From cradle to grave: Evolution of a superannuation fund

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EXECUTIVE SUMMARY

The opening paragraph of the Government's response to the Cooper review sums up the superannuation landscape, both current and future, perfectly;

> *By 2050, almost one in four Australians will have reached retirement age, compared to one in seven today. The gift of longer life means that Australia is at a critical point in the development of its retirement savings system. We need to improve the operation of the superannuation system so it can deliver a comfortable and secure retirement for current and future generations of Australians.*

The challenges facing superannuation providers as large numbers of members begin to transition into retirement will be substantial. The changing needs and behaviour retirees will necessitate new business models, services and products.

This paper seeks to highlight some of the hurdles and opportunities facing the industry in becoming true cradle to grave service providers. As we've observed over many years, the complex nature of retirement savings, together with the social implications of getting it wrong means that it is an area that will continue to be a major focus of government policy.

Striking the balance between effective government policy and the unintended consequences that might arise will be important. The government response to Cooper appears to have struck an appropriate balance with respect to focusing on the key areas of fees, governance and efficiency.

Whilst some sectors of the industry are seeking support to extend default arrangements, mandates or compulsion towards retirement income policy, the sheer complexity of the issues means that there is no ideal solution. As this paper outlines, inevitably, it will fall upon the shoulders of funds and their trustees to determine appropriate investment strategies, services and products based on the needs of their members. Attempts to foist solutions upon fund members without appropriate advice or engagement will inevitably result in reduced levels of retention and increase the relative attractiveness of the self managed sector.

One thing is certain; the ongoing evolution of superannuation has reached a critical point of inflection. As the remainder of this paper highlights, navigating this changing landscape offers substantial opportunities to funds that have the vision and appetite to adapt.

INTRODUCTION

Review. This is the word that sums up the last couple of years for the superannuation industry. Henry, Harmer, Ripoll, and Cooper have all had their say, with many now sifting through the debate and detail related to the form and content of the resulting government policies.

Meanwhile the metronomic marching of feet can be heard as the Baby Boomers steadily move on towards retirement. It is this shift—from saving to spending, and from work to leisure, of the largest and wealthiest demographic in modern society that will fundamentally change the superannuation landscape in the years to come.

While many funds recognise the need to act, the uncertainty created by constant tinkering with the superannuation system has resulted in hesitancy for what will be key strategic decisions that will determine whether funds are able to remain relevant as their membership undergoes a dramatic shift over the coming years.

As the policy and investment environment returns to some semblance of stability, funds are beginning to review their post-retirement strategy. The potential windfall for those who act early and with vision is sizeable. However, as this paper demonstrates, dealing with this market segment is challenging and will require new ways of thinking, product solutions and business models.

IT'S NOT SO SIMPLE

The challenges in becoming a cradle to grave provider are substantial and mirror the difficulties facing fund members as they transition from working life through to retirement and beyond. As many funds are discovering, being a whole of life solution for members goes well beyond the ability to simply have an accumulation and income product.

Retirement is a different proposition relative to the experience of working life and represents a dramatic turning point in the lives of fund members. The products, services and interaction that funds have with their members through this phase will require an approach that is capable of addressing their changing needs. (See Figure 1 on page 2.)

Some key issues include:

- **The financial stake involved**
  The road to retirement follows a well worn path. Work, marriage, children, and mortgage are some of the traditional

FIGURE 1

DESCRIPTION	ACCUMULATION	RETIREMENT
GOAL	ABSOLUTE WEALTH	REGULAR INCOME
TIME HORIZON	FIXED (RETIREMENT AGE)	UNKNOWN (LIFETIME)
FINANCIAL CAPITAL	INCREASING	DECREASING
HUMAN CAPITAL	SOME ABILITY TO SUPPLEMENT SAVINGS	LIMITED / NO ABILITY TO SUPPLEMENT INCOME
LEVEL OF ENGAGEMENT	LOW, INCREASING TOWARDS RETIREMENT	HIGH
RISK TOLERANCE	HIGH	LOW

milestones along the way. Throughout this progression, life is generally improving, health is (generally) robust, and the biggest balancing act is between spending today and saving for tomorrow.

