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Dynamics of the Australian Superannuation System

The next 20 years to 2041

Deloitte Actuaries & Consultants

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Australia's total superannuation assets are projected to almost triple to over $9 trillion in 2041.

CONTENTS

EXECUTIVE SUMMARY

In this tenth edition of *Deloitte's Dynamics of the Australian Superannuation System – the next 20 years to 2041*, we model the components of the superannuation industry in Australia, project their growth, and comment on the market dynamics, demographic shifts, longevity and retirement incomes, and the possible asset allocation impact in respect of the Australian sharemarket.

Growth and more growth

Total superannuation assets have risen to $3.4 trillion as at 30 September 2021, and are projected to almost triple over the next 20 years. While the uncertainty of the COVID-19 pandemic has caused volatility in investment markets over the past couple of years, and with inflation and cash rates at all-time lows, the Australian superannuation industry has continued to grow. This growth has been driven by both contribution inflows exceeding benefit outflows, as well as robust investment returns. However, increased switching activity, particularly post the Hayne Royal Commission and following the introduction of the *Your Future, Your Super* reforms have resulted in some funds experiencing significant outflows.

Consolidation and industry rationalisation

We expect to see further consolidation in the superannuation system:

- **At a fund level** – with significant merger activity underway and likely to continue as the industry rationalises around improving member outcomes and best financial interests of members
- **At an account level** – account consolidation has been continuing at pace, driven by funds encouraging members to consolidate their superannuation arrangements, the Australian Taxation Office (ATO) working to proactively match Unclaimed Super Monies to active accounts as well as leveraging the MyGov portal to help individuals identify their multiple super accounts, and the account stapling measures under *Your Future, Your Super* which came into force from November 2021.

Retirement incomes

Each generation is building larger real superannuation balances than earlier generations, underpinned by longer periods of their working lives covered by the compulsory Superannuation Guarantee (SG) system and higher SG rates than in the past. The maturing of the superannuation system will greatly increase the importance of the retirement segment of the market. This increase in demand for retirement solutions has been clear for many years and there has been slow progress on developing a more robust framework in which to deliver better retirement outcomes. This has led to the concept of a Retirement Income Covenant to stand alongside the other covenants and legislation that govern the actions of Trustees.

Superannuation funds in Australia will have to develop a retirement income strategy suitable for differing groups of retirees at different life stages. This provides real opportunities as well as challenges for the industry to innovate and develop retirement products to enable retirees to manage the dual risks of longevity and investments, while still being simple and easy to understand. One of the hurdles facing funds is the lack of complete information they hold on individual members, in respect of their retirement objectives and broad financial position (including that of their partner), not just their superannuation holdings. Trustees will need to develop a plan to address the data gaps in order to construct better segmented cohorts of members.

Adequacy and longevity

It is common knowledge that the 'old age dependency' ratio in Australia is projected to 'worsen' over the next 20 years and on to 2050, that is, an increasing proportion of the population will be retired. Managing the issues of adequacy and longevity continue to be important for individuals and for Australia as a whole. The Retirement Income Review's report in November 2020 concluded that the objective for the system should be developed around the goal: '***to deliver adequate standards of living in retirement in an equitable, sustainable and cohesive way.***'

Accordingly, we consider the impact on retirement incomes as a proportion of final salary for individuals entering the workforce today. This reflects comparisons if their superannuation benefits are based on the current 10% SG rate, or an increased rate of 12% (being the ultimate maximum level per current legislation) and using different life expectancy ages. Our projections show that an increased contribution rate throughout an individual's working life and the length of time spent in retirement have a material impact on the final retirement income that an individual can expect to receive.

Immediate focus

In the next few years, superannuation funds will be focused on ongoing merger activity, increased contributions from the existing membership and implementing the Retirement Income Covenant. Implementing the covenant will transform the retirement income segment of the market, but this will not be quick. Trustees and product providers will need time to develop and adapt. Nevertheless, we can expect to see:

- Further incremental development of retirement products
- The integration of account-based and lifetime income stream products
- The development of much more sophisticated member segmentation analysis with enhanced data gathering
- The development of more sophisticated advisory services facilitated by technology
- Ongoing development of the legislative and regulatory framework.

The dynamics of the retirement income system will continue to shift over the coming decades.

We trust you will find this report useful and thought provoking and we look forward to discussing it with you as you consider the superannuation industry, your own needs and objectives, member outcomes, and the implications of our projections. We are available to present our findings and strategic perspective to executive teams and Boards.

If you would like to obtain more detailed information on the market projections set out in this report to inform your business planning, we would be happy to discuss how we can support you.

Methodology

The Dynamics of Super Report is based on the SPROUT Super Model which has been developed by the Deloitte Actuaries & Consultants team. It references a combination of data collected by the Australian Bureau of Statistics (ABS), the Australian Prudential Regulation Authority (APRA), the Association of Superannuation Funds of Australia (ASFA) and other public organisations and associations, together with research conducted by Deloitte.

The dynamic nature of the SPROUT Model, which calculates the future market for superannuation assets, in aggregate, and within segments, is based on projected inflows and outputs from the system and enables sensitivity tests to be done using different rates for important variables.

These variables include the Superannuation Guarantee contribution rate, levels of voluntary contributions, administration and investment costs, rates of exercise of fund choice by individuals, income stream take up rates, investment returns, inflation and salary growth, taxation on super, consolidation of superannuation accounts, estimated impacts of account stapling under ***Your Future, Your Super*** legislation, and the impact of COVID-19 on migration.

MARKET OVERVIEW

Projected total superannuation assets

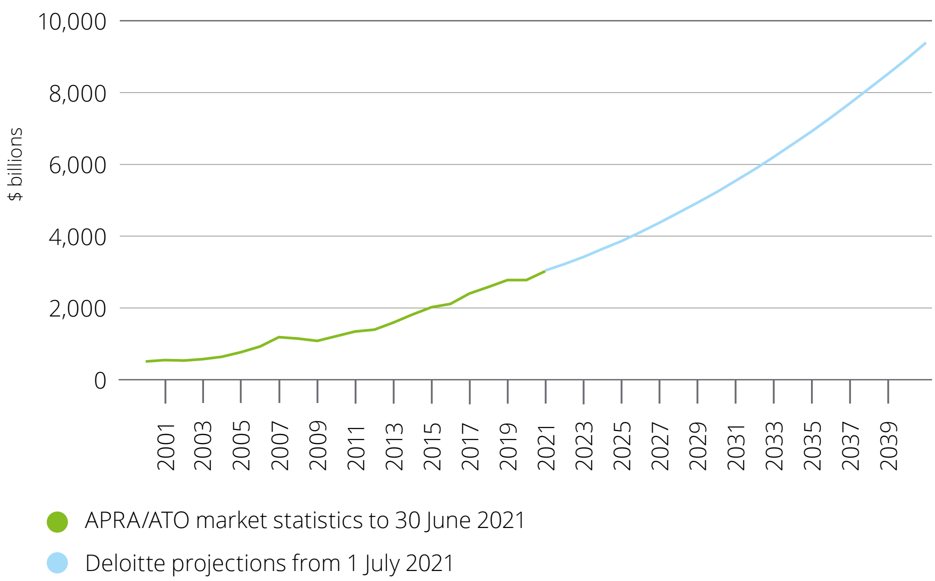
Despite the uncertainty of the COVID-19 pandemic causing volatility in investment markets over the past couple of years, and inflation and cash rates reaching all-time lows, the Australian superannuation industry has continued to grow. Total superannuation assets have risen from $2.6 trillion as at 30 June 2018, to $3.4 trillion as at 30 September 2021.

