The Alliance for a Fairer Retirement System

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cc. The Hon. Michael Sukkar MP, Senator the Hon. Jane Hume, Senator the Hon. Anne Ruston

Dear Treasurer

The impact of COVID-19 on retired investors

The Alliance for a Fairer Retirement System (the Alliance) was formed to advocate for the principles of adequacy, sustainability, certainty and fairness in retirement policy. It exists to represent senior Australians, shareholders and self-funded retirees planning a sustainable retirement and, as such, is keen to explore options to fix problems with the existing superannuation, taxation, Age Pension means testing and broader retirement income systems.

The Alliance is writing to you on the eve of the release of the report of the Retirement Income Review to raise important issues facing retirees impacted by the COVID-19 pandemic. We believe the impact on retirees who derive some or all their income from savings and investments, has received little attention in the media. Much of the public commentary has been on why older Australians should bear the burden of the cost of the economic recovery. However, there has been little understanding on how the COVID Financial Crisis (CFC) has undermined retirees' capacity to do so.

With around 3.8 million Australians aged 66 and over, it is important to understand the enormous contribution this section of society has on the economy. Retiree spending, and willingness to spend, will have critical impacts on the economy in any post-stimulus recovery phase. However, under the current market conditions there is a risk older Australians will further withdraw from the economy, slowing the recovery. Retirees are unlikely to have the confidence to spend if they continue to face significant impacts on their income.

The attached paper outlines some of the structural issues facing our retirement income system. It suggests both short and long-term reform options.

We welcome any opportunity to discuss these ideas with you should the opportunity arise.

The Alliance for a Fairer Retirement System

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COVID-19 and Investors:
Short and long-term impacts on retirees and the economy

Introduction

The COVID-19 pandemic is a significant crisis affecting the health and wealth of all Australians.

The federal, state and territory governments rightly responded to the potential high levels of the deadly contagion by seriously limiting social contact, testing widely to find more potential spreaders of the virus and building the medical capacity to treat those who become infected.

In comparison with other countries, the Australian response in terms of identified cases and the number of deaths is remarkably low. However, the limits on social contact have seriously damaged the economy.

The worst affected sectors have been hospitality, tourism, retail and airlines. Many of those businesses are now idle and without capital injections are in danger of bankruptcy. Unemployment is expected to reach 10% by the end of June and the economy predicted to contract by more than 6% over the June quarter. This downturn is the most severe since The Great Depression. In the absence of a vaccine, when and how the economy returns to normal is uncertain.

This economic contraction has had a flow-on effect.

Many businesses are finding the reduced economic activity is affecting their viability. Their costs remain largely unchanged, but their revenue is reduced. This means many corporations have slashed or stopped paying dividends in their attempt to preserve capital in the face of an uncertain future. Banks have experienced reduced revenue while also making provision for bad debt as more and more households and businesses struggle to pay their loans.

Many businesses are having trouble paying rent. That means commercial landlords find their cash flow compromised. This is a problem for the retail sector of the property market particularly, as non-essential shopping virtually ceased during the height of the lockdown.

Similarly, workers who find themselves unexpectedly unemployed, are also having difficulty paying their rent, which means residential landlords also have their cashflow compromised.

While government has acted quickly with stimulus measures to stem job losses and inject money into the economy to maintain consumption, the distribution of this support is uneven. Some sections of the economy and community are surviving with support while others are heavily impacted and have received little or none.

Pensioners and Commonwealth Seniors Health Card will receive two stimulus payments of $750, but those retirees with investments exposed to the economic downturn are experiencing significant pressure on their incomes, their savings, and their investments more broadly.

There are 3.8 million Australians[1] over the pension eligibility age (66+) and more than 4 million who have retired. All have had their savings and income impacted by the crisis. This part of the population plays a powerful role in the economy and retirees' spending behaviour will play a crucial role in the nation's economic recovery in both the short and long-term.

Most worrying is the impact of the crisis on retirees' expenditure patterns. This is something that should concern all Australians. The Governor of the Reserve Bank recently recognised the important role spending will play in the recovery of the economy in the coming months. The spending of these 4 million seniors will be crucial to Australia's future.

The 'silver economy', as it is known, is a hugely significant sector of the economy and with-it rests Australia's ongoing prosperity. There are whole industries built around it. For example, the many businesses set up to service grey nomads. These play an especially important role not just in cities but also in regional, rural and remote economies. These businesses are likely to experience significant downturns as retirees' capital declines and income evaporates.

This will not just affect the economy in the short-term but also the long-term as confidence declines.

