Retirement explainer series

Retirement income covenant objectives

Edition 1

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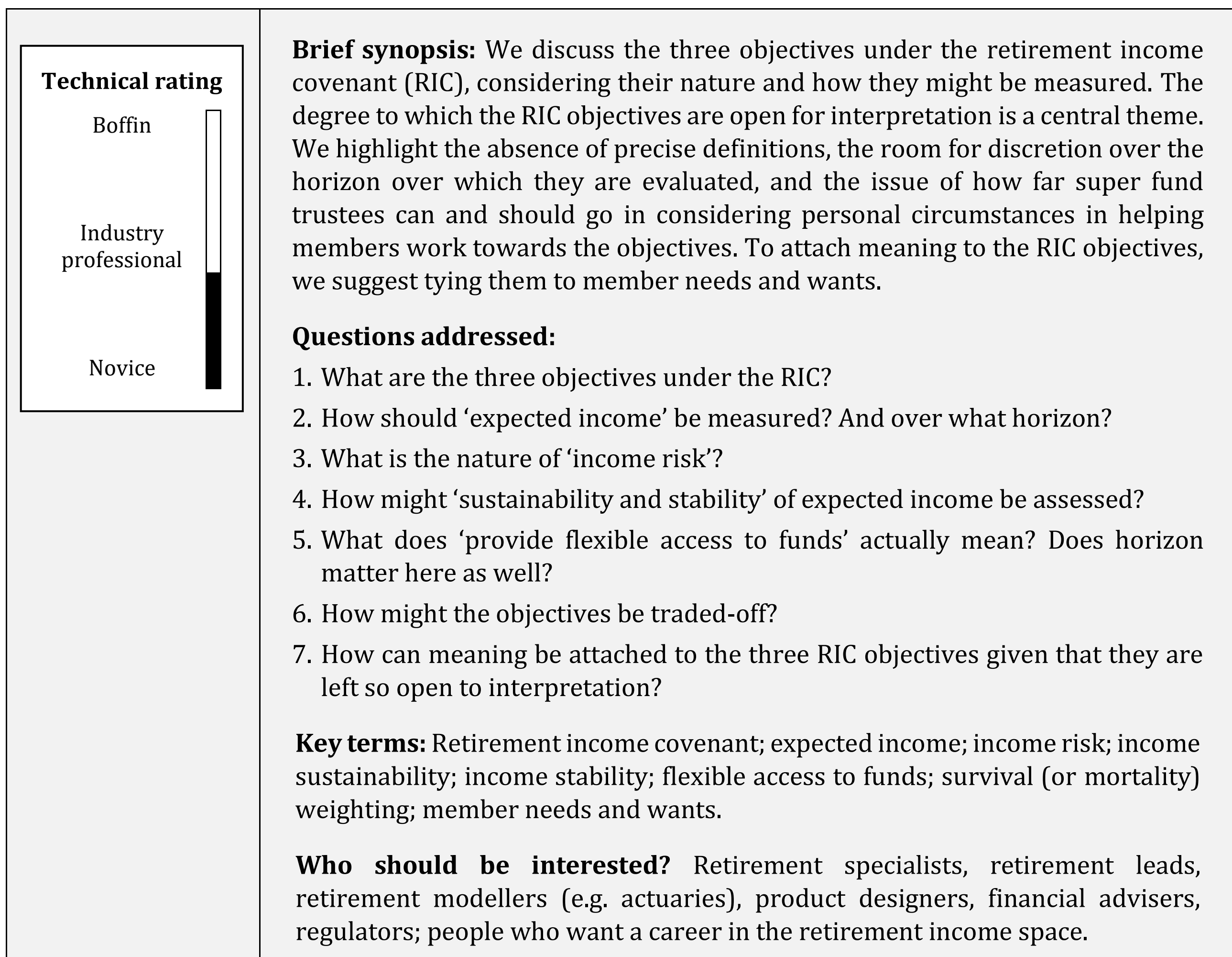


Brief synopsis: We discuss the three objectives under the retirement income covenant (RIC), considering their nature and how they might be measured. The degree to which the RIC objectives are open for interpretation is a central theme. We highlight the absence of precise definitions, the room for discretion over the horizon over which they are evaluated, and the issue of how far super fund trustees can and should go in considering personal circumstances in helping members work towards the objectives. To attach meaning to the RIC objectives, we suggest tying them to member needs and wants.