The base projections from the Deloitte super projections model show that total net superannuation assets in Australia will continue to increase to $9.2 trillion by 2041 (See Figure 1 *Projected superannuation assets*). These projections also reflect the legislated increases in the SG rate from 10% at July 2021 to 12% by July 2025, with increases of 0.5% at each 1 July in the intervening period.

Caveat: There is an important caveat to the projected 206% growth to $9.2 trillion in superannuation assets by 2041. The current low interest rate environment has continued to prevail for more than seven years, with cash rates reaching all-time historic lows. While the COVID-19 pandemic has had an impact in Australia and globally in constraining economic growth over the past couple of years, the low interest rate environment was already appearing to be the 'new normal' in most developed countries.

Despite this, super fund returns have continued to be strong, with robust real returns consistently earned over the medium term despite investment returns being volatile in the short-term. Although there were sudden declines in investment markets in the first half of 2020 as investors reacted to the pandemic, investment markets quickly regained most of those losses as it became clearer that economic impacts of the pandemic were not as bad as first feared.

Figure 1: Projected superannuation assets (All amounts are in future nominal dollars)



Source: APRA, ATO and Deloitte Actuaries & Consultants, 2021

Average balances at retirement are increasing, driven both by strong investment returns and by members having received superannuation contributions for increasing proportions of their working lives (noting that the SG was introduced from 1992, and non-compulsory Award arrangements applied prior to that). Post-retirement assets are also expected to grow as Baby Boomers continue to move into retirement closely followed by Generation X. As a result of this we expect continuing strong growth in post-retirement assets over the next 20 years despite retired members drawing down their accumulated superannuation savings over time.

However, given that there are no maximum constraints on the pace at which members can draw down their benefits in retirement, if retirees are forced to draw down greater than expected proportions of their retirement savings to meet their needs in a low return environment, then the projected asset growth would slow, and commensurately, the call on the government for the age pension would be greater.

The Retirement Income Review's report was released in November 2020. The report concluded that the objective for the system should be developed around the goal: '***to deliver adequate standards of living in retirement in an equitable, sustainable and cohesive way.***' One key element of this is the objective that the system should have effective incentives to smooth consumption and support people in taking personal responsibility for their retirement incomes.

In response to the Review, the Government has drafted legislation that will introduce a Retirement Income Covenant for superannuation trustees, to take effect from 1 July 2022. The draft legislation seeks to codify the obligation for superannuation trustees to have a retirement income strategy that outlines how they plan to assist their members in retirement. The strategy must consider how the trustee will assist their members to balance maximising their retirement income, managing risks, and having some flexible access to savings.

In our modelling for the ***Dynamics of Superannuation*** research, we have continued to assume that many individuals will reduce their rate of voluntary contributions as the SG rate increases. However, the modelling has not allowed for any other changes in member behaviour which may result from the SG increase.

Superannuation in the economy

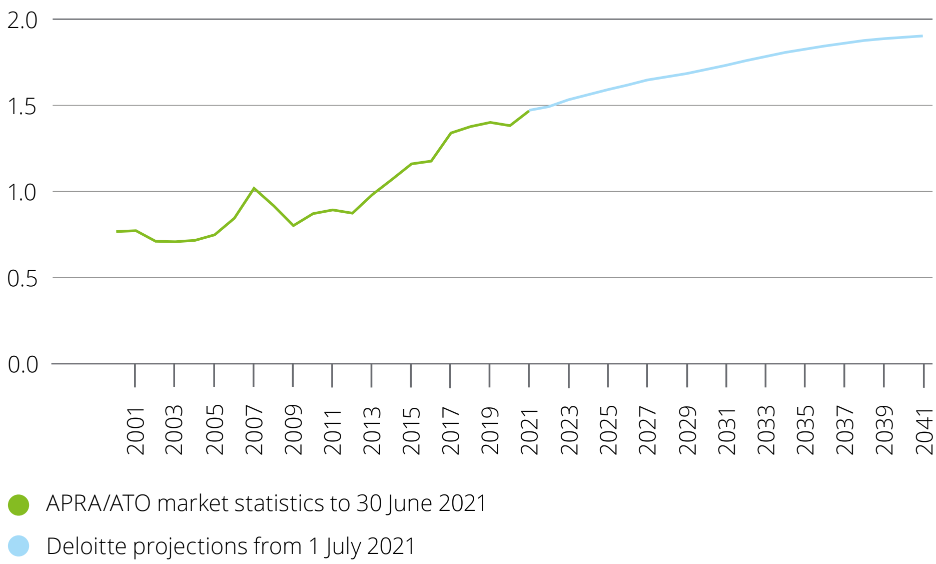
To better understand the superannuation industry in the context of the Australian economy, Figure 2 shows the relationship between total superannuation assets and Australia's Gross Domestic Product (GDP) over the last two decades, and as we project into the future.

The results demonstrate that:

- The superannuation asset pool has increased considerably over the past few years, despite the short-term hiccups resulting from uncertainties and disruptions caused by the COVID-19 pandemic
- The percentile relationship between total superannuation assets and GDP is sensitive to the fluctuations in actual investment returns for super assets year on year but, overall, there is a clear increasing trend over time
- There is a long-term trend of growth in superannuation assets relative to GDP, although the rate of growth has slowed in the past few years. This easing in trend is expected to continue over the coming years.

As well as growing in terms of total assets, superannuation funds are also growing their share of total financial system assets, aided by increases in the level of compulsory SG contributions and strong real returns in recent years, despite (or in spite of) economic uncertainties and historically low cash rates.

Figure 2: Superannuation assets as a proportion of nominal GDP at 30 June



Source: APRA, ATO and Deloitte Actuaries & Consultants, 2021

This means

The increased share of total assets has meant superannuation funds face higher expectations for their investment activities, which in turn has led to greater scrutiny of comparative returns and peer-relative performance metrics.

As a result, some funds have moved key parts of their investment management activities in-house and/or into passive rather than active investments, with a focus on those asset classes where they expect to be able to outperform the market. As larger funds have increased in size, they have also sought more sizeable investment transactions such as those through joint ventures and private equity consortiums.

Dynamics of the superannuation industry

Contributions

Many members continue to pay significant additional contributions into their superannuation in the years approaching retirement. Accordingly the level of contributions remains strong year-on-year. As a result we anticipate that sizeable voluntary contributions will continue into the future, although there may be some reduction in future voluntary contribution rates due to the contribution caps and to offset, at least partially, the increase in the compulsory SG contribution rate to 12%.

It is encouraging to see the SG rate increase to 10% from 1 July 2021. This increased rate of minimum contributions will support Australians to build up their super balances before retirement, in the wake of 3.5 million people utilising the COVID-19 Early Release of Super scheme to withdraw a total of $36.4 billion from their superannuation accounts.

Investment returns

Investment returns on superannuation assets remain a significant contributor to the growth of the superannuation industry. Over the past three years the general trend for net investment income to exceed total net superannuation contributions has continued, due to the investment markets remaining robust in an environment of historically low interest rates. However, markets have seen significant short-term volatility due to the effects of the COVID-19 pandemic across the world. Australian superannuation funds experienced reduced investment returns to June 2020 before investment markets recovered as governments and central banks provided significant fiscal and monetary stimulus to economies globally.