Australia has one of the best retirement income systems in the world, but it is not immune to the impact of the current crisis. Weaknesses have been exposed, which are in desperate need of redress. These stem from the clumsy way in which personal savings interact with the Age Pension and other safety nets.

Rather than having a relatively simple retirement income system, Australia has created a complicated one of punishment and reward. There is at its heart, a punitive means testing regime with rules and regulations which make the administration and receipt of income support both difficult and costly. While this has been done to reduce the overall expense of providing support to Australians in retirement, and in recognition that private citizens should be encouraged to be self-reliant, it unfortunately leads to perverse outcomes.

These are exacerbated in times of financial crisis. This has been seen with the COVID-19 pandemic, and the GFC in 2008/09. The system is not able to easily account for rapid changes in investment outcomes and this results in incomes that are either sub-par at best, or at worse, catastrophic.

For retired investors with insufficient or low cash reserves it means they must liquidate investments at the worst time possible, or they suffer through a period of little or no income, further contributing to the contraction of the wider economy both in the short and long-term.

Because the system isn't flexible or responsive to these perturbations, it requires government to manually amend and adjust. It has done this with the halving of the superannuation drawdown requirement, both in the GFC and again now. However, there are structural limits to what can be adjusted. This is because the system is inflexible.

There is a need for government to redesign and simplify the retirement income system to make it more responsive.

[1] ABS 2020. *3101.0 - Australian Demographic Statistics, Sep 2019* Cat No. 6238.0
https://www.abs.gov.au/ausstats/abs@.nsf/mf/6238.0

This paper outlines the impacts of COVID-19 on the economic fortunes of retirees, highlighting the systemic failures of the retirement system and offers some options that could go some way to remedy these defects.

The risks of saving for retirement

At the heart of the problem is a system that shifts risk from government to the individual. Without adequate safety nets, this shifting of risk poses significant threats to the operation of the entire retirement system and knock-on effects for the whole economy.

Unlike government, which has at its disposal the means to alter its revenue capacity through the alteration of taxation settings and the use of debt, retirees with investments rely solely on the vagaries of the market. They rely instead on prudent investment strategies to generate future income from savings. And unless they have set aside sufficient cash to ride out an economic crash, which could last years, they are in trouble.

Government too, has to share a slice of the blame for why far too many retirees are not carrying enough cash for a crisis. As interest rates have reduced to stimulate the economy the Government has set deeming rates higher than returns available on cash deposits, pushing people away from this option. The current upper deeming rate is around double what you can get from bank interest. The current high deeming rate setting encourages retirees to invest in more riskier investments, which in turn discourages cash deposits. The franking credit policy has also encouraged retirees to go for bank shares rather than cash in the bank.

Despite the existence of the Age Pension as a safety net for all, retirees with investments do not have a risk-free lifestyle, almost the opposite.

As was found in the Per Capita report *The Adequacy of the Age Pension in Australia,* many retirees believe the Age Pension does not provide an adequate level of income to support retirement.

It is little wonder then retirees strive to accumulate savings to ensure they have more to live on than what is offered by the pension. Many also seek to accumulate enough savings to avoid the complications of any dealings with the welfare system altogether.

Recent research by Challenger indicates the primary motivation for accumulating savings is not to preserve capital to provide bequests but to ensure adequate ongoing income to fund health and wellbeing in retirement, including aged care[2].

To do this the retiree must manage a multitude of risks:

Longevity risk
Australians are living longer. Longevity risk refers to the risk that our retirement savings will not last as long as we do. Managing one's personal retirement funds over a lifetime has many pitfalls, even with expert help. Nobody knows how long the money must last.

[2] Challenger 2017 *Seniors more savvy about retirement income.* October 2017

Life expectancy at retirement is an average. Half of all retirees will live longer than average and a growing number are becoming centenarians. Planning to live to a certain age is risky and planning to live to the life expectancy for someone their age, will not work for half of retirees. For retirees the task is to make sure their money will last to an uncertain date of death, while also dealing with life's vicissitudes.

These include:

- **Unexpected health issues**. Demands for additional health services increase with age because the risk of unexpected health issues increases with age. The risk of dementia increases with age. Public health provision (Medicare) underwrites health care for all but its quality is inconsistent and wait lists are often long, especially for elective procedures. A knee replacement in some states requires a wait not in months but years. Retirees can manage this risk with private health insurance. However, it is very expensive, not least because of the increasing gap payments and growing list of exemptions.

- **Loss of capacity.** The need for additional care and assistance due to illness and/or disability (especially dementia) increases with age. Government support is available to retirees identified in need, but demand for care packages outstrips supply and many retirees need to fund the shortfall from their own resources. At present there are more than 104,000 people on the home care wait list. Admission to residential care requires a substantial financial commitment. Home care also comes with substantial costs.

