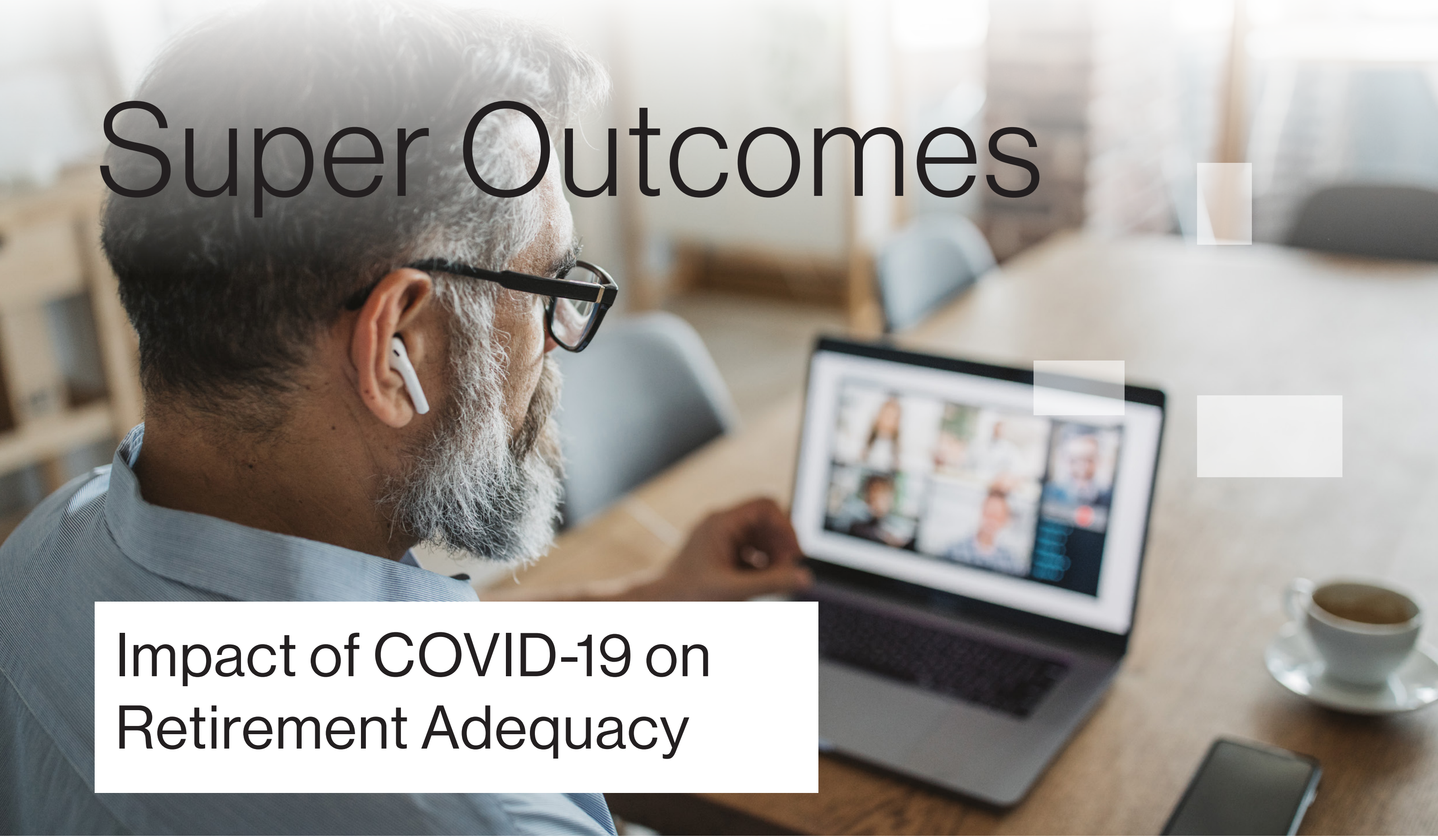
Super Outcomes



Impact of COVID-19 on Retirement Adequacy

COVID-19 has diminished prospective retirement outcomes for many Australians. Beyond the government's early release scheme, this is the result of a range of factors, with the impact on individuals differing depending on age, personal circumstances and actions.

In this article we break down the way the pandemic may impact retirement outcomes for a range of individuals with different ages, current account balances and earnings potential, by considering:

- investment returns
- switching behaviour
- early release payments, and
- periods of unemployment.

