Member Outcomes: Bringing Retirement Adequacy to the Forefront

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JANA
DEPTH WITH DIFFERENCE

Important information

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Summary

JANA believes a key outcome of the SPS515 requirements is the enhanced focus on retirement adequacy. ***That is, what amount of retirement income is a superannuation fund's default MySuper option expected to deliver for a fund's membership cohorts?*** Assessing retirement adequacy given the complex Australian retirement system can be challenging but we firmly believe this important endeavour can be achieved. We have outlined a practical, robust and flexible framework in the thought piece below.

In this thought piece

The key elements of JANA's Framework for assessing retirement adequacy that are covered in this thought piece include:

1. Step 1: Construction of representative fund members
2. Step 2: Consideration of appropriate retirement adequacy objectives
3. Step 3: Stochastic assessment of likelihood of meeting retirement adequacy objectives

In this thought piece we have also included analysis from our proprietary model (JANA Solve).

Key takeaways

- JANA is strongly supportive of the focus on retirement adequacy as part of SPS515. In this thought piece we have provided a framework for superannuation funds to consider when working through these issues.
- We believe that retirement adequacy is a metric that RSE Licensees should be incorporating into the inaugural 2020 Business Performance Review.
- We have developed the capability within our proprietary model (JANA Solve) to undertake retirement adequacy modelling for funds as part of the mandatory SPS 515 requirements.
- JANA is supporting our clients where assistance is required from a holistic level or for a specific aspect of member outcomes related work and stand ready to be called on further.
- Please contact us if you have any questions or would like to discuss any of the areas in this thought piece in more detail.

Member Outcomes: Bringing Retirement Adequacy to the Forefront

1. Background

Superannuation funds undertake a delicate balancing act when managing competing investment objectives. The more well-known of these include outperforming CPI-based targets, index-based benchmarks and peer groups whilst controlling costs for members.

The APRA heatmaps represent an additional objective to balance, which we discussed in our December 2019 thought piece.

The recently introduced ***Superannuation Prudential Standard SPS515 – Strategic Planning and Member Outcomes (SPS515)*** has been a catalyst for the introduction of member outcomes centric investment objectives

Retirement adequacy-based targets are also a focus of SPS515 and we discuss this topic in more detail in this thought piece.

2. SPS 515

SPS515 is a multi-faceted policy but in summary, it attempts to form a closer tie between a superannuation fund's strategic objectives and business plans and the improvement of outcomes for members. A detailed overview of SPS515 from an investment perspective is contained in our November 2019 Note.

Key elements of SPS515 that relate to **member outcomes** are as follows:

Business Performance Review

SPS515 mandates an annual evaluation (named the Business Performance Review) of the outcomes achieved for members and an assessment of where improvements can be made in the future. Two components of the Business Performance Review are the "Outcomes Assessment" and "Cohort Analysis."

Outcomes Assessment

The 'Outcomes Assessment' component is a multi-faceted assessment focused at the product level and has a heavy emphasis on whether the product promotes the financial interests of members relative to peer offerings.

Cohort Analysis

The 'Cohort Analysis' component is a more granular analysis that seeks to assess the outcomes achieved for the different underlying members within a product.

3. The time to act is now

It is our expectation funds will be constructing their first Business Performance review now in order to meet the end of year timescales outlined by APRA[1]. Whilst the inaugural Business Performance review has to be completed by the end of 2020, APRA have been clear regarding their expectation of a "best endeavours" basis in 2020 but with an uplift in the "depth and sophistication" of the framework in future years.

WE BELIEVE THAT RETIREMENT ADEQUACY IS A METRIC THAT RSE LICENSEES SHOULD BE INCORPORATING INTO THE INAUGURAL 2020 BUSINESS PERFORMANCE REVIEW.

4. Shining a light on Retirement Adequacy

Retirement adequacy, or expectations regarding the amount of retirement income a default fund will deliver to underlying members is one of (if not the) key objectives for the superannuation system.

The Business Performance Review component of SPS515 shifts the light back onto retirement adequacy. Two of the questions that must be answered in the Outcomes Assessment are:

1. "whether the options, benefits and facilities offered under the product are appropriate to the beneficiaries" and
2. "whether the investment strategy for the product is appropriate to the beneficiaries[2]."

In our view it is difficult to answer these questions without assessing retirement adequacy.

The central tenet of the Cohort Analysis component of the Business Performance Review is to assess outcomes for the cross-section (rather than the average) member of a fund and this is extremely relevant for the issue of retirement adequacy.