The strategic asset allocation adopted by each superannuation member, whether that is implemented through a MySuper default option, or an investment portfolio chosen by the member, continues to have the greatest impact on the member's final benefit; greater in fact than the selection of individual managers within each asset sector.

Consistent with consensus forecasts by economists in Australia, we expect lower nominal returns in future, due to the effects of the prevailing low-interest, low inflationary economic environment.

Ongoing regulatory change

Change is not foreign to the Australian superannuation system and there have been many refinements since the SG system started in 1992. Key legislative items which are shaping the industry include:

- *Your Future, Your Super* reforms, which aim to:
  - 'Staple' new members to a fund for life (or until they exercise Choice)
  - Place restrictions on trustee expenditure to ensure it is in the best financial interests of members and place the evidentiary burden of proof on trustees
  - Measure the investment performance of MySuper products against peers and show this on a new ATO comparison website (which commenced on 1 July 2021)
  - Measure the investment performance of default products initially and, from July 2022, most other products where trustees select and control the asset allocation.
- Retirement Income Covenant, which implements measures such that:
  - Trustees are no longer expected to provide a Comprehensive Income Product in Retirement (CIPR). However, they do need to consider longevity in their benefit design
  - Trustees must prepare a strategic document that identifies and recognises the retirement income needs of the members of the fund (including existing retirees) and presents a plan to build the fund's capacity and capability to service those needs
  - Trustees need to consider the different needs of different cohorts of members
  - Trustees need to consider when members might retire and what access to the Age Pension they might receive and what other financial assets they may hold.

Treasury is going to undertake a review of financial advice in 2022. Separately, the Australian Law Reform Commission is conducting a major review of the legal framework for financial services and will report back in 2023.

This means

Given the long-term nature of superannuation, which is preserved for retirement, it is important that members do not invest too conservatively in the early to middle years of their working lives, so they can maximise the impact of investment returns compounding over the long term, up to and into retirement.

Members should be able to withstand the short-term volatility inherent in growth-oriented portfolios and achieve a higher long-term average return overall. This factor is taken into account by trustees in setting their MySuper portfolios and should also be considered by members making an investment choice.

It is important that members do not over-react to short-term market falls, which may result in crystallising losses and possibly missing the upside of a subsequent recovery. This is particularly the case in the current economic environment where most cash investments return less than general inflation, resulting in a negative real return and loss of purchasing power if a member is invested in cash for an extended period.

Australian superannuation – financing members' retirements

We have modelled the value of superannuation assets held, split between the pre-retirement and post-retirement phases of the system. This is especially pertinent given the introduction of the Retirement Income Covenant and increasing concern over the demographic challenges presented by an ageing population.

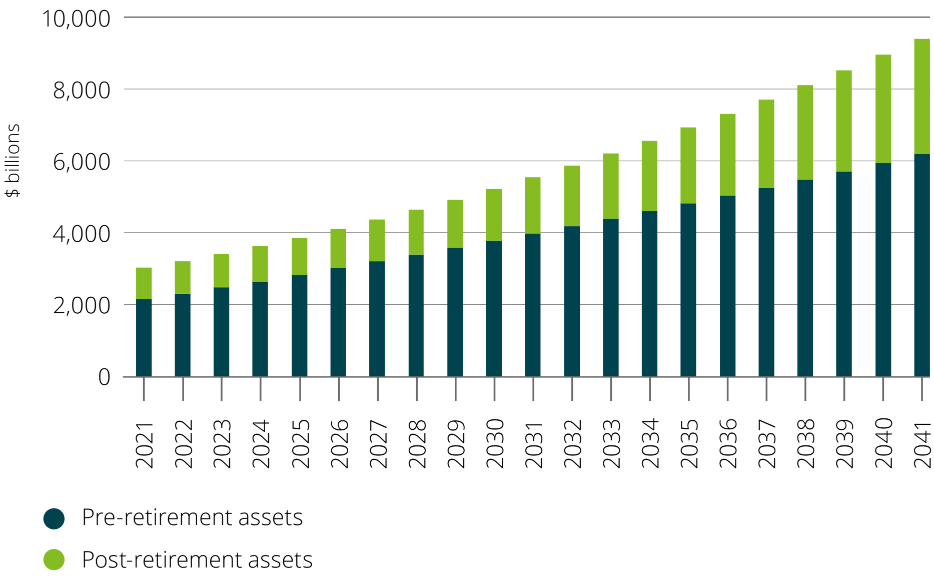
Figure 3 illustrates the projected assets in accumulation (pre-retirement) and pension (post-retirement) phase. Post-retirement assets include tax-exempt balances (that is, assets supporting retirement phase pensions) as well as concessionally taxed balances such as transition to retirement pensions and balances in excess of a member's Transfer Balance Cap.

Post-retirement pension assets – represent a significant and growing pool of assets in their own right. The tax-free status of investment earnings on assets backing pensions (up to relevant caps) continues to be a major factor encouraging this growth.

Recent growth in post-retirement assets has been further supported by the Government reducing the minimum annual payments for account-based pensions and market-linked pensions by 50% for the 2019–20, 2020–21 and 2021–22 financial years. This change aimed to assist retirees who did not wish to drawdown their balances whilst they were suffering the adverse effects of financial market losses during the COVID-19 pandemic.

Generational change – each subsequent generation is building larger real superannuation balances, underpinned by longer periods of their working lives covered by the compulsory SG system and higher SG rates than in the past. As final balances grow, increasingly higher proportions of members will take their benefits as an income stream by gradually drawing down their balance over time – although many will continue to face the risk of outliving their savings due to continuing improvements in mortality.

Figure 3: Projected superannuation assets (2021 to 2041)



Source: Deloitte Actuaries & Consultants, 2021

This means

Retiring members will need more guidance and/or advice to help them manage drawing down their retirement savings over time. They will need to manage the conflicting elements of not drawing down too quickly and risk outliving their savings due to increasing longevity, and at the same time not drawing down too slowly so a significant proportion of their superannuation remains when they do eventually pass away and so have lived more frugally than was necessary.

The Government's plans to introduce the Retirement Income Covenant is intended to improve member outcomes in retirement by encouraging trustees to focus on and implement strategies for members in retirement or approaching that stage. One of the difficulties facing funds is the lack of complete information they hold on their existing members, whether in accumulation or in pension phase. Trustees will need to develop a plan to address the data gaps in order to construct better segmented cohorts of members.

Looking to the near future: As Baby Boomers continue to move into retirement, closely followed by Generation X, there will be significant growth in post-retirement assets. However, it appears that there will also be sizeable leakage from the superannuation sector. We anticipate a considerable proportion of benefits will continue to be withdrawn as lump sums, either at retirement, or as ad-hoc withdrawals from account-based pension accounts, rather than using superannuation balances to provide a regular income stream over an individual's remaining lifetime.

Sequencing risk: The intentions, and ultimately, actions of members in choosing how they will take their superannuation benefits have major implications for asset allocation.

In post-retirement, members are generally less able to withstand the impact of negative returns and are more exposed to sequencing risk around the timing of withdrawing their benefit. Likewise, as pre-retirement members reach the final years of their working lives, they will also be less prepared to accept negative returns and will seek to reduce the risk of a sudden material drop in their savings as they enter retirement.