Representative cameos

For the purpose of this analysis, 12 representative cameos aged between 30 and 60 years and with various earning levels have been created to illustrate the spread of results[1]. The cameos are assumed to:

- work to age 67 with no career breaks,
- receive contributions at the legislated SG rates,
- invest in a Balanced investment option throughout their working lifetime and retirement, and
- be married with a superannuation account balance equal to their spouse throughout retirement, for the purpose of Government Age Pension.

Sustainable Income and Retirement Adequacy Index (RAI)

A Sustainable Income is determined for each individual and modelled such that the amount drawn down, plus the Government Age Pension (if eligible), is equal, in real terms, in all years from retirement to age 90. That is, the retiree has the same purchasing power in each year of retirement.

Retirement Adequacy is measured by comparing the Sustainable Income to a target. There are various forms the target may take, including a dollar-based target, a replacement rate, or a hybrid of these. For this purpose, a dollar-based target, the ASFA Comfortable standard, has been chosen as a target income to enable easy comparison of results.

The Retirement Adequacy Index (RAI) is a measure of the proportion of target income that is met by the individual's Sustainable Income:

$$\text{RAI} = \frac{\text{Sustainable Income (including Government Age Pension)}}{\text{Target Income}}$$

WillisTowersWatson

Retirement Adequacy pre COVID-19

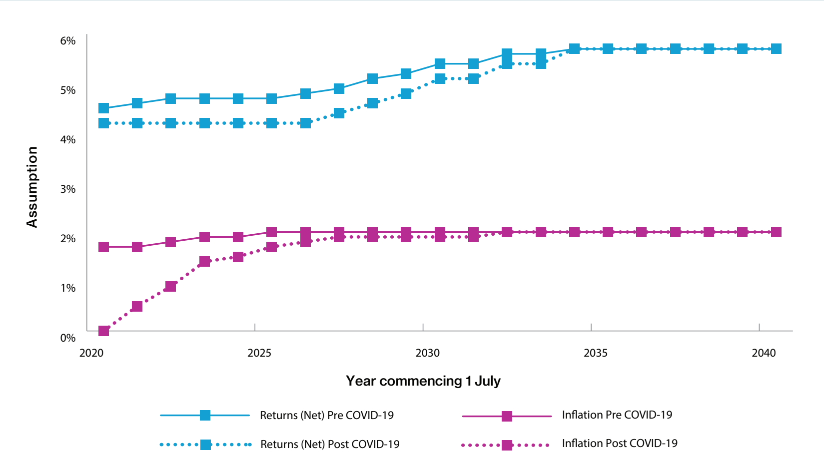
A pre COVID-19 baseline must first be established before we can quantify the impact of the pandemic. This has been achieved by determining the Retirement Adequacy Index (RAI) of the representative cameos based on the economic outlook at 31 December 2019. The results are shown in Figure A.

As expected, younger workers benefiting from a full working lifetime of Superannuation Guarantee (SG) contributions are projected to achieve a higher Sustainable Income and RAI than older workers.

However, even in a pre-COVID-19 scenario, it is unlikely that contributions would be unbroken for the working lifetime of many individuals, in particular younger workers, and those with a lower earnings base. Therefore, the actual spread of outcomes at retirement is likely to be greater than shown.

FIGURE A: Pre COVID-19 Retirement Adequacy

FIGURE B: Key Financial Assumptions



Assessing the COVID-19 impact

For each cameo, the RAI has been recalculated after allowing for each of the identified stresses of investment returns, switches, early release payments and unemployment.

Investment returns

The COVID-19 pandemic saw markets tumble globally in the March 2020 quarter, with a median investment return in Balanced options of -10.5%[2]. Returns over the ensuing months have partially recovered this loss, with returns for the six months ending 30 June 2020 at -4.9%[2].

However, the outlook for investment markets remains uncertain. Fears of a ‘second wave’ and a global recession remain, and governments and central banks continue to (or at least try to) balance public health risks with the economic consequences of social distancing restrictions introduced to slow down the spread of the virus.

While acknowledging the unpredictability of markets in general, and in particular in the current climate, the COVID-19 ‘return’ stress comprises both the impact of the (lower) actual returns to 30 June 2020 and a set of assumptions reflecting lower expected inflation and investment returns in the short to medium term due to the ongoing and residual effects of COVID-19, as shown in Figure B.

Switching behaviour

Throughout March and April 2020, many funds reported members shifting to cash and low growth investment options in response to the market downturn. Similar patterns were observed during the GFC in 2007/08, after which many members did not return to their previous investment options for some time, if at all.