Fortunately, government policy in the form of the superannuation guarantee (SG) means that saving for retirement has in part been decided for us. The result is that, by the time most people reach retirement, their superannuation pot is likely to be the most significant asset outside of the family home, and the primary one they will look to utilize to meet their retirement goals.

As superannuation wealth approaches its peak around retirement, decisions – either taken, deferred or neglected, can have a dramatic impact on retirement outcomes. Throw into the mix the inherent instability of financial markets and it is only natural that levels of engagement will rise.

- **Increased levels of engagement**
  As mentioned above, the financial importance of superannuation combined with the proximity of retirement should ultimately result in higher levels of member engagement.

  This is counter to the existing approaches favoured by many funds, which have relied heavily on a default model designed for the disengaged. As described above, the stakes that are involved as retirement approaches creates in a moment of clarity that many act on.

  Disengagement is an oft used argument in favour of default approaches, and has been presented as a basis for the MySuper reforms recommended by the Cooper Review. However, disengagement is a nebulous concept that should be treated with care.

  Existing statistics on the engagement, or lack of it within superannuation, and in particular, approaching or entering retirement have the potential to be misleading. Whilst current levels of engagement might be low due to the relatively meagre balances of most fund members, a brief inspection of the recent growth in the self-managed superannuation sector should serve as a clear signal of the increasing engagement levels for those with significant assets and sends a warning to funds looking to retain their members with high account values.

  The danger for many funds is assuming that members will continue to remain disengaged, as they move into retirement.

  Stereotyping members currently invested in the default as disengaged potentially incorrectly labels those that;

  — Have insufficient funds, and make an active decision not to manage them

  — View the default option as having an implicit recommendation by the fund

  — Are engaged, but cannot overcome the inertia to make a decision

  Ultimately, there will be natural triggers for each of the categories above that might assist with the transition from a status of disengaged to engaged. Funds that can initiate this transformation process will benefit by minimizing their exposure to external shocks that could potentially result in large numbers of members taking action.

- **Increased frequency and severity of uncertain events**
  As identified above, throughout people's working lives their circumstances are generally improving. In contrast to this, retirement, which promises the reward for all of this hard work, is like a journey down the side of a rocky mountain–unpredictable and potentially rapid.

  As the march of time continues, life slowly begins a gradual decline from active retirement, through passive and frail phases. Holidays become fewer and closer to home, accommodation may be downsized to something more manageable, and physical and mental frailty can result in moving in with family or into assisted or respite care.

  Dramatic changes occur throughout retirement as members transition through active, passive, and frail phases. This impacts dramatically on spending patterns and will require funds to revisit the way they do business if they are to provide a central role in meeting people's retirement needs. Products and services will also need to adapt to the changing needs and circumstances of fund membership.

MYSUPER AND RETIREMENT: SQUARE PEG, ROUND HOLE?

Much time and debate has been devoted to the concept of MySuper, advocated by Jeremy Cooper's review of the efficiency of Australia's superannuation system. While we agree with the concept that Australians should have access to a simple, low-cost superannuation product, there are a number of points made within the Cooper review that appear to potentially extend it well beyond this relatively simple brief.

FIGURE 2

ACTIVE / TRANSITION	PASSIVE	FRAIL
• Aspirational – time to fulfill dreams • Highest spending requirements – travel, etc. • Lifestyle commensurate with pre-retirement • Continuation of work (part-time)	• Decline in physical / mental capacity or both • Health / mobility issues and associated expenses • Activities closer to home • Support of spouse and / or family members • Potentially downsize home	• Cognitive / physical impairment or both • Reliance on external support and care • Movement into retirement village or nursing home • Expenses of assisted care – will vary based on levels of impairment

- **What's in a name**
  Our view is that there is not much that is My about MySuper. If anything, the concept of branding something designed for the disengaged as tailored to My circumstances is potentially misleading and will serve to give members a false impression that MySuper is a tailored and recommended approach – concepts which in our view are central features of an appropriate service offering. This may result in capturing members for which MySuper is neither intended or optimal.