This means

We expect both post-retirement members, and members on the cusp of retirement, to place greater importance on capital and income protection than younger members with decades remaining to retirement.

On the other hand, these members must also balance the risk of underperformance if they move too quickly to a conservative investment allocation, given the period in retirement may extend more than 20 years beyond their retirement date.

The increase in the use of lifecycle types of asset allocations in MySuper offerings (that is, those more heavily weighted to growth assets at younger ages, and gradually becoming more conservative as the individual ages over time) is in response to this trend. Likewise, there is an increased application by super funds of lifecycle investment designs which continue through retirement, not just up to the point of retirement.

Product cohorts: There is no 'one size fits all' approach that applies to individuals of any generation. Individuals will generally be in one of the following groups when they retire:

- **Small balances:** Those with relatively small superannuation balances
  - These individuals will often deplete their superannuation quickly after retirement and will depend on the 'age pension' safety-net to support their income needs in retirement.
- **Moderate balances:** Those with reasonable levels of superannuation and other savings, but with total balances that will not be adequate to support them over the entire period of their remaining life
  - This group is likely to also receive additional support through the age pension
  - These individuals will likely spend all of their investment earnings each year, supplemented by drawing down their capital more quickly than would be appropriate if it was intended to make it last for the rest of their lives.
- **Significant balances:** Those with significant superannuation and other assets, who will have enough savings to support themselves independently throughout their retirement
  - A large part of their retirement income will be their investment income with potentially little or no need to use their capital each year
  - Unless they mismanage their money (such as wilful overspending or poor investment decisions), they will be self-sufficient and will not require any support from the age pension.

This means

The needs and behaviour of members in retirement varies considerably between different cohorts of members. Superannuation funds in Australia will have to develop a retirement income strategy suitable for differing groups of retirees at different life stages. Each of the above groups face very different investment and life challenges and will require different responses to assist them.

As part of meeting obligations related to member outcomes assessments, trustees must conduct relevant cohort analysis. Trustees are expected to consider similar analysis for the purpose of formulating a retirement income strategy as required under the proposed retirement income covenant legislation.

This provides real opportunities as well as challenges for the industry to innovate and develop retirement products to enable retirees to manage the dual risks of longevity and investments, while still being simple and easy to understand.

Where people retire before the age pension eligibility age, they may need to draw down their superannuation more quickly during this early part of their retirement until they become eligible for the age pension. In turn this means they will have a lower remaining superannuation balance at pension age and will be likely to be more heavily reliant on the age pension as they grow older.

It is therefore important to consider the interaction between the age pension eligibility age, and superannuation preservation age, to ensure that the overall outcomes of the Australian retirement system are not undermined.

This was a topic explored in the ***Retirement Income Review*** which noted that retirement is concentrated around the age people are eligible to apply for the age pension but increases steadily beginning around the preservation age. The Review also noted that increasing the superannuation preservation age or the age pension eligibility age would adversely affect a significant number of people who retire involuntarily before these ages which are more likely to be people with lower wealth.

COMPONENTS OF THE MARKET

Fund rationalisation has sped up in recent years and we have seen mergers involving several of the larger players in the market. This has resulted in the development of much larger funds and even mega-funds (with assets under management exceeding $100 billion) dominating the superannuation space. APRA, as the regulator, continues to encourage smaller funds to explore mergers with larger players, applying varying levels of pressure.

In addition, account consolidation has been continuing at pace. This process has been driven by a range of market and legislative forces, including:

- Funds and financial services providers are proactively encouraging members to consolidate their superannuation arrangements
- The ATO is actively working to provide information through the MyGov portal, for individuals to see if they have multiple super accounts, and it supports them to trigger a consolidation of those accounts into the account of their choice
- Changes to the reporting of Unclaimed Super Monies to the ATO including inactive low-balance accounts, small or insoluble lost member accounts and trustee voluntary payments, which the ATO is proactively matching to active superannuation accounts for the individual taxpayers where possible. This is being expanded to also cover all accounts held in Eligible Rollover Funds.

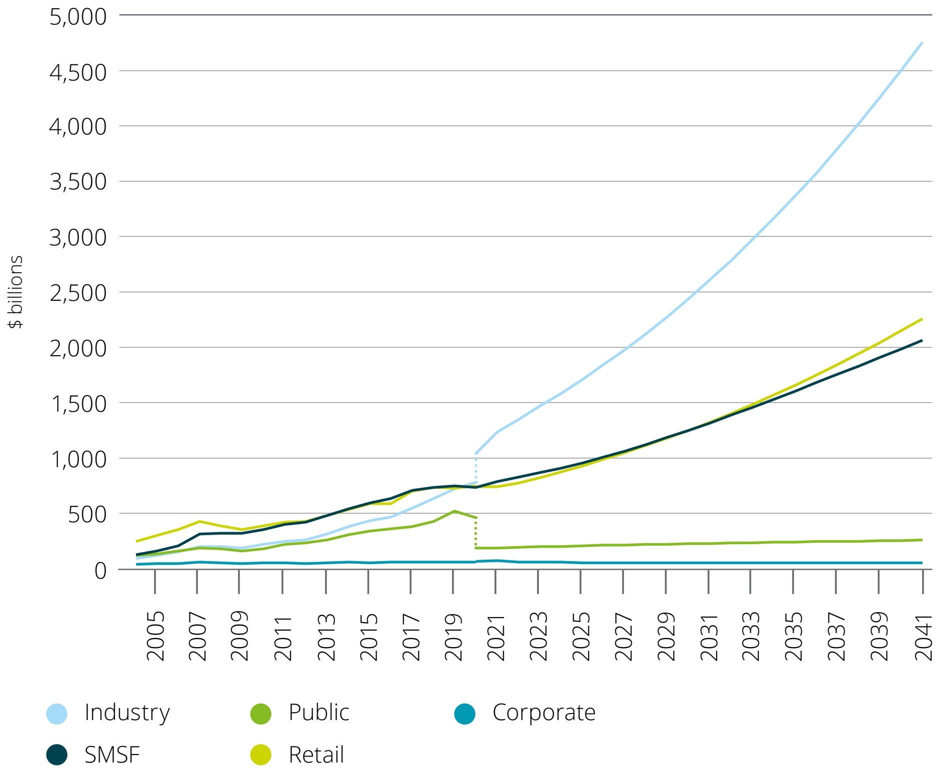
The 'stapling' measures under the ***Your Future, Your Super*** legislation will act as an additional driver in this area over the coming decade. Stapling came into effect in November 2021. Individuals who start a new job, but do not nominate a fund when starting with their new employer (including opting-in to join the employer's default fund or any other fund of their choice), will now have their contributions directed to their stapled fund as advised by the ATO. There are subtleties and complexities to this process, but this is the primary consequence.

Market share by major segments

Australia's compulsory superannuation system means that overall superannuation assets have continued to grow recently, both in respect of contribution inflows exceeding benefit outflows, as well as robust investment returns. However, increased switching activity, particularly post the Hayne Royal Commission and following the introduction of the *Your Future, Your Super* reforms have resulted in some funds experiencing significant outflows.

Figure 4 shows the movement of total assets in each segment from 2004 to 2021 compiled from APRA and ATO data and the Deloitte SPROUT Model's projected movement from 2021 to 2041.