The switching stress has been based on a switch to cash at 31 March 2020, following the most significant COVID-19 related investment losses, returning to a Balanced investment option after 10 years, to illustrate the impact of a long delay before reinvesting.

Early Release payments

In order to assist with financial hardship arising from the COVID-19 pandemic and the associated shutdown throughout the country, the federal government made a special provision allowing the release of up to $20,000 (two payments of $10,000) from superannuation accounts. By early August 2020, over $30.3 billion had been released to 3 million members[3]. Based on data from the second tranche of payments available from 1 July 2020, over 1 million members made a repeat application for early release.

In our analysis, the ‘early release’ stress allows for two early release payments of $10,000, up to the value of the current account balance.

The timing of many tranche one payments, immediately following the poor investment returns of the first quarter of the year, mean that members are withdrawing from already diminished funds, and have reduced exposure to the subsequent market recovery.

Periods of unemployment

The shutdown imposed to restrict the spread of COVID-19 in Australia has resulted in a significant spike in unemployment, with Treasury forecasting an unemployment rate of up to 9.25% in the December quarter 2020[4]. Therefore, large numbers of Australians will see little to no contributions coming into their superannuation accounts over the next few years.

In our analysis, the ‘unemployment’ stress allows for a three-year period of unemployment to illustrate the potential impact of a period of sustained unemployment, after which time the individual is assumed to return to their previous level of earnings.

FIGURE C: Summary of stress assumptions

Stress	Assumption
Returns	Actual returns to 30 June 2020; lower cash rates, inflation and investment returns over the short to medium term
Switching	Switch to Cash at 31 March 2020, return to a Balanced investment strategy after ten years.
Early Release	Two payments of $10,000 (up to a maximum of the account balance).
Unemployment	Nil superannuation contributions for three years.

Retirement Adequacy post COVID-19

Figures D1 and D2 show the reduction in Retirement Adequacy, measured using the RAI, as a result of each stress, considered both in isolation and collectively. The results have been set out across each age and earnings band reflected in the cameos.

Figure D1 sets out the results of the analysis for the 40 year old cameo with a mid-earnings base. It shows the progression of RAI from pre to post COVID-19 projections, isolating the impact of each of the identified stresses.

Figure D2 sets out the progression from the pre to post COVID-19 projections for all of the cameos.

FIGURE D1: Impact of COVID-19 on 40 year old cameo, mid earnings base

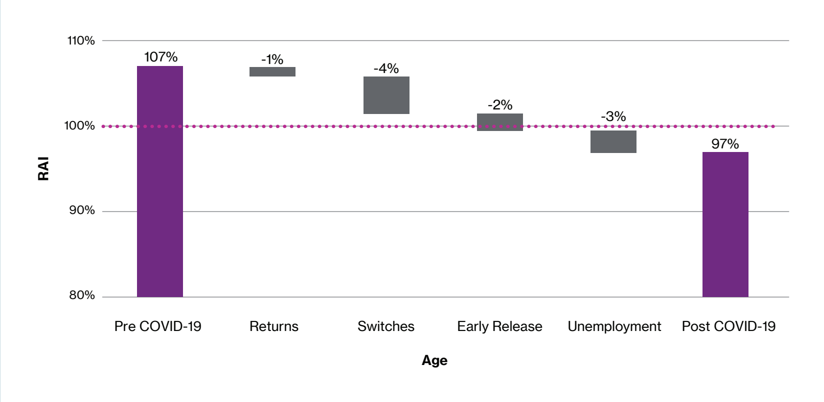


FIGURE D2: Impact of COVID-19 on RAI

Earnings Base	Low				Mid				High			
Age	30	40	50	60	30	40	50	60	30	40	50	60
Pre COVID-19 RAI	91%	84%	75%	68%	117%	107%	102%	94%	190%	186%	184%	179%
Returns	0%	-1%	-1%	-1%	-2%	-1%	-1%	-2%	-7%	-7%	-7%	-12%
Switches	-2%	-3%	-3%	-5%	-6%	-4%	-6%	-18%	-18%	-28%	-35%	-58%
Early Release	-1%	-2%	-3%	-2%	-3%	-2%	-2%	-2%	-5%	-4%	-3%	-1%
Unemployment	-1%	-2%	-1%	-1%	-3%	-3%	-3%	-2%	-12%	-9%	-7%	-3%
Post COVID-19 RAI	87%	77%	67%	59%	103%	97%	91%	69%	150%	139%	132%	105%