- **The myth of disengagement**
  As described in the previous section, the proximity of retirement and the financial significance of superannuation should ultimately result in increased levels of engagement (and be a central objective of the superannuation system).

  Whilst many of the MySuper proposals rely on a substantial and continued population of disengaged members, we argue that this is likely to be less applicable for members approaching retirement. After all, simply making the decision to retire in whatever form is a life changing event that naturally requires engagement with one's circumstances.

  The key risk is that members without sufficient access to advice will accept MySuper as an appropriate or recommended retirement vehicle and not seek to validate it against other alternatives. The extension of the MySuper proposals into a whole of life product would potentially exacerbate this.

- **Whole of life default**
  As Cooper notes, 'MySuper should be a whole of life product and include a single type of retirement income stream product, chosen by the trustee' – i.e., a one-size-fits-all model will apply in the event that members carry their disengagement through to retirement.

  However, Cooper goes on to suggest that, 'Because retirement needs vary considerably, there is no one-size fits-all retirement income product that the government should mandate.' Given this, one must ask whether it is reasonable to impose a default income solution on retirees – particularly where policy can go a long way to introduce appropriate incentives and mechanisms to reduce the extent to which lump sums are taken.

  As Cooper continues, 'There is a strong case for requiring MySuper products to provide proactive intra-fund advice periodically to this group of members.'

  MySuper therefore seems to be caught in the middle of being a vehicle for the disengaged and a low-cost whole of life product and advice solution.

  It's our belief that focusing on levels of engagement as a means for designing retirement savings products is a blunt and inappropriate tool. Whilst it is easier to institutionalize an approach that relies on disengagement, funds should concentrate on providing appropriate advice and increasing levels of engagement earlier within their membership.

  Whilst a lack of engagement for those with small account balances could potentially be overlooked, similar disengagement amongst members with the ability to fund a large portion of their retirement should be viewed as something to rectify. In the end, perhaps the Cooper review's vision of MySuper was never intended to simply extend existing default arrangements into retirement. However, as an industry, this is the conclusion that appears to have been made.

  Alternative approaches may be feasible within the MySuper framework and could be considered before racing to implement something that might be sub-optimal for both funds and their members. Some alternatives are explored in the Risk Management section that follows.

- **Risk management**
  Risk management is a critical issue that has the potential to undermine the entire framework of the MySuper proposals. As identified in previous Milliman reports[1], the development of a significant financial asset (superannuation) in and around retirement creates exposure to a variety of risks:

  — Market
  — Health
  — Inflation
  — Longevity
  — Behavioural

1 Milliman *Risk in Retirement* and *Preparing for change: Financial Planning for Retirees* research reports. Please refer to the link at www.milliman.com/retire.

FIGURE 3

FOCUS TO DATE HAS BEEN ON ASSETS, WITH LITTLE THOUGHT TO LIABILITIES

LONGEVITY	LIVING LONGER THAN EXPECTED
MARKET	POOR MARKET RETURNS IMPACTING ON RETIREMENT SAVINGS
INFLATION	HIGH INFLATION INCREASING THE COST OF RETIREMENT
BEHAVIOUR	POOR SPENDING OR INVESTMENT DECISIONS
HEALTH	POOR HEALTH LEADING TO INCREASED COSTS

Cooper suggests that 'trustees consider longevity issues more explicitly when developing investment strategies' and should have a 'duty to consider longevity risk and inflation risk in relation to members in retirement phase.'

Counterparty risk is another that needs to be explicitly considered given the long-term nature of retirement and has been brought to the fore due to high profile corporate failures experienced during the recent financial crisis.

The challenge here, as discussed in the research identified above, is that risk manifests itself differently at an individual level based on a variety of factors. At a minimum, the need to consider risk within default arrangements would necessarily give rise to the consideration of a number of default options to which members could be allocated based on a number of specific criteria such as account balance, age, etc. Consideration would need to be given to an individual's objectives, factoring in their total assets – including those outside of superannuation as well as any reliance on social security via the government age pension.