Inflation Risk
Inflation risk refers to the way the purchasing power of an asset declines due to the effects of inflation. Even low rates of inflation can seriously erode the financial well-being of retirees. It's an ongoing concern for anyone living on a fixed income.

Retirees can manage this risk by investing more in growth assets so that the asset value grows at least as fast as inflation. However, this exposes retirees to increased risk. According to Dr Doug Turek, declining interest rates have eroded the income available from assets, meaning you have to hold substantially more savings to achieve the same level of income[3].

If a couple bought an annuity of $1 million in 2019 it would have purchased an income stream of $44,250 for life, indexed to inflation. The interest rate in October 2019 was 1.5%. If they had bought an annuity in 2011 with the same $1 million it would have generated an income stream of $54,300. Today, in response to the COVID-19 pandemic, the interest rate is 0.25% and so that annuity is now less than the Aged Pension.

Market Risk
The market price of assets is affected by political and economic events beyond anyone's control. Retirees who sell assets into a market to generate their income, need to manage the volatility of market prices.

[3] Doug Tarek "The rising cost of retirement" The Australian 10 October 2019

Because shares are the easiest to sell, their inherent liquidity makes the stock market the most volatile market. Even setting aside the present situation, and the 2008/09 GFC, price falls of more than 20% are not uncommon. Such losses can seriously reduce retirement savings. But shares have substantially outperformed other investments over time, and thus are often recommended for retirees' long-term investments as part of a balanced investment strategy.

Retirees can manage market risk by holding a diversified portfolio because the prices of different asset classes usually do not move in the same direction at the same time. A diversified portfolio reduces the risk of volatility at the cost of lower returns.

Many retirees manage market risk by reducing or eliminating their exposure to growth assets altogether. Investments in bonds or term deposits eliminate volatility over the term of the investment but provide the lowest return on savings. By controlling market risk in this way, the effect of such a portfolio is to increase inflation risk and longevity risk.

Legislative Risk
All retirees are exposed to legislative changes which may alter the types and rates of taxes as well as changes to entitlement to benefits such pension or the health cards. All citizens are exposed to adverse legislative changes, but retirees are generally not in position to return to work to rebuild their nest eggs if unexpected legislative changes seriously affect their projected retirement income.

Retirees cannot manage legislative risk except through advocacy. This is not always successful. Governments can help manage legislative risk by ensuring long lead-in times for changes to take effect and/or quarantining (grandfathering) existing recipients from proposed changes.

COVID-19 has exposed savers to the risk of retirement

The key risks faced by retirees with investments have been outlined above.

The COVID-19 pandemic has demonstrated this exposure graphically. As most retirees depend on their investments for some or all of their income, the fall in economic activity is having a dramatic impact, both short and long-term.

There are a number of factors contributing to this situation:

- **Low interest rates / term deposit rates / bond rates**. Prior to the GFC it was possible to get a term deposit paying 8% or more. Today, it is difficult to do better than 1%. That is almost a 90% reduction in the income many retirees depend on as they try to avoid the volatility of the share market. Government bond yields are similarly low with the current rate of return less than 1%. Meanwhile the current upper deeming rate is 2.25%. This is more than twice the 1.1% the Commonwealth Bank is offering. The record low interest rates have made term deposits unattractive. JPMorgan estimates interest payments will fall by $8 billion until the end of June 2020[4].

[4] Shane Wright 2020. 'Universal pension for all: Retirees call for tax and income reform' in *Sydney Morning Herald* 25 May 2020

- **Rental income from residential and commercial property**. Some states have established a fund to assist tenants pay rent. But there is nothing for the landlords who have paid off their mortgage. The issues involved are complex, but the expectation of many governments is property owners will bear the brunt of losses. This will affect the attractiveness of those investments and therefore reduce their future sale price. All analysts are predicting COVID will cause a drop, if not crash in the property market, with the Commonwealth Bank warning of a worst-case scenario of a 32% decline from the March 2020 peak[5]. Analysis by JPMorgan suggests property income will slump by $59 billion in the 12 months to the end of June 2020[6].

- **Dividend Income from Australian shares.** On the advice of the Australian Prudential Regulation Authority, major banks have suspended or cut dividend payments in response to the pandemic induced economic downturn. JPMorgan estimates dividend income will drop by $68 billion in the 12 months until the end of June. This disproportionately affects retirees. Retirees who rely on bank dividends for their income will be hit hard by these measures, some are reporting their incomes have halved.

  Retirees find themselves in the same position as workers and businesses in this period of Covid-19; their present income has fallen, and their future income is uncertain. Based on past experiences of financial crises, this could extend for years.