We observe that:

- Those in the low earnings band show the least absolute reduction across the board, due to overall retirement income being bolstered by the government Age Pension.
- Switching has the greatest adverse impact. While the proportion of members that switch to cash is still reasonably small across the industry, the analysis demonstrates that it can be very damaging and is particularly acute for older members, reflecting the impact of investment returns in the ‘retirement risk zone’ in the years immediately preceding and after retirement date.
- The impact of early release is higher for younger members. The exception is those with a low earnings base and account balance, where withdrawals are significantly less than the full $20,000,
- Younger members are most impacted by periods of unemployment, with lost savings in the early years leading to the largest differences at retirement through the force of compound interest.

Offsetting the impact of COVID-19

The projections illustrate that the events of 2020 will have a negative impact on the retirement outcomes for large numbers of Australians. However, there are a few actions that can be taken by fund members to offset this impact.

- Some members, particularly higher earners, may choose to retire with a slightly lower retirement income if they are able to maintain their desired lifestyle with the resources available to them.
- For others, the most obvious action may be to contribute more by way of voluntary member contributions. However, at a time where unemployment is projected to reach its highest level since the great depression, many members will not have the ability or inclination to use available income to support additional contributions even where the need is recognised.
- Those who are unable or unwilling to make additional contributions may be forced to work past their preferred retirement age – if such an option is available to them. Figure E illustrates the additional number of years an individual would need to work to achieve their pre COVID-19 RAI assuming all the scenarios outlined in Figure D2 apply. Clearly, for any approaching retirement, this approach may not be feasible with an additional working life of up to eight years required to achieve pre COVID-19 adequacy levels.

FIGURE E: Additional working years required to restore Pre COVID-19 Retirement Adequacy

Earnings Base	Low				Mid				High			
Age	30	40	50	60	30	40	50	60	30	40	50	60
Additional years required	2	3	4	8	3	3	3	7	3	3	4	8
New Retirement Age	69	70	71	75	70	70	70	74	70	70	71	75

An opportunity for funds

COVID-19 and the associated shutdown will affect individuals differently depending on their personal circumstances and actions. However, the current climate offers a unique opportunity for funds to increase engagement with members who, in many cases, will have connected with their fund more strongly than previously through accessing early release payments. Well-crafted and targeted communications can positively influence member behaviour, demonstrating the value of additional contributions and the importance of making appropriate investment choices.

Funds need to understand their membership, what their projected retirement adequacy looks like, and how it has changed through this tumultuous time. A Retirement Adequacy Study, which produces a Retirement Adequacy Index for each fund member and selected cohorts, can provide valuable insights into the projected retirement outcomes of the fund as a whole, and help identify cohorts of members for targeted communications or other action.

[1] Australian Bureau of Statistics - Household Income and Wealth, Australia, 2017–18
[2] SuperRatings Fund Crediting Rate Survey – median SR50 Balanced (60-76) Index
[3] APRA COVID-19 Early Release Scheme – Issue 15
[4] Economic and Fiscal Update July 2020

For further information please contact:

Erinn Cullinane

Associate Director, Retirement
T +61 3 9655 5138
erinn.cullinane@willistowerswatson.com

Level 4, 555 Bourke Street
Melbourne VIC 3000
T +61 3 8681 9800
www.willistowerswatson.com.au

Nick Callil

Head of Retirement Solutions, Australia
T +61 3 9655 5163
nick.callil@willistowerswatson.com

Level 4, 555 Bourke Street
Melbourne VIC 3000
T +61 3 8681 9800
www.willistowerswatson.com.au

About Willis Towers Watson

Willis Towers Watson (NASDAQ: WLTW) is a leading global advisory, broking and solutions company that helps clients around the world turn risk into a path for growth. With roots dating to 1828, Willis Towers Watson has 45,000 employees serving more than 140 countries and markets. We design and deliver solutions that manage risk, optimise benefits, cultivate talent, and expand the power of capital to protect and strengthen institutions and individuals. Our unique perspective allows us to see the critical intersections between talent, assets and ideas – the dynamic formula that drives business performance. Together, we unlock potential. Learn more at willistowerswatson.com.

willistowerswatson.com/social-media

The information in this publication is general information only and does not take into account your particular objectives, financial circumstances or needs. It is not personal advice. You should consider obtaining professional advice about your particular circumstances before making any financial or investment decisions based on the information contained in this document.

WTW660AU

willistowerswatson.com.au

Willis Towers Watson