Figure 4: Superannuation assets by market segment



Source: APRA, ATO and Deloitte Actuaries & Consultants, 2021

Figure 4 shows a disconnect in the lines for Industry funds and Public Sector funds, due to a reclassification of some large funds as Industry funds that were previously regarded as Public Sector funds. These funds, such as QSuper (which will be part of the Australian Retirement Trust from March 2022 following the completion of the merger with Sunsuper) and Aware Super (previously First State Super), are public offer funds open to anyone, not just public sector employees but also private sector employees, and therefore the breakdown between the public and private sectors has become increasingly blurred. In practice, these funds are operationally more like Industry funds irrespective of how they first came into being.

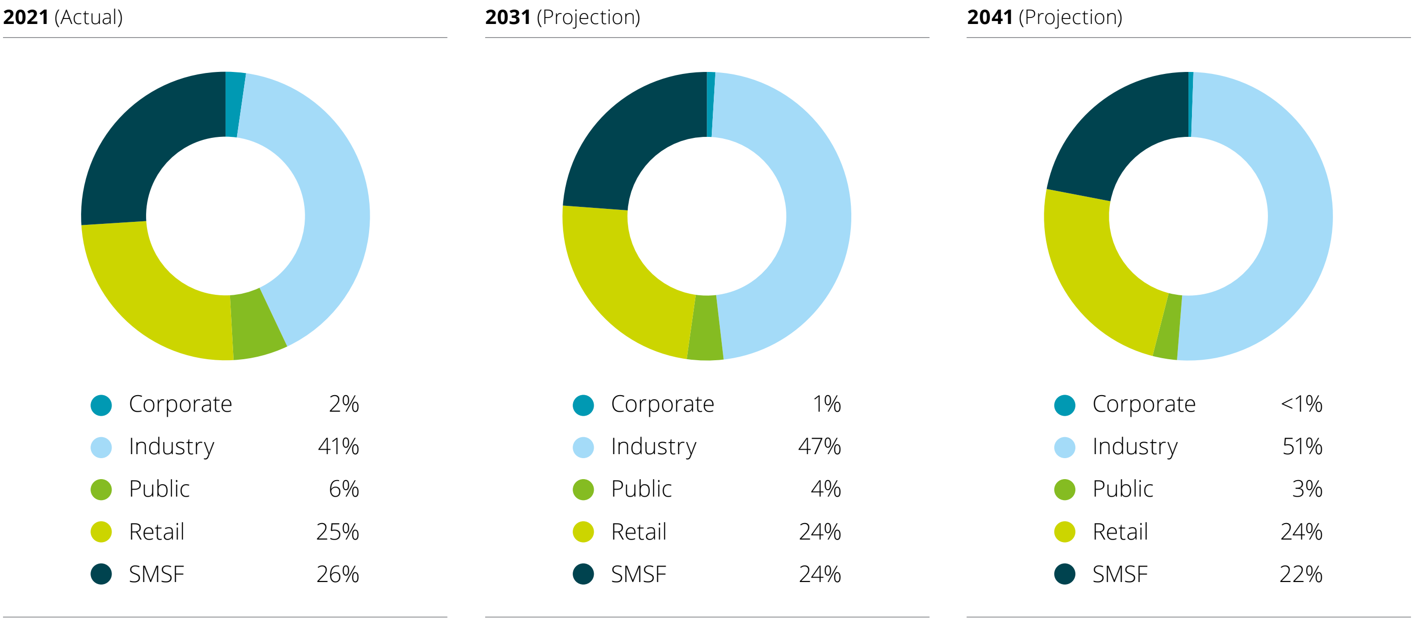
Some highlights from these projections include:

- **Growth:** Each of the dominant fund sectors (Industry, Retail and SMSFs) are expected to grow significantly over the next 20 years. Within this set, Industry funds are expected to grow at a rate above competitors due to strong current positioning and lower fees on average.
- **Industry funds:** Fund mergers are increasingly commonplace in the superannuation environment and are acting to shift the market structure. Mergers of funds with different backgrounds are increasing the market share of the Industry fund segment. Also, Industry funds are the market segment which is likely to benefit most from the recent stapling legislation.
- **Retail funds:** Following the Hayne Royal Commission, Retail funds have responded with changes which intend to uplift business operations. This has seen many product closures, remediation exercises, product simplification and investment in member services. Into the future we expect growth in the Retail segment by virtue of their existing scale, wealthier demographic base and ability to spend capital to develop new products which retain members up to and through retirement.
- **SMSFs:** SMSFs remain a preferred vehicle for investing the assets of wealthy Australians due to their tax benefits and provision of additional control. Despite these benefits remaining, we expect that SMSFs will decline in market share in the next two decades due to their older demographic transitioning to retirement and commencing material drawdowns of their assets.
- **Other funds:** We expect that the remaining Public Sector funds will continue to grow, albeit at a diminished pace over the coming years. We expect that the Corporate segment will continue to slowly decline, due to many not being public offer funds and therefore only available to a restricted group of people.

Assumptions:

These projections assume no changes in the current legislative environment applying to superannuation. We note that given the significant debate in the market and within government around the level of tax concessions and product structures for superannuation, and numerous reviews (Financial Services Inquiry, Productivity Commission Inquiry into Competitiveness and Efficiency of Australia's superannuation system, Hayne Royal Commission, and the Retirement Income Review), further change is possible. Nevertheless, as any future changes are still hypothetical and unpredictable, we have not taken any potential changes into account for the purposes of this report.

Figure 5: Proportion of Superannuation assets by market segment



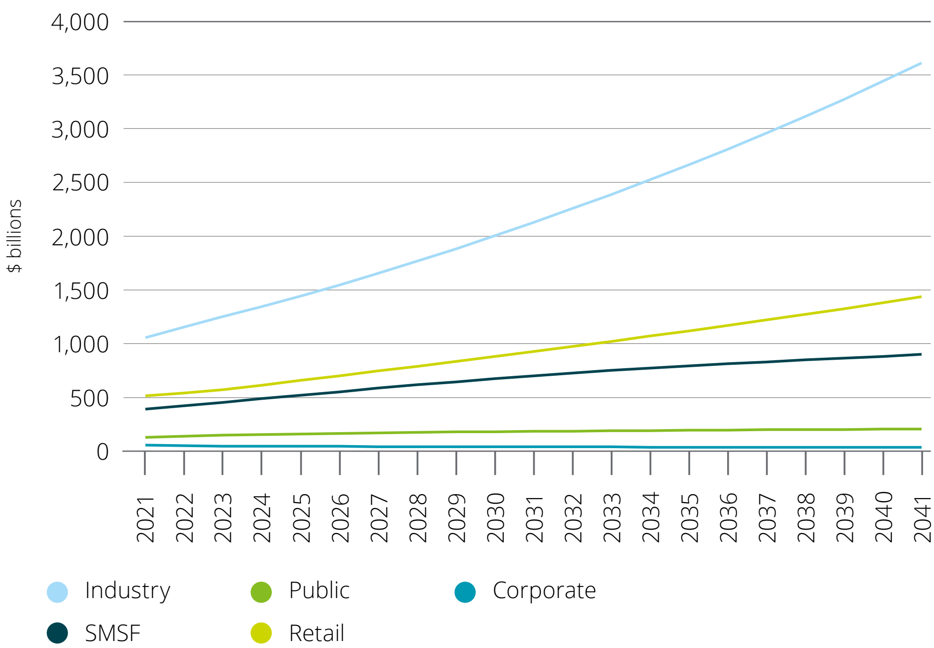
Source: Deloitte Actuaries & Consultants, 2021

Pre and post-retirement assets

Figure 6 shows that Industry funds are now the largest pre-retirement sector and this position will gradually strengthen into the future. We expect that the introduction of the stapling measure under the ***Your Future, Your Super*** package will favour Industry funds as most young people joining the workforce for the first time are likely to join an employer whose default super arrangement is an Industry fund under the Awards system.