Questions addressed:

1. What are the three objectives under the RIC?
2. How should 'expected income' be measured? And over what horizon?
3. What is the nature of 'income risk'?
4. How might 'sustainability and stability' of expected income be assessed?
5. What does 'provide flexible access to funds' actually mean? Does horizon matter here as well?
6. How might the objectives be traded-off?
7. How can meaning be attached to the three RIC objectives given that they are left so open to interpretation?

Key terms: Retirement income covenant; expected income; income risk; income sustainability; income stability; flexible access to funds; survival (or mortality) weighting; member needs and wants.

Who should be interested? Retirement specialists, retirement leads, retirement modellers (e.g. actuaries), product designers, financial advisers, regulators; people who want a career in the retirement income space.

Objectives as set out by the RIC

While the RIC is directed at superannuation fund trustees, it provides a useful point of departure for a discussion of the objectives that any retirement solution should cater for. To quote verbatim from the explanatory memorandum that accompanied the RIC legislation:

"The retirement income covenant requires trustees to have a strategy to assist beneficiaries to achieve and balance the following three objectives:

- *maximising their expected retirement income;*
- *managing expected risks to the sustainability and stability of their expected retirement income; and*
- *having flexible access to expected funds during retirement."*

The first two objectives refer to income, and allude to a trade-off between seeking to increase the level of income while managing income risk. This sounds sensible enough, and might be seen as a counterpart to trading off expected return and risk in an investment context extended to income streams. The objective relating to access to funds implies that available assets also matter, specifically having funds available for use if they are needed. This makes the RIC about more than just delivering income. It also complicates the trade-offs involved.

The RIC is intended to be 'principles-based'. So it is in spades, leaving it up to fund trustees to interpret these three objectives as they may. Below we highlight the scope that this affords trustees, and the complexities that arise.

What does 'maximise expected income' mean?

On face value, this seems straightforward. Doesn't maximising income merely imply making average income[1] as large as possible? Maybe. It depends on how you define 'expected', which in turn brings up the issue of the treatment of horizon.

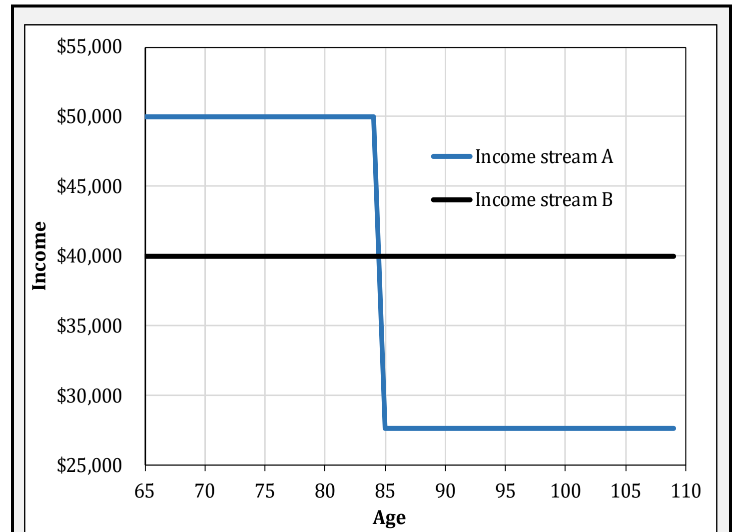
Let us explain through comparing two simple income streams covering age 65 to age 109 (an age with a vanishingly low chance of survival), as plotted in the chart appearing at top right. Income stream A is $50,000 to age 80 and $27,664 thereafter – the value of the full Age Pension plus supplements at the start of FY2023-24. Income stream B is a constant $40,000.

Calculating expected income requires taking a stand on the treatment of horizon. The table below the chart shows that averaging through to age 92 – the horizon used by ASIC's Moneysmart – results in expected value of income steam A being larger than that for income stream B. Averaging to age 109 flips the results, so that income stream B now has the larger expected value. Another possibility is to weight by the probability of survival[2] and hence the likelihood of being alive to experience the income – an approach often used in academic research. This results in income stream A having the larger expected value. Further, expected values for income stream A all differ. There is no unique answer!

The choice of horizon thus runs into the issue of how uncertainty over time of death should be treated. We intend to discuss this issue in a later explainer. But for now, let us say there is no 'right' answer.

Which income streams offers greater expected income?

Expected income at each age from age 65 to age 109



Different ways of calculating expected income

Basis of measurement:	Income stream A	Income stream B
Average to age 92	**43,618**	40,000
Average to age 109	37,591	**40,000**
Survival-weighted to age 109	**45,423**	40,000

Notes: The top two estimates reflect a simple average of income through to age 92 and age 109, respectively. The survival-weighted estimates adjust income for the probability that the member survives to each age using the 2015-2017 life tables for females from the Australian Government Actuary (without mortality improvement). This weights for the likelihood that the member is actually alive to experience the income.