As you might guess from the points above, we find it difficult to see how default arrangements can survive in their current, simplistic form, into retirement or that assumed by the MySuper proposals without some significant changes. At a minimum, extending a default framework into and through retirement will need to consider:

— The ability to have multiple default funds, products, or strategies each with different risk management mechanisms for different member segments (see Figure 4)

— Access to detailed information regarding member finances and objectives together with their reliance on social security via the age pension in order to allocate them to an appropriate default

— The ability to provide regular information and advice approaching and throughout retirement

But isn't this simply a retail or advised model with the investment universe restricted to low-cost options? Given this, we believe that in the event of wholesale adoption of the existing Cooper recommendations, the most likely outcome will be that funds will install their existing allocated pension products as default retirement income products, potentially with a revised asset allocation model or combined with the ability to direct members towards other products via an intra-fund advice channel.

- **Government Response**
  The recent government response to the Cooper review is laudable in its adoption of most of Cooper's recommendations, in particular, its focus to reduce fees, improve governance and increase efficiency – which were at the heart of the Cooper review.

  As we have identified above, there are a number of areas identified for further consultation where care is needed. Extending MySuper beyond the core concepts outlined above could potentially result in an institutionalized model of apathy that results in sub-optimal outcomes for particular market segments, namely;

  — The acceptance that MySuper provides a single investment strategy for all members that do not make a choice, although the government has indicated they will consider tailored strategies such as lifecycle investment options.

FIGURE 4

Guaranteed Income Stream / Longevity Protection
Members with a need or desire for longevity protection / insurance

Variable, lifetime or deferred annuity, LTC, etc.
Lower cost
Improved liquidity
Greater control
Less counterparty risk

Protection Strategy
Part age pensioners or self supported

Revised investment strategy for those *at risk*

Allocated Pension
Full age pension members

Default position, with complete flexibility and control

Architecture:
A core strategy with the ability to allocate or select alternatives based on advice linked to personal preferences and circumstances

- The assumption that MySuper will be selected by members who do not wish to be actively involved in choosing their superannuation arrangements. As mentioned, there is a risk that members will assign a recommended status to MySuper, believing it has been developed in their best interests regardless of their particular circumstances.

- The focus on net returns and comparison, which will serve to incentivize a homogeneous industry with potential conflicts between peer performance and member interests.

The potential evolution of MySuper into a whole of life product, with the inclusion of income stream products and advice should be treated with high levels of caution. As raised elsewhere in this paper, the sheer complexity and individual nature of retirement – together with increasing innovation across income based solutions and strategies – means that we should strive for member engagement rather than attempt to extend default arrangements into a whole of life proposition.

INSTITUTIONALISING CURRENT APPROACHES

As discussed above, we believe that the current default approaches employed by many funds are exposed to a number of shortcomings when it comes to providing for their members' retirement income needs:

- No consideration of individual circumstances and behavioural biases

- Asset allocation models that do not adequately manage risk

- Focus on wealth rather than income stability

Innovation is underway to address these issues, with potential solutions covering dynamic investment strategies such as volatility and tail risk management as well as insurance product solutions. Interestingly, much of the developed world is faced with the same problem and it is here that Australian funds potentially have an opportunity to leverage international best practice.

Whilst we don't intend to discuss products in detail here, it is important to identify the challenges facing funds wishing to extend their suite of solutions as cradle to grave providers.

The potential complexity and sophistication of solutions means that funds will need to consider the extent to which they develop internal capabilities or partner with appropriate specialists in meeting their member's retirement needs.

Partnership models within a long-term income based product give rise to additional complications that will need to be considered such as:

- **Cost and complexity**
  Fees and complexity will always be at the front of the mind of fund trustees and will feature prominently in the assessment of any proposed solutions.

- **Distribution and advice**
  As the suite of strategies and options grows, funds will need to develop sufficient distribution and advice channels to ensure that members are provided with appropriate guidance.

- **Flexibility, control, and portability**
  Ultimately, funds will look to develop approaches that fit with their existing practices and will therefore need to be flexible. Whilst some funds may seek to outsource their retirement income solution to a third party, we believe that this will be limited to smaller funds that will ultimately consolidate or merge with others that have sufficient scale.