Research shows retirees were wary of another GFC many years after the main impacts had receded[7].

Retirees who are heavily invested in the economy, at the encouragement of government, are the only group not being supported through this crisis. The assumption appears to be these retirees are wealthy and can afford to take a loss.

But it should be noted the median SMSF has only $693,000. In other words, 50% of all SMSFs are smaller than this. There are hundreds of thousands of Australians who don’t qualify for a pension but are not rich enough to weather the impact of this economic crisis.

There is a clear expectation that retirees should spend their capital before they call on government support. But if retirees liquidate assets when market prices are deeply depressed in order to survive, their capital will disappear quickly. If there is little or no market for assets, such as a residential property in a country town where tenants may have not been able to pay rent, retiree/landlords face an even bigger problem. They may end up with no income, costs to bear but still too asset rich for any help.

It is in this context the government’s decision to halve the mandatory withdrawal limits from superannuation should be seen. It may help those who would otherwise be forced to sell assets at depressed prices, but it is only of benefit to the ones who can afford to live on half their normal superannuation income.

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[5] Michael Janda 2020. ‘CBA warns Australia risks 32 per cent house price crash in a 'prolonged downturn', flags $1.5 billion coronavirus-hit to bank’ in *ABC News*, 13 May 2020

[6] JP Morgan 2020. Australia: Income shocks are hard to hide. Economic research note 21 May 2020

[7] National Seniors and Challenger. (2018). *Once bitten twice shy: GFC concerns linger for Australian seniors*. Brisbane: National Seniors.

For most retired investors, reduction of capital is permanent. This is because they are not able to return to work to rebuild their wealth. After assets have been sold, any increase in their value will be of no benefit.

A permanent loss of capital for retirees has several consequences:

1. The pandemic is of uncertain duration, but the economic impacts are expected to last at least two to three years, according to the experts. Retirees who have depleted assets as a result of this will have less to spend in their remaining years. This will have serious implications for consumer spending and overall consumer confidence.

2. More retirees will become eligible for the pension at increased cost to government.

3. It will affect the ability of retirees to pay for their aged care. Self-funded retirees who are completely independent of government support pay substantial amounts for their age care. As their capital declines, so will their capacity to make private contributions to the cost.

A system in crisis

The age pension is an annuity, paid for life and indexed to inflation. At present it pays a couple who own their own home, around $37,000 per year. According to Dr. Doug Turek the purchase price of such an annuity in the private market in October 2019 was more than $800,000. At today's much lower interest rate, the cost would be proportionally much higher.

If they purchased an annuity today for $1 million from a private provider their income would not even match a pensioner couple's income. Indeed, if this couple had saved only $394,500, they could receive the full pension as well as the income from their investments. In terms of income needed to cover current liabilities, they would be better off.

One might question why anyone would bother if that is the reward. Others argue they are punished for their self-reliance.

The taper rate on the assets test is $3 per fortnight for every $1,000 over the limit, or 7.8% per annum. In other words, if the couple can **reduce their assets** by $100,000 they would **increase the pension** by $7,800. This is considerably more than that $100,000 can earn if it was invested in any other way. As the family home is a non-assessable asset, reducing assets to become eligible to qualify or increase their age pension is not difficult through upsizing or home renovations.

The Age Pension has perverse incentives for retirees to impoverish themselves to qualify for this entitlement. It is perhaps not surprising that many try to arrange their affairs accordingly and even are advised to find the "sweet spot" by some accountants and financial advisors.

In many countries, workers retire with an indexed pension paid by their former employer or the taxpayer that is a set proportion of their final salary, paid for life, often with a residual paid to the surviving spouse. They can then plan their retirement with certainty.

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Reform options

There are a range of reform options open to the government, many of which could not only reduce the impact and future risk for retirees but also assist in the broader economic recovery.

Temporary assistance could avert serious and long-term consequences and provide stimulus to the economy through spending on consumable items. For retirees with investments, it could serve as a bridge to the other side, until their investments return to normal and they can then continue being independent of government support.

In the face of dramatic losses to capital and income, retirees will be less likely to have the confidence to contribute to economic recovery through the purchase of goods and services. Feedback about older Australians intentions with regards to the $750 stimulus payments, indicates this money will be largely spent to help stimulate the economy. This is in direct contrast to some public commentary claiming retirees will not do this.

But without support, retirees spending looks set to drop dramatically, blunting the economic recovery for years. The latest report by Challenger says almost 2/3 of retirees are anxious, with 27% cutting back on spending on food and 37% cutting back on clothing. Perhaps the most worrying statistic is almost half don't feel confident about their financial security over the next five years[8].

