

***Retirement system
development and
implications for financial
market participants***

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Outline

- Robust features of the existing system
- The life-cycle model
- Saving
- Investing
- Spending

Robust Features of the System

- High participation rate
- Accounts are individually owned, not pooled
- Accounts are fully funded, not notional
- No mandated investments, some restrictions
- No mandated providers, licensing
- Restrictions on leverage and preservation
- Limited regulatory regime uncertainty

The Life-cycle Model

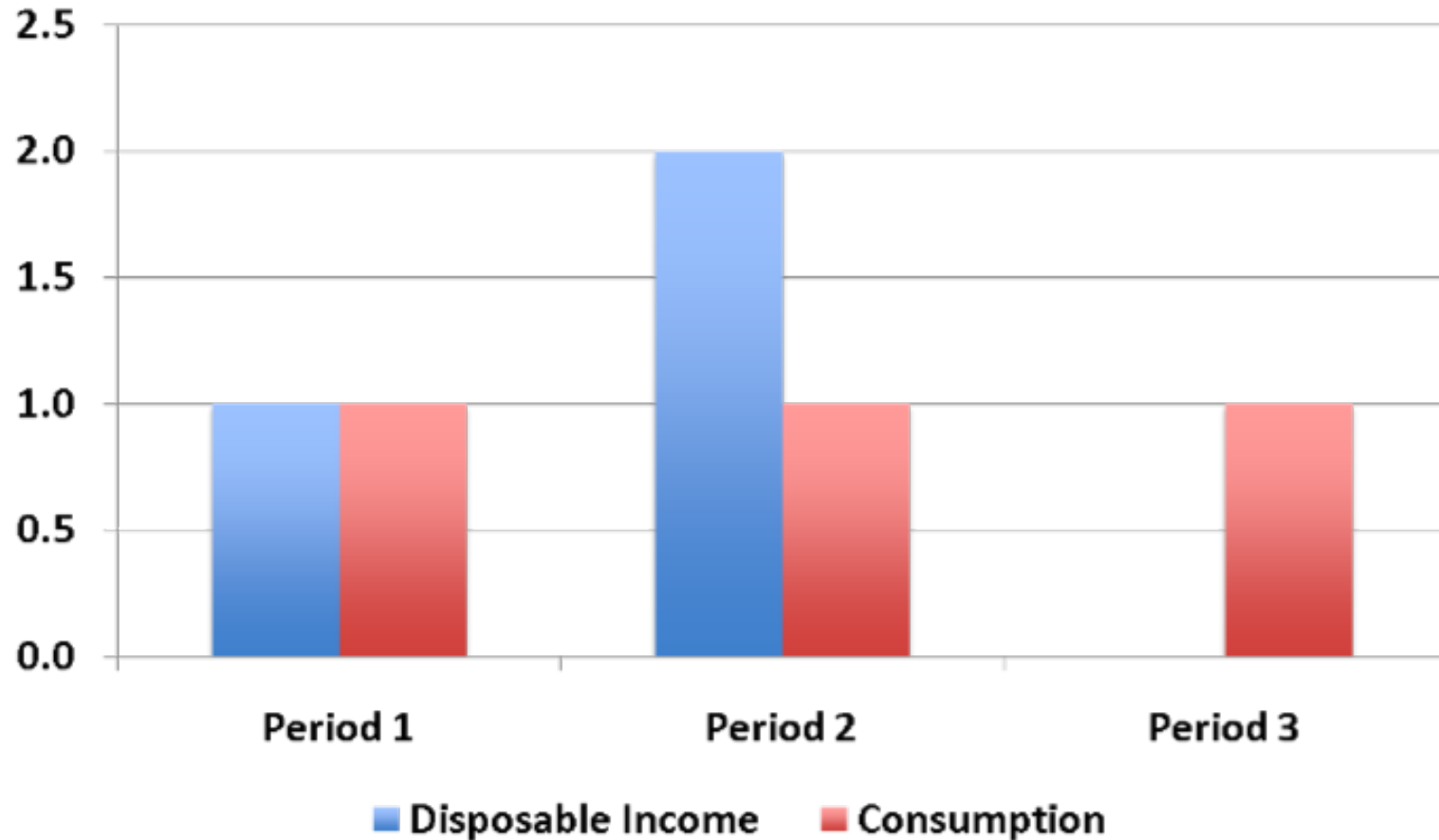
The life-cycle model

- Three key features:
 - The notion of a lifetime budget constraint determined by lifetime wages, savings and tax transfers
 - The use of financial assets to transfer consumption across time
 - The use of contingent claims to transfer consumption from one scenario (state) to another

