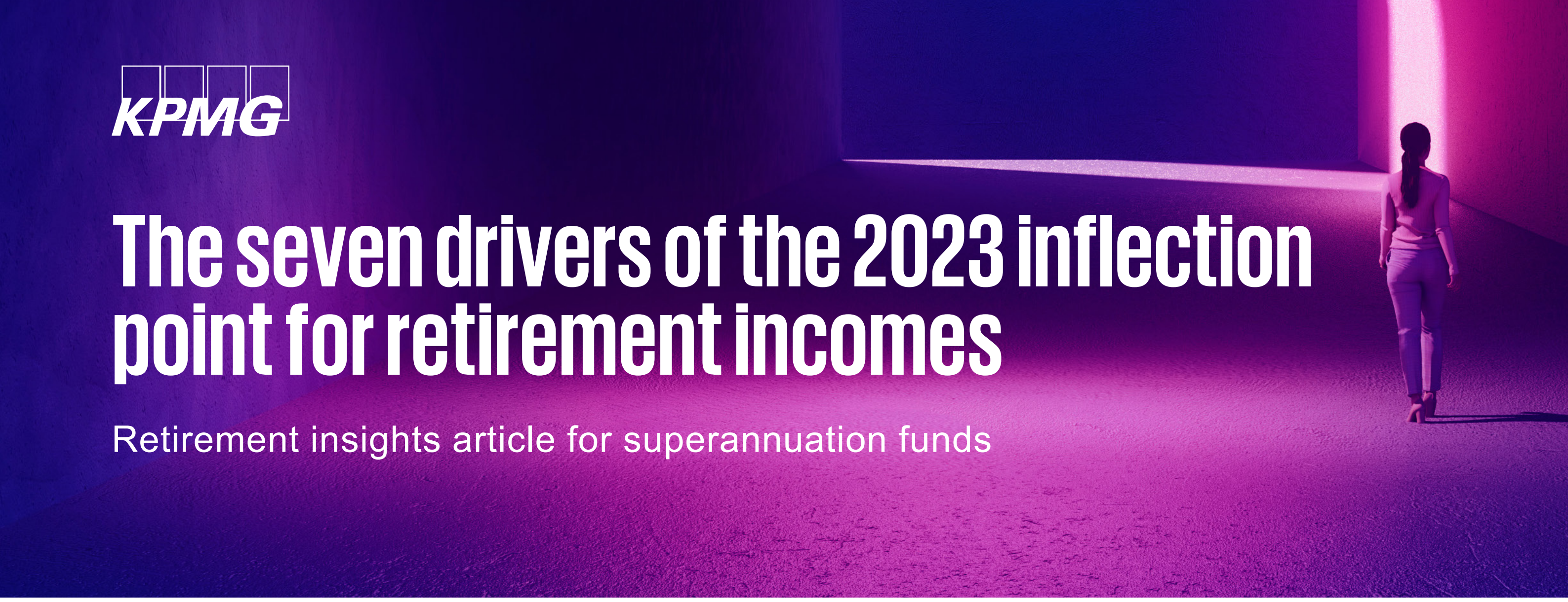


The seven drivers of the 2023 inflection point for retirement incomes

Retirement insights article for superannuation funds

You may think that change to Australia's retirement income system will continue to be sporadic, with new product momentum slow to build. However, KPMG expects 2023 to be an inflection point for retirement incomes, and has identified seven drivers that will deliver rapid change and fast take-up of new offers.

While a number of innovative longevity protection products have been launched over the last decade, few have gained significant traction amongst Australian retirees.

KPMG believes the 'time to shine' has finally arrived for strategies designed to tackle confidence around spending in retirement – that is, to manage longevity risk and deliver certainty of income.

We've identified seven drivers which are creating rapid change in the Australian retirement incomes landscape.

