-based pension and term annuity to pay for non-essential items or ‘desirables’, such as holidays, entertainment and home improvements. This component of the retirement portfolio is also used to cover unforeseen costs or emergencies.

INCOME LAYERING APPROACH



Source: Colonial First State/CommInsure

Myth: Inflation, longevity and investment risk can be fully managed in an account-based pension.

Reality: 94% of pension assets are held in account-based pensions. A combination of an account-based pension with a product that addresses longevity, investment and inflation risk, such as an annuity, may provide a superior result for retirees, especially if they are risk-averse.

Debunking retirement myths

The increasing number of retirees and their impact on the Australian economy is a commonly discussed topic, and for good reason. Our superannuation system, though strong, is potentially unequipped to support Australia’s retirement needs. Some retirees, or those nearing retirement, may be unaware that their retirement savings may be inadequate to support the type of lifestyle they desire. However our research has shown that retirees are, for the most part, using their retirement assets sensibly. Most convert their superannuation to a retirement income stream and of those who take their retirement savings as a lump sum, most reinvest the funds or use it to pay off debts. The myth of Australian retirees blowing their hard-earned superannuation savings on frivolous expenses appears to be incorrect.

In this landscape of an ageing population and decreasing reliance on the Age Pension, the need for financial advisers to help their retiree and pre-retiree clients fund their own retirement has never been greater. Strategies advisers can put in place to help their clients restructure their assets to improve social security entitlements, contribute more to super prior to retirement, and structure retirement income to address longevity, inflation and investment risk are crucial.

We’re here to help

To find out more, please contact your local Business Development Manager, Adviser Services on 13 18 36, 8am to 7pm Sydney time or visit our website at colonialfirststate.com.au/adviser.

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