A lifetime budget constraint

- Affordable retirement incomes will be determined by average lifetime wages not final wages
- Both high and low wage earners will have similar savings rates in the absence of tax transfers and bequests
- Assets peak a few years before retirement and people run down their assets towards the end of their lives

Illustration of Life-cycle Principles



The Role of Financial Assets

- Borrowing for current consumption involves bringing resources from the future to the present
- Saving and investing involves deferring current consumption to increase future consumption
- The rate of interest is the penalty to bringing consumption forward or the reward for deferring consumption

The Role of Contingent Claims

- Risky investments have outcomes that pay-off more in some future states than others.
- Combining risky investments and bonds can be used to create contingent claims that shift resources across states at a future point in time.
 - **Example 1:** income replacement and accident insurance moves resources from scenarios of good health to scenarios of poor health
 - **Example 2:** A life annuity moves resources from participants with shorter than expected retirement to those with longer than expected

Illustration of Contingent Claims

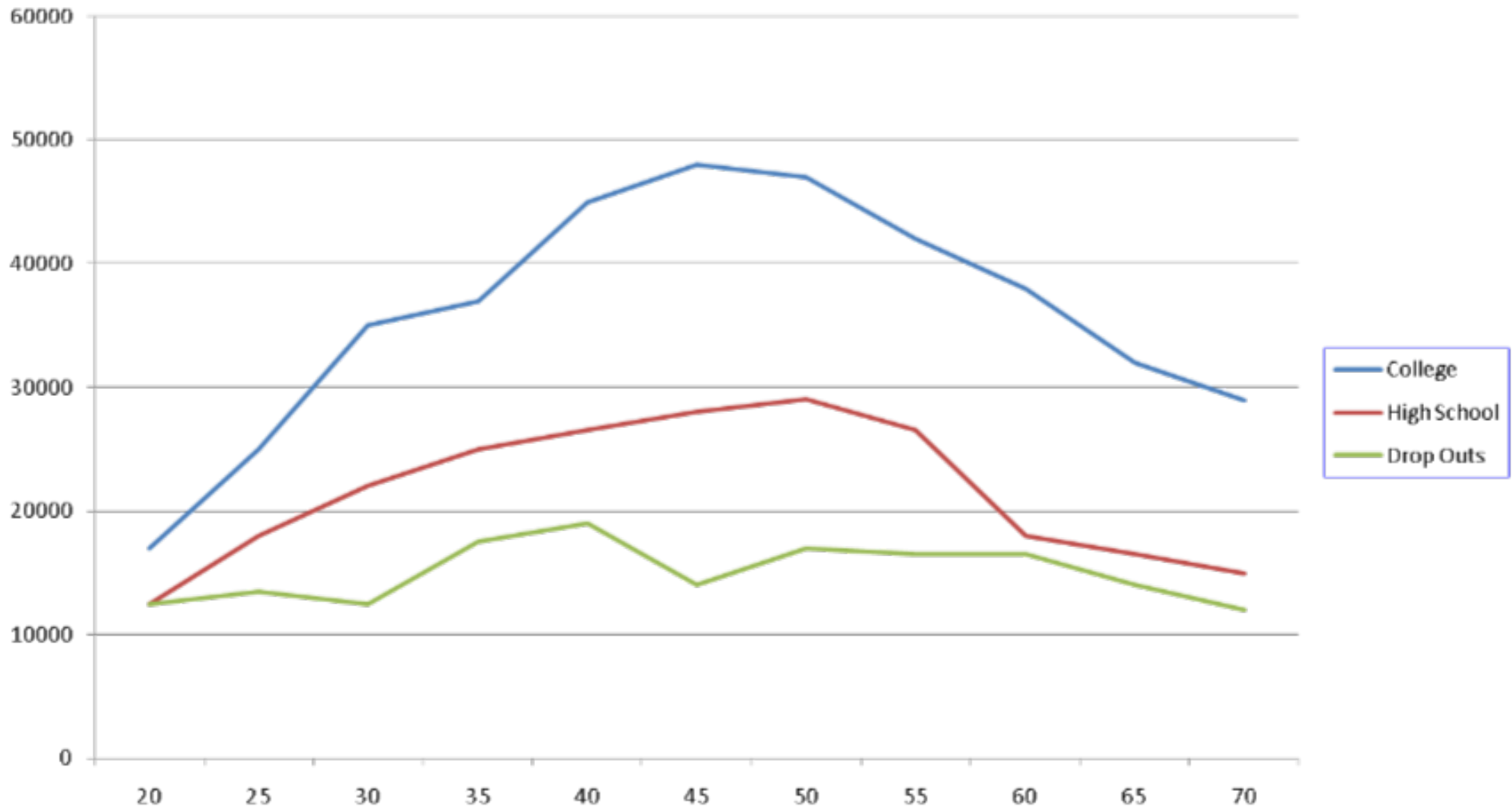
- Period 1 (youth) income is 1 unit
- Period 2 (prime) expected income is 2 units, 2.5 if health is good and 1.5 if health is poor
 - Health insurance costs 0.5 and pays +1 if health is poor and zero if health is good. Borrowing to buy insurance has zero cash flow in period 1 and +0.5 (poor health) and -0.5 (good health) in period 2.
- Net income with health insurance is 2 units in both good and poor health