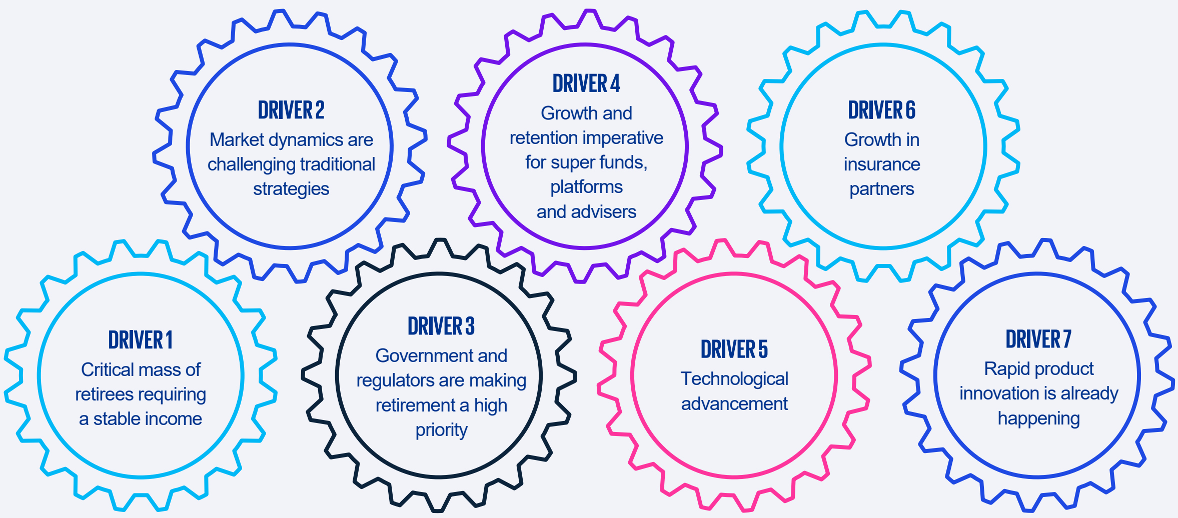
An inflection point is a time of significant change. Despite previous 'false dawns' there is good reason to believe the coalescence of these seven drivers will create a tipping point and we will see a much stronger take-up of new innovative retirement income products by Australian retirees and their advisers.

This will revolutionise Australia's retirement incomes landscape by:

– solving the social problem of longevity risk for current and future retirees, giving them peace of mind to spend confidently and the flexibility to adjust as circumstances change

– providing a significant growth and scale opportunity for super funds and successful product providers, necessary for retention of fund members into retirement and critical for survival in today's competitive market.

2023 inflection point for retirement incomes



Driver 1: Critical mass of retirees requiring a stable income

There is now a critical mass of retirees with a common unmet need – dealing with their longevity risk and achieving a certain income for life.

Retirees who have locked in their level of income can spend with confidence and have a higher standard of living. Without income certainty, they spend less in order to preserve capital and reduce their risk of running out of money. This locks retirees into a lower standard of living than they can actually afford.

In the year 2020, just over half of the baby boomer generation had reached age 65. In the year ending 30 June 2020, the population aged 65 years and over increased by 145,600 people, or 3.6% in a single year.[1]

> *"Over the next 10 years, an estimated 3.6 million Australians will move from the accumulation phase to the retirement phase of superannuation, with somewhere in the region of $750 billion in aggregate retirement savings."*
>
> **Helen Rowell**
>
> APRA Deputy Chair, November 2021[2]

These retirees are faced with the challenge of extracting an income from their savings and the Age Pension that will last them a lifetime, whilst being unsure how long they'll need it to last. They face risks including:

- investment (market fluctuations)
- inflation (the buying power of their income)
- longevity (the risk of outliving their assets).

Most retirees, especially those working with a financial adviser, can estimate their income needs and implement strategies to manage inflation and market risk – although, as 2022 demonstrated, there can still be significant volatility in their returns from year to year. Advisers can ensure that clients don't run out of money by adjusting their income, however, this does not mean a retiree has the confidence to live their best life in retirement and to spend based on guaranteed income.

Importantly, it is very difficult – if not impossible – for an individual or their adviser to manage longevity risk without pooling or guarantees.