The complications in gauging expected income also run up against the issue of how 'income' is defined. From the perspective of individual members, all their income sources should be included. However, it is unclear how member income should be defined from the perspective of a fund trustee. Should it be just the income arising from the member's superannuation assets? Or should other income sources available to the member be included?

The explanatory memorandum accompanying the RIC legislation suggests that the Age Pension should be considered. We note it is difficult for trustees to do so without knowing more about their members, including all assets or income impacting on Age Pension eligibility, and whether they are dealing with an individual or a couple. If the member has assets or income outside of super, should (and can) this also be taken into account in expected income?

[1] There is an argument that median income may be a more suitable as it reveals the 'centre point' of the distribution.

[2] This is also called 'mortality weighting'.

The knowledge and scope of the relationship that a fund has with its members will thus dictate how trustees might define the expected income they are attempting to maximise. Again, there is no definitive answer.

What is income risk?

We first note that the issues raised around defining expected income related to treatment of horizon and what is included in income also translate through to how income risk might be defined and measured.

An additional consideration is that the RIC mentions two dimensions to income risk – stability and sustainability. It turns out that these concepts do not lend themselves to clear definitions any more than does expected income. To illustrate, we provide some charts below of income percentiles for two retirement solutions, based on earlier Conexus Institute analysis.[3]

Both income streams derive from investing in an account-based pension with 60% in growth and 40% in defensive assets, but with different drawdown strategies being applied. The chart on the left applies the minimum drawdown rules for account-based pensions. The chart on the right follows a strategy where income reflecting ASFA comfortable (at the start of FY2022-23) is drawn[4] until the account-based pension account is exhausted, after which income falls to the Age Pension plus supplements.

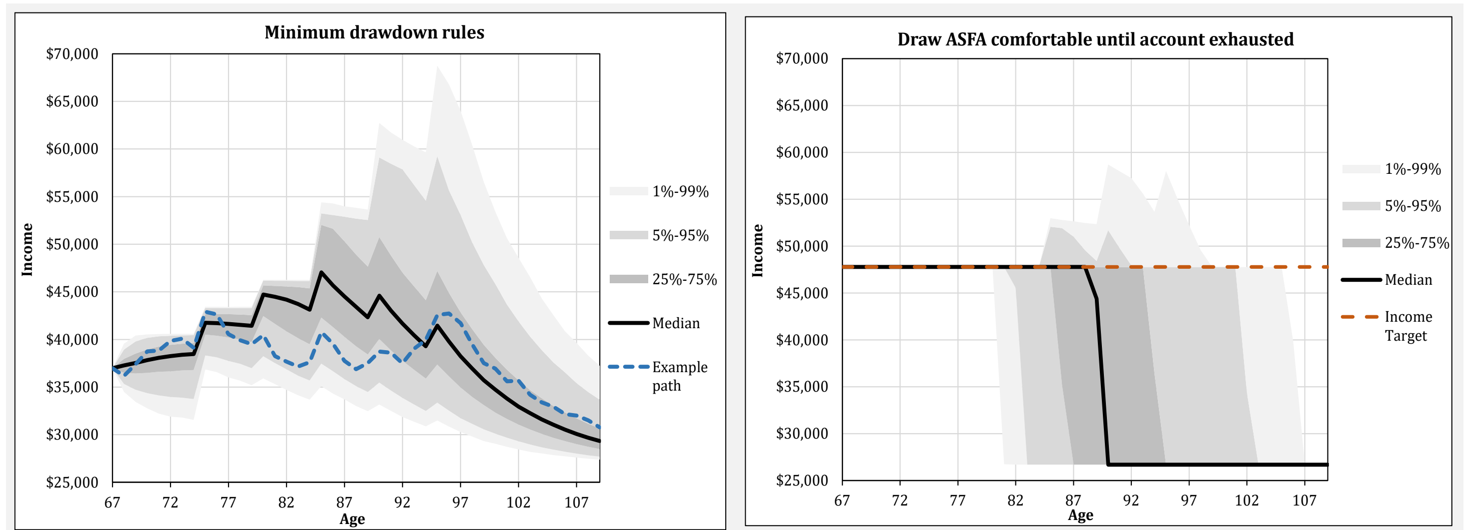
It is unclear which income stream is riskier under each dimension. In terms of stability, the minimum drawdown rules deliver an income stream that is quite variable through time. The chart plots income percentiles that show the spread across income paths. There is also underlying variability within individual paths, which we illustrate with one example path. However, drawing ASFA comfortable delivers stable income only up until a (random) point when income drops sharply once the account balance is exhausted. It is debatable whether this can be called a pattern of 'stable' income.

