Retirement explainer series

Providing flexible access to funds

Edition 3
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Technical rating	
Boffin Industry professional Novice	**Brief synopsis:** We discuss the third objective under the retirement income covenant of providing flexible access to funds. Four reasons why members may desire access to funds include meeting unplanned spending needs, bequests, aged care and flexibility to adjust. We outline how superannuation (super) fund trustees might understand and cater for these desires, ideally considering available assets outside of super and capacity of the member to adjust their spending. We suggest establishing a 'contingency' account that the member may draw from as a practical approach for facilitating flexible access to funds. **Questions addressed:** 1. What might be the motivations for a member desiring flexible access to funds? 2. What determines how and when accessible funds should be provided by fund trustees? Is this largely related to motivation, or are other influences at play? 3. How can flexible access to funds be measured? 4. How might income objectives and flexible access to funds be combined? **Key terms:** Retirement income covenant; access to funds; member needs and wants; precautionary savings; homeownership; aged care; flexibility; retirement solution design; contingency account **Who should be interested?** Retirement specialists, retirement leads, retirement modellers (e.g. actuaries), product designers, financial advisers, regulators, people wanting a career in the retirement income space.

Introduction

Explainer #1 discussed the three objectives under the retirement income covenant (RIC), the third of which relates to "flexible access to funds". In this third Explainer, we drill down into the nature of flexible access to funds and how it could be provided. We outline why accessible funds are valuable to members; and discuss how flexible access to funds might be measured and combined with income objectives. Creation of a 'contingency account' (i.e. 'rainy day account') is suggested as a straightforward approach.

Why flexible access to funds is valuable

Below are four reasons why a retiree might want to have funds available that may be readily accessed:

- **Meeting significant yet unplanned spending needs** – It can be useful to have funds available to meet any unplanned spending needs that are not covered by regular income. Examples include large medical expenses, home renovations or helping out family members. This is effectively a precautionary saving motive.
- **Provide a bequest** – Some retirees may be keen to leave a bequest for their partner or children,

which may appear in the form of accessible funds[1]. Research suggests that only a minority of people have strong bequest motives[2]. However, assisting adult children to purchase a home (the 'Bank of Mum and Dad') is an emerging trend that might be seen as a form of early bequest.

- **Support access to aged care** – Some retirees may want to have funds available to support access to aged care if required, especially non-homeowners who may need to fund aged care from their financial assets[3].
- **Ability to alter course** – Having funds that are readily available provides greater flexibility to respond to change or opportunities[4].

Any of these reasons could support a desire for accessible funds. Further, the reasons may be overlapping and interchangeable. For instance, precautionary savings that are left unused could provide a bequest. And funds intended for a bequest or aged care could be redeployed towards more pressing needs that happen to arise unexpectedly.

Providing confidence is a further reason why a fund trustee or a financial adviser might encourage retired members to set some funds aside. 'Fear of running out' is widely considered to be a contributor to under-spending during retirement. Having some precautionary savings available 'just in case' may reduce reluctance to draw down on other assets, and thus assist members to get more out of their retirement savings than they might have otherwise.

Establishing the need for flexible access to funds

A range of factors could influence the nature of the need for flexible access to funds:

- **Motivation** – Which of the reasons listed above apply will dictate both the magnitude and timing of the need for accessible funds. Precautionary motives might require more moderate amounts to be available at any time, i.e. throughout retirement. Motives around bequests and aged care require sizable funds to be available later in retirement. Capacity to respond to change requires holding a meaningful portion of assets in accessible form, but probably becomes less important as retirement proceeds[5].
- **Existing assets** – A retiree would have less need for flexible access to funds if they:
  (a) have total assets that are more than adequate to fund their desired level of spending, i.e. they are asset rich;
  (b) own a home; or,
  (c) have other sources they can draw on, such as well-off older parents who can assist them if needed or are likely to leave a future bequest.

  Homeownership in particular could substantially attenuate the need for flexible access to funds. A family home can support both a bequest and funding for aged care, and provide a substantial backstop that may be accessed through home equity loans, downsizing or sale if need be.
- **Flexibility to adjust spending** – Members with greater flexibility to adjust their spending might need lower levels of accessible funds. Such members have more scope to cut back spending to accommodate any unplanned spending needs.

The box lists what fund trustees might want to know about a member[6] to gauge their need for flexible access to funds within super.