We believe that the refocus on retirement adequacy, driven by SPS515 is welcome and starts to adjust the focus from objectives such as peer relative performance and towards questions such as:

What amount of retirement income is a superannuation fund's default MySuper Option expected to deliver for a fund's members?

Assessing retirement adequacy given the complex Australian retirement system can be challenging but we firmly believe this important endeavour can be achieved.

We have outlined a practical, robust and flexible framework in the following section.

[1] https://www.apra.gov.au/response-to-submissions-%E2%80%93-proposed-revisions-to-spg-516

2https://parlinfo.aph.gov.au/parlInfo/download/legislation/bills/s1089_aspassed/toc_pdf/1720420.pdf;fileType=application%2Fpdf (section 52(11))

5. JANA’s Framework for assessing Retirement Adequacy

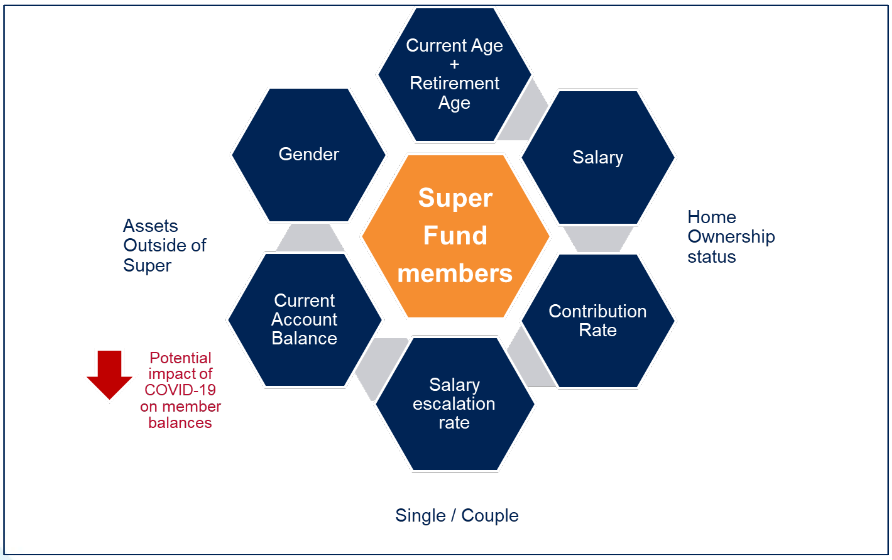
It is possible to assess retirement adequacy in a very simplistic way. For example, the superannuation balance for a 20-year-old Australian who has just joined the workforce could be projected assuming the member achieves the CPI + X% per annum investment objective of their default fund. In our view this methodology is over simplistic for arguably the most important objective of a default fund. It also ignores a key principle of SPS515, namely that the annual evaluation should not just consider an average member of a fund but instead should consider the different ‘cohorts’ of Australians that make up a superannuation fund membership. Importantly the deterministic nature of the methodology by definition considers only the expected outcome and ignores the downside.

We instead believe the following three stage process represents a sensible approach that superannuation funds can adopt.

JANA’s Framework for Assessing Retirement Adequacy

Step 1: Construction of representative fund members

- The first step is to analyse the fund membership to understand the range of underlying member cohorts.
- A summary of factors that are useful when analysing a fund’s membership is outlined in the diagram below.



- Whilst the Australian superannuation industry is reasonably unique in having a number of funds that focus on members who work in a specific industry and therefore may exhibit some degree of homogeneity, there are still significant differences in the demographics and financial situations of the members that will drive variations in retirement outcomes.
- The typical output of Step 1 is to construct a number of representative 'straw persons' that reflect the broad cohorts of a fund's membership.
- The selection of factors should be primarily based on the drivers of differences in retirement outcomes.
- Step 1 has particular importance at the current point in time because of the impacts of COVID-19 on retirement outcomes. APRA data[3] shows that approximately 4.1M of early superannuation release payments have been made since the inception of the scheme. Given the conditions for early release it is likely that those members who have utilised the flexibility will be members with comparatively low account balances and therefore those at most risk of an inadequate retirement income.

A simple example of the construction of a representative 'straw person' is outlined in the table below.