In terms of sustainability, neither drawdown strategy seems to tick the box – although the minimum drawdown rules at least ensure that income remains above the Age Pension. The issue also emerges of whether more weight should be placed on risk incurred earlier in retirement when there is a higher likelihood the member is alive to experience any decline in income that could occur, i.e. should survival weights be incorporated into the measurement of risk as well?

We are at a loss to make a clear statement of which of these income streams is riskier through the dual lens of sustainability and stability. Clearly there is ample scope for interpretation.

Which of these income streams is riskier?

Income percentiles for 60/40 account-based pension under two drawdown strategies



[3] These charts are taken from a Conexus Institute thought piece of June 2023 titled *How to Approach Quantitative Assessment of Retirement Income Strategies.*

[4] More income may be drawn than is needed to deliver ASFA comfortable under the minimum drawdown rules.

While sustainability and stability are not well-defined as stand-alone concepts, they do, however, make sense in the context of trade-offs. For instance, drawing less income means that income becomes more sustainable, although the expected income will be lower. Adjusting income in response to fluctuations in investment returns and hence asset values results in income volatility, but also enhances sustainability as it ensures that assets are not run down quickly after experiencing poor returns.

One more matter is worth touching on. The RIC legislation refers to the expected risks to be managed as including "longevity risks", "investment risks", and "inflation risks". These are often cited as key risks in retirement. We think these factors are better viewed as potential *drivers* of income turning out lower than expected or desired, rather than a characterisation of income risks faced by members. Members do not think in these terms, but rather worry about whether they will have enough income. From this perspective, the primary focus in gauging risk should be the potential distribution of retirement income, and how it relates to the needs and wants of the member.

We say more on the topic of income risk in Explainer #2 on 'Income objectives'.

How should flexible access to funds be viewed?

The mention of flexible access to funds invokes a concern with assets themselves, rather than just the income they generate. While this may seem at odds with an 'income covenant', it makes sense given that access to funds can be valuable to members for a range of reasons. Having funds available can help meet unexpected needs (e.g. medical, renovations, family-related), support access to aged care, provide a bequest, and underpin a capacity to respond to changes and opportunities. We drill down into flexible access to funds in Explainer #3. For now, we highlight two issues, both of which parallel those raised for the income objectives.

First is that the horizon issue also arises for access to funds. Here the relevant horizon can depend on the reason(s) for having funds available for use. Catering for unexpected needs suggest having some funds available throughout the course of retirement. Motives around aged care and bequests require funds to be available towards the end of retirement. Capacity to respond to changes and opportunities is probably more important earlier in retirement. In any event, flexible access to funds needs to be managed towards ensuring that funds are available when they are needed. Focusing on how much is placed in (say) an account-based pension at the start or retirement does not suffice.

Second, the need for the trustee to provide flexible access to funds to members will depend on the other assets they have available. The need could be much decreased if the member has substantial assets outside of super, own their home, or is expecting a large bequest from aging parents. Again, the knowledge and scope of the relationship of funds with their members may dictate the way in which trustees define and provide flexible access to funds.

Our take: Start by identifying needs and wants

Our discussions have highlighted how the three RIC objectives are wide open for interpretation. Key issues include: (a) lack of precise definitions, (b) horizon over which objectives should be evaluated, in light of uncertain longevity, and (c) how far fund trustees can and should go in considering personal circumstances in assisting members to achieve and balance the three objectives. For fund trustees, the RIC objectives provide for plenty of discretion but will be testing to implement.

A way to square the circle is to give meaning to the three objectives by first determining the needs and wants of members. Success or failure in delivering on those needs and wants could then be assessed along the lines of the three RIC objectives. Rather than starting by imposing definitions on expected income, income risk and flexible access to funds, the first step could be to identify the type of income stream and access to funds that a member needs. This could then guide how success is defined and measured under the three RIC objectives.

For example, consider a solution being designed for members who desire a stable income stream that is sustained while they remain alive, but also values flexible access to funds. 'Expected income' might be tied to the income stream that is being targeted, while both income risk and flexible access to funds would relate to the possibility of the retirement account being exhausted so that income and accessible assets run out. Measures would be devised to assess these elements and how they change as the targeted income level is varied, thus tying the analysis to member needs and wants.

Explainer #2 has a closer look at income objectives and Explainer #3 at flexible access to funds and how they might be implemented from this perspective.