Retail funds will also continue to grow, but their growth rates are not expected to be as strong, reflecting the gradual remediation of issues raised by the Hayne Royal Commission and progressively winning back the trust of consumers, whilst addressing impacts from APRA heatmap and underperformance reporting. SMSFs continue to remain popular, although their growth is expected to be less strong for pre-retirement assets than post-retirement assets.

Figure 6: Pre-retirement assets by market segment



Source: Deloitte Actuaries & Consultants, 2021

Figure 7 shows that, together with SMSFs, industry funds will become the dominant sector in the post-retirement space. Industry funds will benefit from the 'stapling' of superannuation accounts, and individuals being more likely to be industry fund members at the point of retirement and therefore continuing to remain in that fund post-retirement.

Many industry funds are also improving their investment propositions for members by allowing members to be able to directly invest in equities of large ASX-listed companies, ETFs and managed funds. This provides a viable alternative for members to setting up their own SMSF in order to take more control over the selection of investments in their fund, although there are generally limitations on how much of a member's accounts can be allocated to direct investments and a more restricted range of permitted direct investments.

The low fees and strong investment performance of industry funds, combined with strong inflows, will result in a growth rate of approximately 10% per annum for industry fund post-retirement assets, compared to 6.5% for retail funds and 5.5% for SMSFs.

Ongoing disruption in the financial advice industry due to the introduction of the Financial Adviser Standards and Ethics Authority (FASEA) requirements, and bans on conflicted remuneration, will likely result in most consumers remaining in the same fund type at retirement. However, it is still anticipated that wealthier consumers seeking advice as they approach retirement is likely to result in a number of these moving into SMSFs at that point.

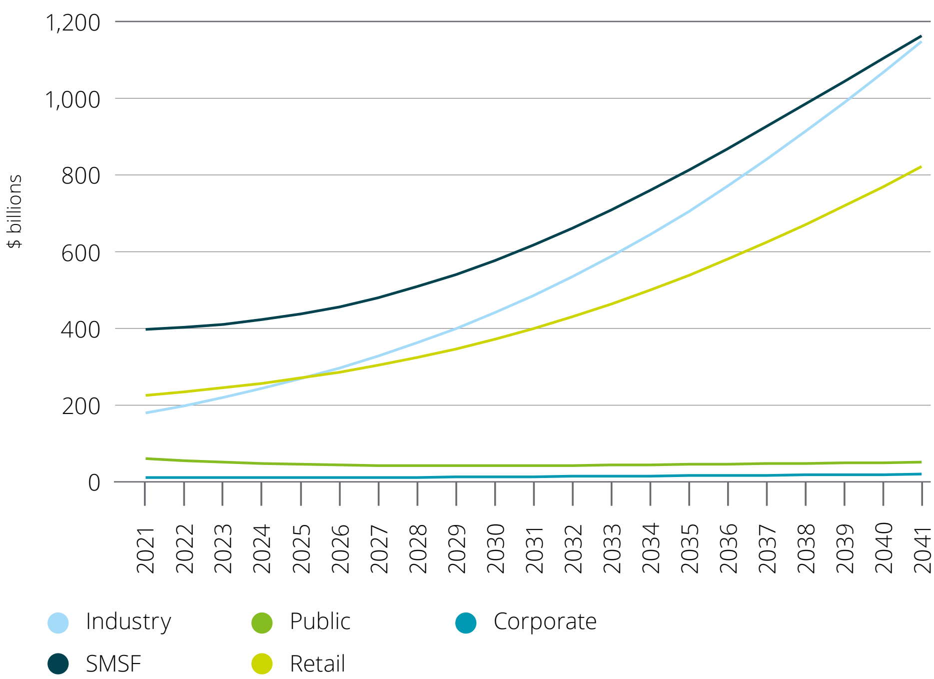
Other key points regarding post-retirement include:

The significant proportion of benefits which are taken as a lump sum has a dampening effect on the level of post-retirement assets. Apart from industry funds, growth in post-retirement assets will be relatively modest over the next 10 years due to the:

- Rate of drawdowns from post-retirement accounts (regular pension payments plus additional ad-hoc withdrawals) remaining a relatively high proportion of account balances each year
- No minimums on the proportions of retirement benefits to be converted into post-retirement income streams, and lack of widespread guidance and advice to members to assist them in making such a decision
- Progressive tightening of contributions limits restricting the rate of growth in superannuation balances up to the date of retirement.

Even for SMSFs, the growth in post-retirement assets is lower than previously forecast, as the level of benefit payments has been consistently higher than the level of contribution inflows into the SMSFs.

Figure 7: Post-retirement assets by market segment



Source: Deloitte Actuaries & Consultants, 2021

INVESTING SUPER ASSETS

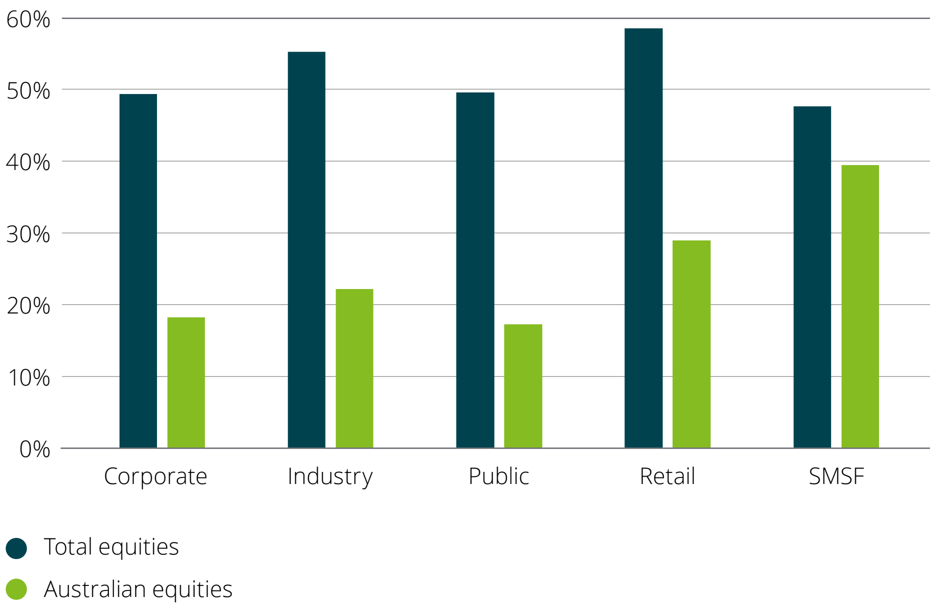
Across superannuation funds in Australia, about two-thirds of assets are invested in 'growth' type of assets – equities, property and growth alternative investments. The high allocation to growth assets recognises that the Australian superannuation system is predominantly comprised of account balances tied to investment returns earned on the underlying assets, both during accumulation phase and also throughout the pension drawdown period during the retirement phase and based on a long investment time horizon spanning many decades.