Factor	Why Factor Included	Example Output
Age	Drives investment horizon and therefore account balance at end of accumulation phase.	50
Current Account Balance	Drives account balance at the end of the accumulation phase.	$85,000
Salary (and expected salary progression)	Drives Superannuation Guarantee contributions. Potentially also drives retirement income objective if using an income replacement ratio.	$85,000
Retirement Age	Drives both accumulation and decumulation investment horizons.	65
Gender	Impacts life expectancy and therefore length of decumulation horizon.	Male
Home ownership status	Significantly impacts retirement income needs.	Homeowner

Step 2: Consideration of appropriate retirement adequacy objectives

- Step 2 involves the consideration of an appropriate retirement income objective.
- This question has been explored in length in several of the submissions in the Treasury Retirement Income Review[4] and for brevity we will avoid revisiting the issues here.
- Two common forms of objectives are an absolute dollar amount such as the Association of Superannuation Funds of Australia ("ASFA") Comfortable or Modest amounts or an income replacement ratio based on a percentage (typically between 60% and 80%) of a member's final salary.
- Whilst the ASFA Comfortable metric has become one of the gold standard metrics in Australia and will therefore likely be considered, an income replacement ratio-based objective will have more relevance the further the member is away from the mean Australian salary and lifestyle.

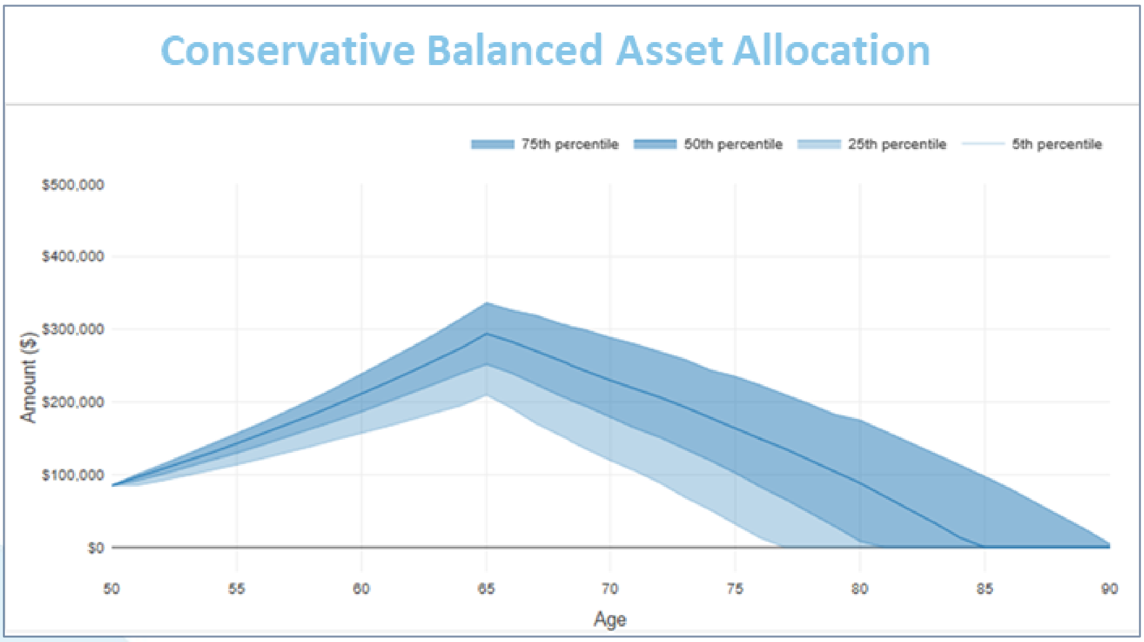
[3] https://www.apra.gov.au/covid-19-early-release-scheme-issue-17