Most Australian retirees are still investing their superannuation into traditional asset allocations in account-based pensions, and as a result are bearing both market risk and longevity risk. Research indicates that this is a major source of concern for retirees.[3]

> *"Many older Australians must live with the constant worry that they might outlive their savings and be wholly dependent on the age pension. Results from the most recent 2019 National Seniors Social Survey indicated that one in five participants frequently worry about outliving their savings and investments, and over half agreed that they worried either frequently or occasionally."*

This fear of running out of money leads many retirees to live more frugally than their means allow. How do more retirees have the certainty to spend confidently, and the flexibility to adjust as their circumstances change?

A new emerging generation of retirement income products go a long way to delivering certainty and flexibility, whilst overcoming other obstacles that prevented traditional lifetime annuities gaining traction with retirees in the past (refer Driver 7).

In short, the new generation of products will be seen by retirees as more than just an add-on that locks in some income to top up the Age Pension. These products are designed to form the anchor of the retiree's strategy, managing longevity risk and providing more certainty of income and peace of mind.

These new products are discussed further under Driver 7.

1. Data from Australian Bureau of Statistics: Twenty years of population change | Australian Bureau of Statistics (abs.gov.au)
2. APRA Deputy Chair Helen Rowell - Speech to the Australian Financial Review Super and Wealth Summit | APRA
3. https://nationalseniors.com.au/uploads/0120203573PAR-RetirementIncomeWorry-ChallengerRpt-FNREV.pdf

Driver 2: Market dynamics are challenging traditional strategies

Market instability in all asset classes through 2022 and continued share market volatility in 2023 is challenging traditional retirement income strategies, whereby retirees invested in growth assets as a major defence against longevity risk.

The longest bull market in US stock market history began in the depths of the financial crisis in 2009 and lasted almost exactly 11 years, until the COVID-19 pandemic brought it to a close in 2020.[4] The S&P 500 index delivered gains of more than 400% across that period. Australian superannuation and retirement funds experienced a similar bull market run, with strong returns through to mid-2021 – a record-breaking year with some super default options returning more than 20%.

For all of that time, Australian account-based pensions with a balanced or growth investment have delivered strong returns to retirees, mitigating their risk of outliving their pension balances.

In contrast, the end of the bull market saw heavy falls on stock and bond markets, with many super funds posting negative returns in the year to 30 June 2022. Retirees in account-based pensions were exposed to these markets, and many experienced losses across both their growth and defensive allocations.

Experience in previous market downturns has shown that volatile markets have a larger psychological impact on retirees than other investors and may cause hyper loss aversion where retirees move to very conversative asset allocations.

2022's challenging market conditions, along with the prospect of more modest investment returns, has left retirees and their advisers seeking alternative ways to secure capital and manage longevity risk.

At the same time there has been a seismic shift in the inflation and interest rate environment.

In 2022, Australians experienced the sharpest rise in inflation since the 1990s with the Consumer Price Index rising 7.8% to December 2022.[5] This has eaten into retirees' standard of living as their income has failed to keep pace with price rises.

Australia has had low interest rates for most of the last decade culminating in a record low interest rate of 0.10% in November of 2020.[6] In an effort to contain inflation to their target 2-3% range, the RBA has sharply raised interest rates. Following ten consecutive cash rate rises from May 2022, rates were sitting at 3.6% in March 2023, with the RBA The Board expecting that further tightening of monetary policy will be needed.[7]

Low interest rates had made traditional longevity products (mostly annuities) appear relatively unattractive over the last decade, with retirees unwilling to lock in a low return on products supported by fixed-interest style investments and forgo the strong returns they could earn on growth investments. The shift to a higher interest rate environment has dramatically changed this and provides opportunities to lock in more attractive returns.

In overseas markets, retirees access insurance-based products as part of their mix to help provide greater certainty through investment market cycles.