In particular, there is a high percentage of assets invested in equities, of which a significant proportion are domestic (Australian) equities. This is illustrated in Figure 8.

Australian equities remain attractive to superannuation funds for many reasons including:

- The dividend imputation system in Australia means that superannuation funds effectively receive refunds of excess franking credits on franked dividends, boosting overall investment returns
- Many Australians hold Australian shares directly as a result of past privatisations and demutualisations, and as a result they are comfortable and familiar with these investments and their growth potential
- The investment horizon for superannuation investments is long, spanning more than 40 years between starting work and retirement, and extending into the retirement phase
- Interest rates, which have reached historical lows, has meant that more conservative investments such as bonds and cash have struggled to achieve a return much more than keeping up with inflation, with cash failing to even achieve this most recently.

Figure 8: Allocation to equities



Source: Deloitte Actuaries & Consultants, 2021

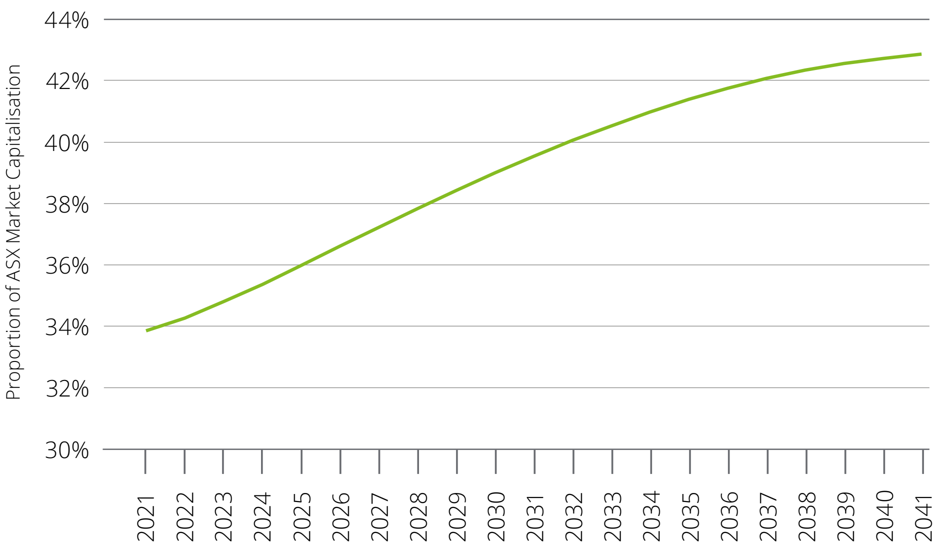
Currently the total investment by superannuation funds in Australian shares (including allocations within managed funds and Pooled Superannuation Trusts) comprises about 34% of the total market capitalisation of the Australian Stock Exchange (ASX).

If we assume that superannuation funds seek to retain the same percentage allocation to Australian shares, we have estimated that the proportion of the ASX market capitalisation represented by superannuation funds would steadily increase to more than 42% by 2041. This is illustrated in Figure 9.

This means

Superannuation funds would own a large and increasing proportion of the ASX holdings over time if they continue to hold a similar allocation of assets to Australian shares as they hold now. However, a key issue will be whether there will be enough capacity in the ASX to support this level of demand from superannuation funds, and any consequential impacts on assessment against APRA's super product heatmaps.

Figure 9: Proportion of ASX market capitalisation represented by superannuation funds



Source: Deloitte Actuaries & Consultants, 2021

- Will superannuation funds seek to increase their exposure to overseas investment markets over time to further diversify their exposures?
- Will funds utilise passive or active investments and/or investment managers to fulfill their allocations to equity markets?
- Will growth in the ASX maintain a similar pace to recent history? Will growth slow or speed up, and how would this affect the strategic asset allocations of super funds?
- Will superannuation funds seek representation on the boards of public companies in which they will hold significant investments?

We have also seen superannuation funds enter into joint ventures and consortiums to make large acquisitions and investments. For example, a consortium of super funds (plus several Australian and international investment and infrastructure funds) has made a bid this year to acquire Sydney Airport, which has been unanimously supported by the board and is now subject to shareholder and regulator approval. This will be one of the largest corporate takeovers in Australian history if it proceeds.

LONGEVITY AND RETIREMENT INCOMES

In its green paper on 'Options for an Improved and Integrated System of Retirement' published in 2019, the Actuaries Institute noted that the proportion of retirees who are expected to receive the Age Pension as income support will reduce over time, through a combination of higher accumulated superannuation balances, increases in the age pension eligibility age, and tightened means testing rules.

According to the ABS, the government age pension remains the main source of income for most retirees, but more people are retiring with superannuation as a source of income (although the increase was higher for men than for women). Over a third of retired women, but only about 7% of retired men, relied on their partner's income to meet their living costs in retirement.

Over the past 20 years, the proportion of older Australians in receipt of a full age pension has been falling, while the proportion receiving a partial age pension has remained fairly stable. This means that the proportion not receiving any age pension has been increasing.

These trends will continue. In the 2021 Intergenerational Report, Treasury estimated that, over the next 20 years, those who don't qualify for an Age Pension (the so-called self-funded retirees) will increase from 25% to 40% of retirees, whereas those on a full Age Pension fall from 45% to 25% of retirees.

A key driver of this will be that the accumulated superannuation savings are becoming more substantial for individuals at retirement. However, a continuing uncertainty is whether those retirement savings will be sufficient to meet an individual's needs for their full (unknown) period of their retirement – or whether they will need to fall back on the age pension in the later years of retirement, due to a combination of living longer and/or drawing down their monies too quickly (given the lack of maximum drawdown restrictions).

Because individuals do not know how long they will live, they face longevity risk in the sense that they may outlive their superannuation savings. On the other hand, the alternative is that they are too conservative in drawing down their account balance, so experiencing a lower income in retirement than necessary and ultimately leaving money unspent when they pass away.

Preservation age and Age Pension eligibility

By 2024 there will be a seven-year gap between the preservation age (which will then be age 60 for everyone in practice – noting that all those born earlier than July 1964 who do have an earlier preservation age will also be aged at least 60 by then) and the Age Pension eligibility age (which will have increased to age 67 for everyone by July 2023).

> **This means**
>
> Access to superannuation from an earlier date than the Age Pension eligibility age recognises that superannuation is a form of deferred earnings for individuals. Therefore, it is important that those who need to retire early are able to access it to support themselves, as an alternative to accessing other government income support, and to lessen the burden on taxpayers (at least in the short term).
>
> The Retirement Income Review noted that increasing the superannuation preservation age or the age pension eligibility age would adversely affect a significant number of people who retire involuntarily before these ages which are more likely to be people with lower wealth.

While members of superannuation funds may not be dependent on the age pension when they initially retire (that is, they will effectively be self-funded retirees at that point), as their superannuation balances reduce over time, many retirees will become eligible for a partial age pension in the later stages of their retirement, and possibly eventually receive the full age pension in time if they are lucky to live long enough (or unlucky to run out of superannuation savings).

Managing longevity

The Retirement Income Review's report concluded that the objective for the system should be developed around the goal: '*to deliver adequate standards of living in retirement in an equitable, sustainable and cohesive way*.' One key element of this is the objective that the system should have effective incentives to smooth consumption and support people in taking personal responsibility for their retirement incomes.