[4] https://treasury.gov.au/review/retirement-income-review

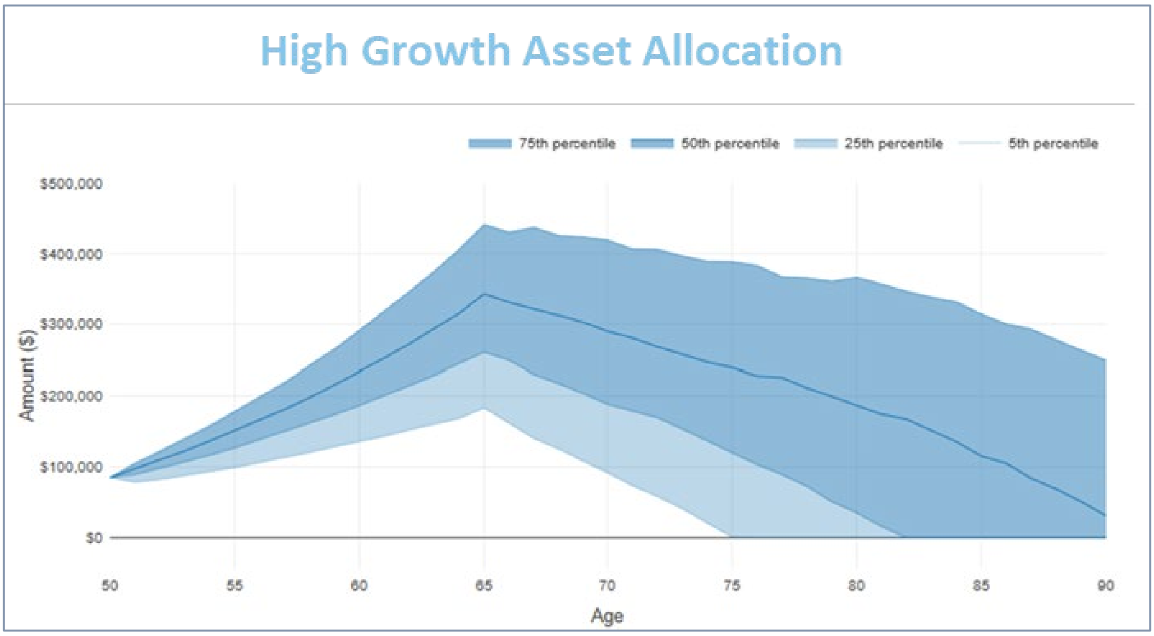
Step 3: Stochastic assessment of likelihood of meeting retirement adequacy objectives

- Step 3 involves stochastically modelling the account balance of the representative members designed as part of Step 1 through both the accumulation and decumulation phase and assessing the probability of meeting the objectives defined in Step 2.
- If the current investment strategy does not provide an adequate probability of meeting these objectives, then the impact of modifying the investment strategy can be assessed.
- In our view, it is therefore important to undertake the modelling stochastically to be able to assess the trade-offs of potential modifications to the investment strategy (that is, whilst a riskier target allocation to growth assets may increase the probability of achieving a suitable retirement income, it also comes with greater risk which can be quantified with stochastic analysis).
- Robust analysis will also integrate the Age Pension given this makes up a significant proportion of the retirement income of a proportion of Australians.
- Taking the representative member designed as part of Step 1 above, for illustration we have shown the impact on the retirement income of increasing the risk of the investment strategy by switching from a portfolio with a target of 50% growth assets (Conservative Balanced asset allocation) to a target of 90% growth assets (High Growth asset allocation).

The charts below demonstrate a stochastic projection of the account balance and show the percentiles for the age at which the superannuation balance is extinguished, assuming the member has an ASFA Comfortable income requirement. The modelling shows the account with a 50% growth asset strategy is expected to be extinguished at age 85 but this can be increased beyond age 90 with a higher growth investment strategy. This benefit of course has to be assessed against the increased risk, namely the more severe downside outcomes, i.e. the balance is extinguished at an earlier age under the very poor percentiles of the distribution.



Source: JANA proprietary model (JANA Solve)



Source: JANA proprietary model (JANA Solve)

We are cognisant that if modelling shows a default investment strategy is unlikely to deliver a sufficient level of retirement income there are a number of steps that would need to occur before any change to the investment strategy is made. Simply increasing the risk may look attractive from a modelling perspective but the member switching activity in Q1 2020 demonstrates that there is a range of additional considerations that are part of the decision-making process. However, retirement adequacy analysis is an important input into the discussion.

We believe that the key strength of this framework is the flexibility. Modifications to 'straw persons', investment return assumptions and even the structure of the Age Pension can all be easily accommodated to help provide a robust analysis of retirement adequacy of a default option. An additional extension is the use of the framework to assess the abundance of decumulation strategies currently being innovated by the industry.

6. What does this mean for a Superannuation Fund?

We believe it is timely for superannuation funds to undertake the retirement adequacy analysis outlined in this thought piece. This analysis provides superfund Trustees with an assessment of the likelihood that their default funds are appropriate in the context of one of (and arguably the most important) objectives of their members. This is important to both meet the requirements of the inaugural Business Performance Review, as well as assess the impact of the COVID-19 pandemic on the superannuation account balances for many Australian superannuation fund members.

7. Next Steps

JANA is strongly supportive of the focus on retirement adequacy as part of SPS515. In this thought piece we have provided a framework for superannuation funds to consider when working through these issues.

JANA is supporting our clients where assistance is required from a holistic level or for a specific aspect of member outcomes related work and stand ready to be called on further.

Please contact us if you have any questions or would like to discuss any of the areas in this thought piece in more detail.

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