Savings and Contribution Strategies

Income and Savings Strategies

- Average lifetime real wage patterns are hump-shaped, peaking around 10 years before retirement
- The costs of home ownership and family expenditures also tend to be hump-shaped, peaking earlier than above
- Income available for consumption or retirement saving is lower during first half of working life than the second half.

U.S. Median Disposable Income, 1990



Source: David Andolfatto, Christopher Ferrall, and Paul Gomme, "Human Capital Theory and Life-Cycle Pattern of Learning and Earning, Income and Wealth, May 2000.

Implications for Participants

- **Government**

- Level of mandated SG rate
- Contribution caps
- Tax rules

- **Funds**

- A default contribution strategy for members
- Research of member profiles: education and services

- **Financial advisers**

- Individualized lifetime income, saving and insurance advice

Investment Implications

Investment Implications

- The life-cycle model implies an “all assets” perspective – includes human capital, own home, Age Pension and non-super assets
- Investment strategy is designed to preserve and grow wealth, move resources across time, help manage risk and limit uncertainty
- Consumption can only occur after investment tax and cost considerations

Implications for Participants

- Government
 - MySuper
 - SIS rules and role of regulators
- Funds
 - Investment strategies for members (across the life-cycle)
 - Scale, implementation efficiency and risk-return trade-offs
- Financial advisers
 - Customised family wealth management advice

Retirement and Spending Strategies

Retirement and Spending Strategies

- The age of retirement, the option to defer retirement and transition to retirement strategies are key decision variables
- The investment and spending implications of longevity risk
- Understanding phases in retirement and the nature of costs in each phase

Implications for Participants

- **Government**
 - Age Pension and aged care policy settings
 - Preservation and distribution rules
 - Facilitating longevity solutions
- **Funds**
 - Member research: education and advice around transition to retirement and longevity risks
 - Product innovation: longevity solutions and inter-generational risk pooling
- **Financial advisers**
 - Individualised advice and support in retirement (e.g., prepare for cognitive decline in SMSF members)

Conclusions

- **Government – coercive powers**
 - There is a risk of doing too much and a risk of not doing enough
- **Funds – mass market solutions**
 - Requires member and financial market research to support product and service innovation
- **Financial advisers – customised solutions**
 - Requires a knowledge of life-cycle factors to provide whole-of-life financial advice and support