What a fund trustee might want to know to gauge a member's need for accessible funds

Understanding member circumstances:

- *Does the member own a home?*
- *Does the member have other substantial assets outside of super that could meet unexpected needs?*
- *Is there capacity to adjust spending to accommodate unplanned expenditure, if the need arises?*

Gauging the motivation for accessible funds:

- *Desire to have some funds available 'just in case'?*
- *Intent to leave a bequest?*
- *Supporting access to aged care?*
- *Preference for flexibility?*

The first set of three dot points aim to establish whether flexible access to funds is needed within

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[1] Bequests may also be supported by housing or other assets.
[2] A summary of the evidence that leaving a bequest is a low priority for most retirees can be found the *Retirement Income Review Final Report* (2020) on p436.
[3] The need to set savings aside for the possibility of ending up in aged care is debatable. Only a portion of retirees end up in aged care, suggesting that some form of insurance arrangement may be more efficient than self-insuring, which in turn runs the risk of over-saving. The Government also provides insurance through substantial support in meeting the cost of aged care on a means-tested basis.
[4] This benefit is heightened for retirees, who have limited capacity to generate wages and other personal income.
[5] 'Optionality' becomes less valuable as the time remaining reduces.
[6] We propose a hypothetical set of personal information that would be useful to know, while recognising that trustees are currently restricted in sourcing and using such information without triggering personal financial advice requirements.

super. The trustee might not accommodate flexible access to funds for some members where the need is covered due to (say) owning a home or having substantial assets outside of super. The second set of four dot points aim to identify the motivation for accessible funds, with a view to gauge the magnitude and time frame that accessible funds are required.

How flexible access might be measured

The measurement of accessible funds ultimately needs to be tied back to the motivation to ascertain whether an appropriate amount of funds is being made available when they are likely to be needed. This will likely require tracking available funds over the course of retirement, and not just how much funds are available at the start. Estimating the potential distribution (i.e. range) of accessible funds may help to paint a fuller picture.

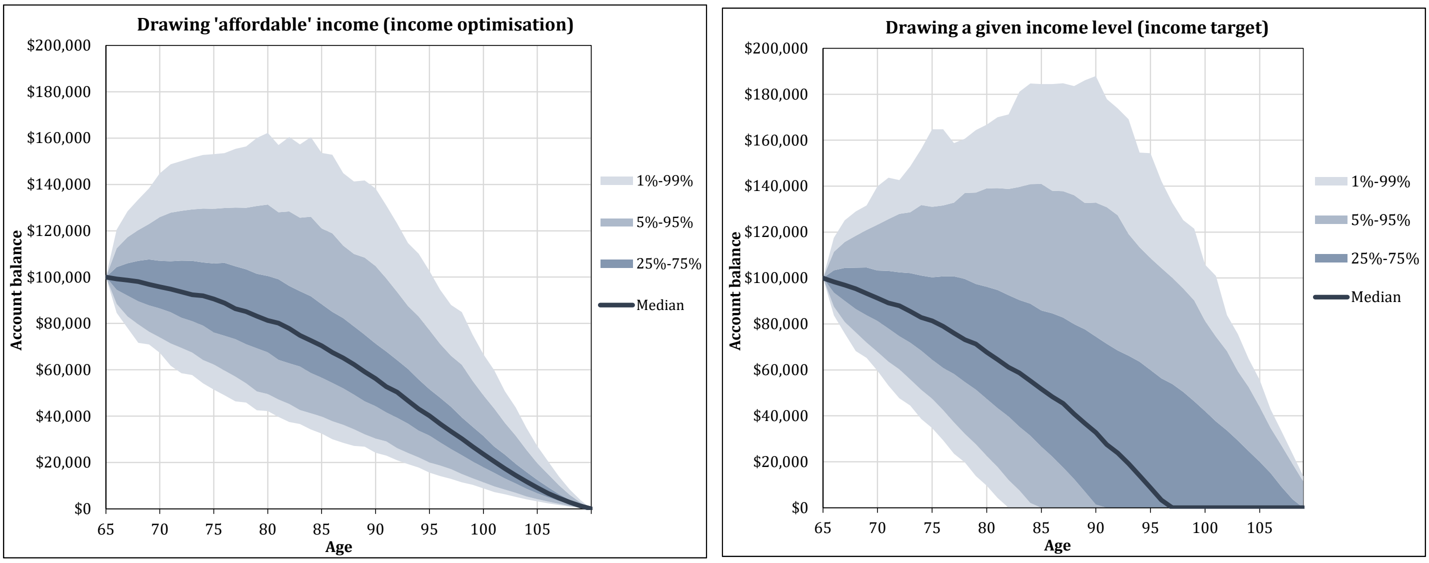
The two charts below[7] illustrate through presenting the percentile distributions for a retirement savings account balance. Here the same investment strategy[8] is coupled with two different drawdown strategies for contrast. The chart on the left shows balance percentiles where an 'affordable' income is drawn as percentage of assets that varies with age. (This drawdown strategy is discussed under the 'income optimisation' objective in Explainer #2.) This solution provides flexible access to funds up until age 109, albeit of a decreasing amount. The right chart shows balance percentiles where a specific level of income is drawn, in line with the 'income target' objective (also outlined in Explainer #2). This solution is likely to lead to accessible funds being exhausted at some stage, e.g. by age 85 with a 5% probability, and by age 97 with a 50% probability. However, it also offers the chance of generating higher balances. The solution on the left might be more suitable for a member that needs some access to funds throughout retirement.