- **Counterparty exposure**
  Any involvement of third parties, particularly where the solution involves a guarantee and, consequently, counterparty exposure, will need to be structured and monitored carefully to ensure that the fund can adequately protect its members' interests and meet its duty of care requirements.

Funds will need to get into the retirement income frame of mind quickly if they want to remain competitive. The existing accumulation approach, a legacy of superannuation's relative immaturity and lump sum mindset, will rapidly shift as account balances become more significant and transition into post-retirement.

POLICY CHANGES WILL CONTINUE

The uncertainty presented by government tinkering with superannuation has made funds reluctant to develop post-retirement solutions for fear of potential changes that would make decisions and strategies redundant.

Whilst the government has ruled out mandating an income product or participating directly as an annuity provider, the importance of the retirement system combined with the impact of ageing demographics on the government's balance sheet means that retirement savings policy is a broader social issue, and is therefore unlikely to remain untouched.

Measures to encourage the provision of sustainable retirement incomes will continue to evolve as the government seeks to balance the inherent costs in providing services to this growing sector of the community – the deferral of pension ages and increases in the superannuation guarantee are just the start.

As we've observed, policy can go a long way to addressing the sustainability (or instability) of the retirement system, for example;

- Increasing the SG from 9% to 12%

- Removal of stamp duty for downsizers in New South Wales as an incentive to access home equity

- The reduction in caps with respect to voluntary superannuation contributions (this is an example of a negative policy setting)

It seems clear that over the coming years, the policy landscape will be fluid and industry will need to adapt. Inaction by industry creates the risk that the government will take responsibility sooner and act to develop broader policies. Early action will be incentivized as funds seek to differentiate themselves and create a loyal and growing base of members within a vital market segment.

BEYOND INCOME

Member needs in retirement go well beyond the provision of income. As funds discovered through the accumulation phase, the responsibility of managing the considerable savings of their members resulted in opportunities to provide access to other products, such as death, disability, and income insurance—with preferential rates often negotiated using the scale of the fund.

As fund members move through retirement, there will be further opportunities for funds to leverage their scale to provide a range of related products and services such as:

- **Advice**
  As discussed, advice in some form or other will be critical at key decision points throughout retirement as fund members seek guidance and experience changing circumstances.

  As the trusted retirement partner of many of their members, funds have developed considerable brand loyalty which has the potential to be leveraged into a long-term advice servicing model. The challenge is ultimately one of resources and access. With limited, but growing advisory resources, many funds are at a disadvantage relative to larger institutional competitors. Developing innovative advice models, distribution and communication strategies will be essential in reaching large numbers of members.

- **Insurance**
  Insurance needs will also change dramatically through retirement. In accumulation, funds focused on providing death, disability, and income protection to members with families and dependents that were designed to replace any loss of future earnings from life-changing events. With the onset of retirement, this is likely to change to focus on the provision of funeral cover, long-term care, and longevity insurance.

- **Complimentary / Ancillary Services**
  Retirement goes well beyond the need to simply access an income. As such, there will inevitably be opportunities for funds to provide their members with various services, relationships and/or financial benefits designed to improve their retirement lifestyle.

  The sheer scale of many funds means that the ability to negotiate on behalf of members can potential result in sizeable benefits or discounts for services ranging from travel agencies or airlines through to legal services, or access to nursing homes.

- **Social and community**
  Finally, there is significant international research that demonstrates a large proportion of fund members experience a relatively aimless and unfulfilling existence upon retirement. This can often be attributed to a lack of planning or loss of contact with friends and community.

  Industry funds are in the unique position of having memberships dominated by particular professions, giving them the opportunity to facilitate the establishment of retirement communities amongst members with similar interests. This could potentially be an outlet for social media in superannuation, and provide funds with the ability to collect insightful membership data.

WHO'S YOUR MEMBER NOW?

The wrinkle in much of this is that over time, funds will need to cater to the diminished mental and physical capabilities of an ageing membership. In one sense, the physical issues may be easier to deal with. Larger font sizes and buttons on Internet sites as well as a variety of communication outlets such as mail and telephones will be necessary.

Diminishing mental capabilities, however, present a more complex set of issues and can dramatically affect one's ability to make important financial decisions.