4. Source Bull Market Explained | U.S. News (usnews.com)

5. Consumer Price Index, Australia, December Quarter 2022 | Australian Bureau of Statistics (abs.gov.au)

6. Sources Australia Interest Rate - 2023 Data - 1990-2022 Historical - 2024 Forecast - Calendar (tradingeconomics.com), Interest Rates | Chart Pack | RBA

7. Statement by Philip Lowe, Governor: Monetary Policy Decision | Media Releases | RBA

Driver 3: Government and regulators are making retirement a high priority

Government has proposed an objective for superannuation which focuses on retirement income.[8] Ultimately, this boosts living standards while simultaneously reducing Age Pension reliance and unintended purposing of superannuation towards growing inheritances.

> *"The objective of superannuation is to preserve savings to deliver income for a dignified retirement, alongside government support, in an equitable and sustainable way."*

Over the 20 years between 2000 and 2020, the proportion of the population aged 65+ increased from 12% to 16%.[9] With our ageing population, the government recognises that income certainty gives retirees confidence to spend and not hoard their pension capital.

> *"The development of the government's retirement income covenant demonstrates growing recognition that trustees must focus on the retirement income needs of members and build the capacity and capability to service those needs. In turn the wealth management market in Australia needs to provide a wider range of high-quality options to help older Australians manage their life savings throughout the retirement phase."*
>
> **Helen Rowell**
>
> APRA Deputy Chair, November 2021[10]

The Retirement Income Covenant, effective from 1 July 2022, is the start of this journey and has set the foundations to make retirement solutions a requirement and priority. The Covenant requires trustees of a super fund "to prepare a retirement income strategy to assist beneficiaries achieve and balance three objectives:

1. maximising their expected retirement income;
2. managing expected risks to the sustainability and stability of their expected retirement income; and
3. having flexible access to funds during retirement."[11]

APRA has made clear that developing a strategy is just the beginning and they will expect trustees to continue to enhance their offerings and strategies in coming years.

KPMG expects that within three years this will lead to super funds across the industry offering strategies and products that assist members to manage longevity risk. Super fund trustees (including platforms) are already responding via enhancing their own offers, and/or partnering with third parties to explore potential strategies and products.

The current complex legislative framework for advice is an impediment to super fund trustees and advisers helping members transition to retirement. The Quality of Advice Review has made a series of recommendations to simplify the regulatory landscape for advice, however, it may take a number of years for changes to be implemented.

Ideally super fund trustees and advisers will be able to more easily assist retiring members with not just comprehensive face-to-face advice but also episodic advice, digital advice, educational tools and calculators. There may even be future appetite for a soft default into retirement.

8. Legislating the objective of superannuation consultation paper (treasury.gov.au)

9. Twenty years of population change | Australian Bureau of Statistics (abs.gov.au)

10. APRA Deputy Chair Helen Rowell - Speech to the Australian Financial Review Super and Wealth Summit | APRA

11. Corporate Collective Investment Vehicle Framework and Other Measures Bill 2021, Explanatory Memorandum Table 17.1 p318

Driver 4: Growth and retention imperative for super funds, platforms and advisers

Following the introduction of the so-called 'stapling' legislation effective November 2021, new entrants to the Australian workforce must choose their own fund rather than relying on their employer to do it for them, and employees will not automatically be shifted to a new employer's fund when they change jobs. Members are now able to leave and join super funds more easily, and over time this will lead to a more mobile membership base.

Super funds with an eye towards size, scale and sustainability (with a big focus on this from APRA) will guard their own high value members whilst also trying to attract members from other super funds. In this environment, retaining members transitioning to retirement is imperative for survival.

Successful product providers or partners will facilitate the ongoing role of the fund and its existing service providers across the value chain – rather than offering entirely external solutions.

The capacity of super funds to develop offerings is improving through mergers and increased size and scale as mega-funds emerge. Such funds have improved the ability to assess, procure and co-develop when sourcing external strategy, product development capability and financial backing.

Attractive retirement income offerings will be a prerequisite for success, as members look to their super fund as a trusted source for retirement solutions.