There are however some systemic options for reform which could rebalance the system, reduce risk and stimulate the economy. Fixing structural problems with the tax and transfer system could reduce risk, nullifying the growing negative sentiments among retired investors while also providing the government with opportunities to make the system fairer overall.

Here are several potential reforms that could be considered in both the short and long-term.

1. **Provide an automatic revaluation of assets to account for falls in the market**.

   Normally, Centrelink automatically re-values market-linked managed investments, shares and securities twice a year to account for any changes in assets and income. This happens on 20 March and 20 September. When Centrelink conducts a review, it bases its revaluation on information it receives at different times of the month, depending on the investment. Market-linked managed investment unit prices are collected at the end of month. Listed shares are collected fortnightly.

   The automatic review that took place on the 20 March would have used market linked managed investment unit prices at the end of February. This was at the peak of the stock boom! It means the calculation of a retiree's current pension would not reflect the present market reality. As for listed shares, if Centrelink receives these figures fortnightly the difference is likely to be less significant, although still not accurate given the large falls in the market during March.

[8] Challenger 2020. *Older Australians concerned about impact of Covid-19 on their financial security* Media Release 2 June 2020

We appreciate the announcement that the federal government will revalue all payments recipients assets in June but this will not fix the ongoing problem.

Rather than expect individuals to request a manual revaluation, government could automatically revalue on a more regular basis or when markets fall significantly. This would have the benefit of reducing the administrative burden on Centrelink from and would provide an immediate boost in income to retirees whose asset values have fallen.

2. **Further reduce deeming rates**

   Deeming rates adversely affect retirees who choose cash deposits as a form of security. In this current environment it is not an accurate reflection of the amount individuals are getting on their investments. Given the RBA cash rate is 0.25% and returns from shares and property have plummeted, it could be appropriate to drop the deeming rate altogether or set both deeming rates at the RBA cash rate.

   The government could also promote that fact that vast numbers of self-funded retirees may now be eligible for the CSHC and hence the July stimulus package of $750. Publicising this and even writing to older Australians identified through the tax system as eligible could be a good first step in providing some help.

3. **Reduce the rate of the Pension Loans Scheme (PLS) and promote it widely**.

   The PLS provides an opportunity for any retiree of pension age to draw on capital in their family home, or other property, to supplement their income. This can be used by retirees to get short term relief when income is depleted or to supplement existing income.

   Unfortunately, the current scheme is not widely known. It is also unattractive at the current rate of interest. The federal government reduced the PLS interest rate from 5.25% to 4.5% in December 2019, but the rate is still considered too high.

   By reducing the rate further and promoting the scheme widely, government would give retirees an option to increase their income, which could lessen the burden on their investments and reduce the impact to the COVID-19 pandemic. It could also stimulate confidence and boost spending in the overall economy.

4. **Adjust the taper rate.**

   This would have an immediate impact on hundreds of thousands of retirees.

   Before the current arrangements came into effect in January 2017 the taper rate was only half what it is at present. It meant couples could have more than $1.1 million in assets before they lost their part pension, compared to the upper limit now of $869,500. Adjusting the taper rate would acknowledge the inconsistency between the assets and income test in the current situation, especially for those who are asset rich but income poor.

   Adjusting the taper rate to provide retirees with extra income could balance the inconsistency caused by the current settings. At present a couple that has saved twice as much as another is more than $1,000 a month worse off. This inconsistency was highlighted in the Alliance for a Fairer Retirement System submission to the Retirement Income Review.

The taper rate should be reduced to remedy this unfairness and provide income relief to retirees.

5. **Extend the eligibility for the Commonwealth Seniors Health Card to all retirees of pension age with no income test and promote take-up of the card**.

   Many people who are ineligible for the age pension often assume they are also not eligible for the CSHC. The federal government could extend eligibility to all retirees and promote the card widely to increase take-up.

   This would lift the confidence of non-pensioner retirees by mitigating some of the risks with unexpected health costs and also provide them access to a range of concessions provided by state and local governments.

   Any concerns about issuing CSHC cards to those retirees with excessive financial assets would be minimal as there would be relatively few who are not already eligible.

We thank you for reading this document and hope it will provide useful guidance to government in this difficult time for all Australians.

About the Alliance:
The Alliance for a Fairer Retirement System is a group formed to represent millions of senior Australians, shareholders, self-funded retirees and those planning a sustainable retirement. The Alliance's mission is to help improve the existing superannuation taxation, Age Pension means testing and broader retirement income systems.

The organisations that form the Alliance include:
- Association of Independent Retirees
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