The question for many funds may be to determine the point (if any) at which are they expected to exert a duty of care in review of their members' decisions. A regular advisory process will help to alleviate this and potentially identify members who might need assistance. In some cases, this will inevitably lead to a third party such as a relative or someone with power of attorney taking over the affairs of the member. In these circumstances, funds will need to adapt to dealing with someone who is not the primary member and manage the risk of potential abuse of these types of relationships.

LOOK AHEAD: WHAT DOES IT MEAN TO BE A *CRADLE TO GRAVE* PROVIDER?

So what does the retirement minefield offer for funds? Although the challenges are great, there are many opportunities for funds to enhance their role and expand the range of services on offer. The key areas to consider are:

- **Advice is critical**
  The breadth of member needs and the focus on individual circumstances will necessitate a customised response to adequately deal with retirement issues and meet a fund's duty of care to its members. As many funds have discovered, this primarily manifests itself in an ability to provide financial advice.

  Looking through the ongoing fee debate between retail and non-profit sectors, the simple fact is that, at present, retail markets have substantial distribution capabilities. Funds will need to develop their own distribution approaches if they intend on competing in this space.

  This will inevitably lead to increased costs, which will need to be balanced against the long-term benefits of member retention.

  When considering the development of new products and strategies for retirement, advice is the lynchpin upon which funds will succeed or fail, since, without the ability to engage members, no amount of improved products or services will help.

- **A long-term plan**
  Fund strategies will need to be reconsidered and adapted as members move through retirement. As we're beginning to discover, it is often too late to put strategies in place after the event and a certain amount of vision and planning will be needed to ensure that funds remain ahead of the needs of their members.

Whilst many of the initiatives are now focusing on the provision of income in retirement, they are predominately focused on the immediate needs of the active Baby Boomers. Longer-term strategies will also need to consider needs for insurance and other products and services throughout the passive and frail years.

For funds willing to think outside the box, opportunities around the development of online retirement communities or the application of scale to secure pricing on related or ancillary services may also serve to strengthen the sense of loyalty among members.

As the toolkit of solutions and services grows, funds will need to revise their engagement and distribution models to remain current.

- **Replenishment—keep looking for new members**
  At the same time, funds will also need to ensure that they maintain focus on their day-to-day activities and continue to attract new members to balance a diminishing base of assets (retirees) and therefore maintain per member expense ratios. Increasing levels of engagement and demand for services by the post-retirement segment will result in increased servicing costs. A balance with growth in the low-cost accumulation membership will be necessary to maintain the economic benefits currently enjoyed within this sector.

  Funds that are unable to build a sustainable model will need to reconsider their ability to service members cost-effectively as they shift towards and into retirement.

- **Industry change**
  As we've seen over many years, the industry undergoes constant change. An increasing focus on and demand for retirement services will further serve to expedite this. In our opinion funds will inevitably find themselves:

  — Sitting on the sidelines

  — Looking for strategic partners or mergers

  — Building capabilities over time, in line with their scale

  This will be a function of appetite, vision, scale and resources. With small funds the most vulnerable, we anticipate consolidation to continue, which will provide medium and larger funds with the scale to tackle the challenge.

SUMMARY

As outlined within this paper, the challenges facing the industry in moving from an accumulation mindset to a lifetime service model are challenging. With changing member needs and an evolving policy landscape, participants will need to be flexible and able to respond to key member segments – with member goals at the heart of the model. (See Figure 5.)

This will require the revision of existing services as well as the development of new capabilities, including;

— The ability to anticipate increasing levels of member engagement

— Improve and extend advice capabilities

— A focus on income generation

— Embedding risk management within investment strategies and product solutions

— Provision of ancilliary benefits and services

— An ability to maintain existing scale benefits through improved use of technology and rejuvenation of an ageing membership base

As discussed, we believe that increasing levels of engagement as members transition into retirement will drive many of these changes. The ability of funds to develop and present strategies as specific to the circumstances and needs of their members will ultimately determine success or failure. As we're beginning to observe, the sheer scale of the opportunity (and consequences for not acting) will facilitate the evolution of the industry.

We look forward to continuing on the journey with you.

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FIGURE 5