As mentioned earlier, the Government has drafted its Retirement Income Covenant legislation that will require superannuation trustees to develop a retirement income strategy that outlines how they plan to assist their members in retirement. It also considers how the trustee will assist their members to balance maximising their retirement income, managing risks and having some flexible access to savings.

In the 2018/19 Budget, the Government announced three measures designed to help older Australians with their finances:

- New means testing rules for innovative retirement income streams purchased from 1 July 2019
- Increasing and extending the Pension Work Bonus
- Expanding the Pension Loans Scheme.

In July 2017, regulations took effect that enabled the development of new innovative lifetime retirement income stream products, including pooled lifetime retirement products. There are several key elements that must be met for a retirement product to be considered an innovative income stream:

- Similar to an ordinary account-based income stream, the fund is not able to start paying benefits until the individual has met a nil cashing restriction condition of release. However, the difference with these products is that the start date for benefit payments is often deferred until a later event, usually age-related. This is built into the terms and conditions of the product
- Once payments start, they must be made at least annually and be payable for the individual's remaining lifetime (and any primary or reversionary beneficiaries), and there can be no unreasonable deferral of payments from the income stream
- Restrictions on the amount that can be commuted to a lump sum or for rollover purposes, which apply after the income stream is in the retirement phase. The restrictions are based on a declining capital access schedule.

New means testing rules have applied for innovative retirement income streams purchased from 1 July 2019. The new rules assess a fixed 60% of all pooled lifetime product payments as income, and 60% of the purchase price of the product as assets until age 84, or a minimum of five years, and then 30% for the rest of the person’s life. These rules make innovative income streams attractive to consumers in terms of increasing their total retirement income whilst protecting against longevity risks, particularly for people who are eligible for a part age pension or are just over the threshold for being eligible for a part pension.

Longevity illustrations

To illustrate the impact of a retiree living to different ages, we have considered a 25 year old entering the workforce with no superannuation savings, based on different contribution levels throughout their working life (the current SG rate of 10%, or a higher rate of 12% aligned to the maximum legislated SG rate).

We have modelled the amount that this individual could withdraw from their superannuation balance as a percentage of final pre-tax salary, such that the member receives the same benefit in real terms throughout their remaining life, assuming that they die at four ages specified in Figure 10. It is not the exact amount of replacement percentages which is important, but rather the relativity between the percentages based on different individual life expectancies, or different contribution rates.

Note: The income replacement percentages depend on the assumptions applied for investment returns and expenses, and are based on simplified assumptions in relation to no time out of the workforce and smooth salary increases.

It is worth noting that the average life expectancy for a 25 year old today, assuming they live to a retirement age of 65, is over age 85 and varies depending on gender and the extent of continuing future mortality improvements – with a quarter of them living beyond age 90 and potentially well into their late 90s.

This means

It is evident from Figure 10 that higher contributions throughout working life makes a meaningful difference – in the order of 7.5% to 10% of final salary – to the eventual retirement income of individuals, particularly those who are going to live longer than average. As women tend to live longer than men, this also means that women would tend to have a lower replacement rate than men if they were otherwise equal in all other areas (that is, same age, period in the workforce, salary pattern, and accumulated superannuation balance at retirement date).

Figure 10

	Annual Income Drawn as % of Final Salary	
Assumed Age at Death	**10% Contributions**	**12% Contributions**
85	49%	59%
90	43%	52%
95	39%	47.5%
105	37%	44.5%

To consider the likelihood of individuals needing to finance long periods spent in retirement, we have calculated the life expectancy for the average 25 year old today based on the latest Australian Life Tables 2015-2017, both before and after allowing for assumed mortality improvements (as published by the Australian Government Actuary).

This means

Even ignoring any future improvements in mortality, it is more likely than not that individuals entering the workforce today will live beyond age 85. A quarter of them will live beyond age 90. Once future mortality improvements are taken into account, individuals are expected to live beyond age 90 on average, with a quarter living into their late 90s and beyond.

Figure 11

	Males	Females
Half of 25 year olds today who live to age 65 will live beyond age…		
ALT15-17, no improvements	85	88.5
ALT15-17, improvements over long term (125 years)	89	92
ALT15-17, recent improvements (25 years)	92.5	93.5
A quarter of 25 year olds today who live to age 65 will live beyond age…		
ALT15-17, no improvements	91	93.5
ALT15-17, improvements over long term (125 years)	94	96.5
ALT15-17, recent improvements (25 years)	97	97.5

CONCLUSION

In this edition of the *Dynamics of the Australian Superannuation System* we have considered what the industry should expect in the next 20 years regarding:

- The **size** of the superannuation assets
- Changes in **market share** of different sectors
- Shifting **demographics and longevity** in an ageing population
- The **dominance** of superannuation assets relative to GDP and in domestic asset allocations (such as the Australian sharemarket).

Despite the uncertainty of the COVID-19 pandemic causing volatility in investment markets over the past couple of years, and inflation and cash rates reaching all-time lows, the Australian superannuation industry has continued to grow. Total superannuation assets have risen to $3.4 trillion as at 30 September 2021, and are projected to increase to $9.2 trillion by 2041.

The superannuation industry continues to experience a frenetic pace of change. The ***Your Future, Your Super*** initiatives and increased trustee focus on members' Best Financial Interests will continue to encourage rationalisation within the industry. Many funds have been conducting transformation projects over the past few years in efforts to improve their efficiencies and value to members, as they reduce the range of legacy products they need to manage.

There has been significant merger activity between funds in recent years, and we predict that we will see continued consolidation of funds, particularly over the next 5 to 10 years. We expect that funds which fail to reach scale or underperform relative to their peers will struggle to survive unless they can transform their businesses quickly. The member outcomes assessment and product heatmaps have given APRA expanded powers in relation to underperforming funds, which has already resulted in some additional industry consolidation.

We expect the superannuation industry will continue to rationalise and we will end up with a modest number of very large funds. These funds will increase their foreign investments due to their size and the relative size of global opportunities compared to the small Australian market. They will also increase investment in privately-held assets.

In addition, we will see an increasing shift from employer-driven superannuation to being focused at the individual level. Initiatives such as account 'stapling' and proactive consolidation of small accounts by the ATO will boost further consolidation of accounts which will reduce the drag of unnecessary fees associated with multiple accounts for one person as well as make it easier for people to keep track of their superannuation.

The Retirement Income Review's report, released in November 2020, concluded that the objective for the system should be developed around a goal comprising four key elements of adequacy, equity, sustainability and cohesion.

The planned Retirement Income Covenant for superannuation trustees, to take effect from 1 July 2022, will codify the obligation for trustees to have a retirement income strategy that outlines how they plan to assist their members in retirement. The strategy must consider how the trustee will assist their members to balance maximising their retirement income, managing risks, and having some flexible access to savings. Funds will be required to develop or offer suitable products, provide information and assistance on managing drawdown patterns, and provide tools to allow members to manage their affairs.

Implementing the covenant will transform the retirement income segment of the superannuation industry but will take time to develop and adapt. One of the difficulties facing funds is the lack of complete information they hold on their members, and therefore trustees will need to develop a plan to address those data gaps in order to construct better segmented cohorts of members.

Further upcoming changes include Treasury's planned review of financial advice in 2022, and the Australian Law Reform Commission is conducting a major review of the legal framework for financial services and will report back in 2023.

Deloitte's team of superannuation partners and specialists look forward to discussing these changes and working with you to consider ways to develop innovative and sustainable retirement products and solutions.

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