The lion's share of retirement balances in Australia sit with platform providers. As other super funds become better at retaining retired members, this market dominance will be threatened. To succeed, platform operators will need to be able to seamlessly mesh their administration with product providers to present a single view to the adviser and retiree. They may also find it advantageous to partner with other super funds, offering their administrative capabilities.

In the wake of legislative reform, the number of financial advisers in Australia has shrunk dramatically. High compliance costs have led remaining advisers to focus on high value clients – typically pre-retirees and retirees – and prioritise efficient administrative solutions.

It will be essential for advisers who want to attract and retain clients to be able to access strong retirement solutions, which allow efficient administration. It will also be advantageous to both advisers and their clients to have compelling strategies that can be implemented in the years leading up to retirement, deepening the relationship at an early stage, meeting the client's need to take action, and providing peace of mind with a certain income locked in well ahead of retirement.

The future will see greater integration and seamless administration, information and customer experience enabling longevity products and account-based pensions to be considered together.

This is essential to meeting the industry goal that members have holistic and optimal retirement income strategies and products, tailored to them and which, together with Age Pension entitlements, present a single consolidated view of retirement incomes.

Driver 5: Technological advancement

Helen Rowell of APRA stated in November 2021:

> *"There are many potential providers that can help address this gap in the market – but it needs superannuation entities, life insurers, investment managers and other players to work together. This is a space that is ripe for good innovation, by those organisations with the acumen – and possibly courage – to grasp the opportunity."[12]*

Technological advancement will enable more seamless integration between key partners ensuring flexible products which can sit within existing structures and within or alongside account-based pensions to provide a consolidated experience for the member and their adviser.

Given technology can act as a significant barrier to entry, we predict that large scale retirement solution providers – mostly insurance companies who can leverage existing product platforms – will play a key role in the development of the retirement income market in Australia. The below diagram highlights recent market developments.

Driver 6: Growth in insurance partners

Retirement products are founded on the need to provide greater certainty; with this comes a greater role for pooling and/or guarantees which require the backing of the capital of life insurance companies.

A number of partnerships exist with domestic and global insurers (traditionally as reinsurers) but in March 2023 the first global insurer Allianz has entered the market with their own product offering via their Australian business Allianz Retire+.

As outlined in Driver 5, we expect to see a significant role for experienced insurers who see the growth opportunity in a country with an ageing population and the fourth largest pension market in the world, experiencing strong growth. New overseas players can bring their global balance sheets and capital to the party, along with the ability to leverage their existing retirement product expertise and technology.

Products and insurers: domestic and global

KPMG understands that the following products are open to partnering with super funds:

- Allianz Retire+ AGILE
- Challenger Life Liquid Lifetime
- Generation Life LifeIncome

Australian Retirement Trust
March 2021
launched Lifetime Pension – an investment-linked lifetime pension that's group self-annuitised – payments guaranteed for life, amount changes with experience

Challenger Life
October 2021 & Sept 2022
enhanced Liquid Lifetime – a market linked lifetime annuity with longevity risk insured by Challenger

Generation Life
March 2022
launched LifeIncome – an investment-linked lifetime annuity with longevity risk insured by Hannover Life Re

AMP
October 2022
launched MyNorth Lifetime – an investment-linked lifetime pension with annual bonus payments guaranteed, insured by TAL (Dai-ichi Life Group)

Allianz
March 2023
launched AGILE (Allianz Guaranteed Income for Life) – an investment-linked lifetime annuity with longevity risk and investment risk insured by Allianz Retire+

Vanguard?
?? 2023
plans to launch a retirement income product in mid-2023

ART Lifetime Pension – Can be opened from age 60. Longevity risk shared amongst participants. Immediate payments. Increased payment option. Death benefit return of purchase price. Retirement bonus may be payable on transition from ART. Available to ART members.

Challenger Liquid Lifetime – Can be opened from age 60. Accelerated payments options. A range of indexation options, deferral options and death benefits. Wide investment choice. Available on a range of platforms and some super fund menus. Is able to be white labelled by super funds.