Combining flexible access to funds with income

Trading off flexible access to funds against income is difficult given that asset values occur at a point of time while income is a stream of value across time[9]. One possibility is to apply 'multiple criteria decision making' to score or rank solutions[10]. For instance, various measures that capture expected income, income risk and flexible access to funds could be combined into an overall measure. These methods, however, tend to rely on scoring or ranking schemes ('objective functions') that involve subjectivity and are often ad-hoc.

Distribution of remaining balance in retirement account under two drawdown strategies

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



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[7] The charts are generated using the models accompanying Butt, A., Khemka, G., Lim, W. and Warren, G. (2023), "[Primer on Retirement Income Strategy Design and Evaluation]", *Society of Actuaries Research Report*,.

[8] The investment strategy is secondary to this exercise, but entails investment in a 60/40 balanced fund combined with access to a guaranteed income stream.

[9] The academic literature uses utility models to help evaluate the trade-off between income and bequests. However, these models are quite complex and not very intuitive. They also do not capture precautionary demand, as they assume that residual funds are accessed at the point of death.

[10] A balanced scorecard approach for assessing retirement solutions is illustrated in Bell, D., Khemka, G. and Warren, G. (2023), "[How to Approach Quantitative Assessment of Retirement Income Strategies]", *Thought Pieces with The Conexus Institute*. A wide range of methods can be found in the literature.

Another possibility might be to draw from the intuition behind goal-based investing or bucketing approaches by 'carving out' some assets that are dedicated to providing flexible access to funds. Having done so, the remaining assets would be directed towards achieving an income objective.

We'll call this carve-out a '**contingency account**', although others have referred to a 'rainy day fund' with respect to the precautionary motive. It could operate as follows:

1. Determine the amount of accessible funds that the member desires to have available.
2. Place the funds in a contingency account, to be tracked separately to income-generating assets.
3. Invest in accordance with the motivation for creating the contingency account. For instance, a precautionary savings motive would suggest investing defensively. A bequest or aged care motive might accommodate taking some risk to build up assets over time.
4. Allow the member to draw from the contingency account as they desire[11].
5. Establish how the minimum drawdown rules are to be handled, noting that these rules will create an obligation to draw from the assets within the contingency account. Most likely the income would be taken from other funds to ensure that the contingency account is left untouched and remains available as required.
6. Consideration might be given to allowing a member to add to their contingency account if they wish. This might be useful when excess assets become available elsewhere, such as after enjoying good investment returns, or upon discovering that income needs are lower than initially anticipated.

Interesting, the appendix to the Treasury "*Retirement phase of superannuation*" discussion paper of December 2023 contained an example bundled retirement product incorporating a "capital reserve", which aligns with the contingency account idea we raise here. The example alludes to the capital account being exempt from the minimum drawdown rules.

Our take: A contingency account has much merit

Flexible access to funds has an important role to play within retirement solutions. Having accessible funds can cater for genuine member needs, such as meeting unplanned spending requirements. A contingency account has a lot of merit as a structure to meet these needs. It offers a practical way of embedding flexible access to funds within retirement solutions that is both straightforward to implement and should be understandable to members. It may give members more confidence to spend their other assets knowing that they have something set aside just in case. A contingency account also allows income and flexible access to funds objectives to be addressed as separate and distinct matters. It thus avoids the need to consider whether an income solution is also making sufficient accessible funds available, and thus limits the need to make ad hoc trade-offs between income and assets.

[11] If there are other funds available elsewhere (e.g. in an account-based pension, or outside of super), the member could choose to use these funds and leave the contingency account untouched.