Generation Life LifeIncome – Can be opened from age 50. Immediate payments. Lifebooster increased payment options. Death benefits within death benefit period. Investment choice. Available via advisers and is able to be white labelled by super funds.

AMP My North Lifetime – Can be opened from any age. Deferral and death benefit options. Increased payments option. Downside investment protection available. Wide investment choice. Available via advisers on the AMP North platform.

Allianz Retire+ AGILE – Can be opened from age 50. Deferral options. Death benefit is account balance. Fixed or increasing payment options, payments won't decrease. Downside investment protection on account balance. Capital access including in annuity phase. Available via advisers and is able to be white labelled and tailored by super funds.

12. APRA Deputy Chair Helen Rowell - Speech to the Australian Financial Review Super and Wealth Summit | APRA

Driver 7: Rapid product innovation is already happening

Account-based pensions have been the most popular retirement income vehicle in recent years as they offer flexibility and full capital access, as well as access to growth investments which have generally been earning high returns.

Super funds which have recently surveyed their members about their retirement preferences are finding that lifetime income (certainty/guaranteed income) is the highest priority for the largest portion of retirees; followed by a high return and flexibility (which various retirees rank second or third).

Given these needs, asking members to explicitly make a trade-off between income certainty and flexibility (i.e. forgoing access to capital in order to purchase a lifetime annuity at a fixed rate of return), has been less attractive to retirees in the past low interest rate environment.

There have been a range of practical difficulties in the past with longevity products being able to easily integrate into super fund offerings. The products looked quite different to the account-based solutions members are used to, with bundled fees including the cost of the longevity protection making the products appear expensive.

Where products were standalone and not integrated into the fund, it meant that super funds could not retain the assets under management and made it difficult for members and their advisers to access the offerings as complementary to the existing account-based pension.

Since the announcement of the Retirement Income Covenant, an existing longevity insurance product has been enhanced and four new products have been launched in the last two years – three of these in the last 12 months. There are encouraging signs of early take-up.

These new more flexible products are designed to work with an account-based pension – either alongside it or embedded within it as an investment option. They can provide retirees with the certainty of guaranteed income, with the flexibility to adjust as circumstances change, and also seamlessly fit into the existing industry systems and structures such as on-platform and integrated into super funds and account-based pensions.

Changes from some of the more traditional product structures include:

- Unbundled fees clearly disclosed, providing greater transparency to members.
- Capital access, from the account-based portion and in some circumstances from the longevity portion, including on death within certain timeframes.
- Investment choice, with a range of investment options including growth investments on the longevity portion. Some allow protected growth whereby retirees can benefit from growth and a downside protection mechanism limiting risk exposure.
- Income choices: for example, the ability to increase annual payments in line with market indices; or higher income options in the earlier, higher spending phases of retirements with a range of ‘bring-forward’ features.
- Early commencement ahead of retirement – some offerings have the ability to lock in a certain income well ahead of retirement, with that guaranteed income increasing with each year the member defers starting to receiving their income. This enables an earlier timeline for crucial retirement planning conversations, rather than the retiree and their adviser having to execute the entire strategy at the point of retirement. This also allows more time over which to select the income payment rates available in market through different market cycles.

What hasn’t changed from the traditional products is the income guarantee which provides surety for Australians to retire with confidence. Many of |these new products are backed by life companies, meaning the statutory reserves needed to fund income payments into the future have been set aside and the promises made to super fund members today will still be legally binding in 30 years time.

KPMG predict that this new style of longevity product will become a retirement income anchor. Rather than being an add-on, we think advisers and members will select the longevity protection product as a central part of a holistic and optimal retirement income strategy, locking in a certain income on top of the Age Pension.

Contact us

Contact Melinda Howes or Michael Dermody for a discussion on trends in product development, or how we could assist your trustee to:

– assess its member cohorts for retirement

– assess the optimality of the retirement income strategy for each cohort using **KPMG's member outcomes calculator** tool.

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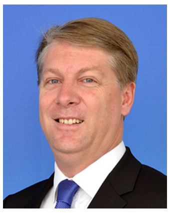

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