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The Hon Kelly O'Dwyer MP
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19 April 2018

Dear Minister,

Retirement Income Covenant and Retirement Income Framework
Comprehensive Income Products for Retirement (CIPRs)

ASFA is a non-profit, non-political national organisation whose mission is to continuously improve the superannuation system, so all Australians can enjoy a comfortable and dignified retirement. We focus on the issues that affect the entire Australian superannuation system and its $2.6 trillion in retirement savings. Our membership is across all parts of the industry, including corporate, public sector, industry and retail superannuation funds, and associated service providers, representing over 90 per cent of the 14.8 million Australians with superannuation.

We are writing about the work that you and the Government are undertaking to help facilitate the superannuation system in providing Australians with an income in retirement.

We understand that the consumer and industry advisory group that is assisting you in the next phase of development for a framework for Comprehensive Income Products for Retirement (CIPRs) has concluded and we felt that it is important that you are aware of ASFA's views on some of the issues that the group considered, including the possible options and scope of a retirement covenant in the *Superannuation Industry Supervision Act 1993*.

In forming our views, ASFA established a cross - industry working group that has considered the potential framework for CIPRs carefully.

The superannuation system must support consumers by providing suitable retirement income stream options. In this context, ASFA supports a principles based 'retirement income' covenant subject to a suitable transitional period.

The covenant should outline principles for trustees in developing their retirement income framework. It should not, however, be seen as an implementation mechanism for CIPRs. We would be concerned if the covenant led to prescriptive regulations and detailed APRA standards that sought to implement core retirement income policy.

We consider the exercise should be one of designing and implementing a phased, long-term road map towards improved retirement incomes. Major policy of this sort should be implemented through the Parliament, via primary legislation.

It will be important to reduce current barriers in the social security settings that influence decisions to adopt longevity products and consider activities that could improve retirement income, including income projections on member statements.

The CIPRs framework should actively reflect the community's desire to retain access to capital and that trustees should not be compelled to include a longevity component. Trustees should be able to offer more than one CIPR with members having the flexibility to 'dial-up' and 'dial down' the various components.

There are still outstanding fundamental questions and concerns about what it means to 'nudge', whether it is appropriate, the interaction with advice and the need for a 'safe harbour' defence that we hope can be addressed in the next round of consultation.

We have attached, by way of annexure, a brief submission on the above points that reflects the observations and concerns raised by the working group. This is consistent with the issues that were identified in ASFA's submission to Treasury in July 2017 with respect to their December 2016 Discussion Paper.

Yours sincerely

Dr Martin Fahy
Chief Executive Officer

ANNEXURE

RETIREMENT INCOME COVENANT AND FRAMEWORK
COMPREHENSIVE INCOME PRODUCTS FOR RETIREMENT (CIPRs)

ASFA Working Group positions

1. Retirement covenant in the *Superannuation Industry (Supervision) Act 1993* (SIS Act)

1.1. Threshold matter as to whether there should be a retirement covenant in the SIS Act

- The Working Group generally considered it desirable that a 'retirement covenant' be inserted into the SIS Act, subject to the following considerations:

1.1.1. Need for transition period for covenant

- There should be a minimum of a one year transition period i.e. the effective date of any new 'retirement covenant' should be no earlier than 1 July 2019. Trustees will require at least a year to give formal consideration to the implications of a retirement covenant, including the development and implementation of a retirement income stream framework.

- Developing a framework will necessitate assessing alternatives, investigating, performing risk analyses, designing processes, reviewing products, due diligence processes, agreeing the approach and documenting the framework. This will be an iterative process, culminating in review and approval by the board and collectively these requirements and activities would be expected to take at least 12 months to work through and complete.

- When the provisions with respect to covenants were introduced into the SIS Act an exposure draft of the amending bill was released for consultation in late 2011 and the effective date of the new provisions was 1 July 2013.

1.1.2. Need for transition period re offering a CIPR

- To the extent that a CIPRs regime is introduced via primary legislation that will necessitate trustees having to consider and/or develop one or more new CIPR products, a longer time - such as three to five years – would be appropriate as a transition period. Given the relative immaturity of the retirement income stream market, a three to five year - or longer – transition period would allow trustees to
  - analyse and assess the membership demographics of their fund in terms of income stream needs in retirement
  - identify the range of appropriate products and solutions
  - consider whether or not to offer a CIPR product; and
  - if not, document reasons to justify their decision not to offer a CIPR product, on an 'if not, why not' basis.

Retirement covenant
There is some support for a 'retirement income' covenant, subject to caveats with respect to • the need for a suitable transition period • an appropriate approach being adopted in the drafting of the covenant; and • the covenant not leading to prescriptive regulations and detailed APRA standards.

1.2. Appropriate approach when drafting the retirement covenant

- The Working Group considered any 'retirement' covenant should
  - involve the trustee developing a retirement income framework and strategy
  - reflect the fundamental purpose of superannuation is to provide income in retirement
  - be 'high level' and 'principles based'
  - reflect the needs of the members of the fund
  - recognise the desire of members to retain access to an appropriate amount of capital for contingencies, such as access to residential aged care, meeting health care costs and expenditure to ensure quality of life
  - recognise the difference between, for example,
    - members retiring in the next 5 to 10 years, especially those with low account balances due to lower income and/or broken working patterns; and
    - members retiring in 20 plus years as the former will not have enjoyed a full working life of contributions to superannuation
  - be 'product neutral'
  - reference opportunities and activities to improve income in retirement.

- The retirement covenant should not
  - be overly prescriptive
  - focus on product.

2. Development of a framework for CIPRs

- The Working Group discussed the CIPRs framework as outlined in the Treasury Discussion Paper of December 2016 and made the following general observations:

2.1. Current paradigm – how members see superannuation

- There is a need to recognise a paradigm shift away from members considering the accumulation of a lump sum towards a focus on the accumulated lump sum being a means to an income in retirement.

- Accordingly, perhaps the exercise should be one of designing and effecting a phased, long-term, road map towards the desired policy outcome of improved income in retirement for members.

- By way of example, ideally
  - any 'retirement income' covenant should, in the first instance, represent the first phase in a roadmap
  - consideration could be given to a staged approach whereby ultimately, from some point in the future, a specified level of contributions (or portion of account balance) is to be returned as income in retirement.

Need for paradigm shift – a phased, long-term, roadmap
The superannuation system must support consumers by providing suitable retirement income stream options. ASFA suggests the exercise should be one of designing and implementing a phased, long-term, road map towards the desired policy outcome of improved income in retirement for members.

2.2. Potential framework for retirement income streams

- With respect to a framework for retirement income streams – it was discussed and agreed that:
    - at a minimum, trustees of funds that have a MySuper should consider whether to offer a retirement income stream product and/or a CIPR on an 'if not, why not' basis
    - a CIPR need not necessarily include a longevity component
    - a trustee could determine that, having regard to the demographics and needs of their membership, it would not be in the best interest of their members to offer a CIPR with a longevity component
    - there is a need to recognise that at present the market is immature with respect to the provision of post-retirement products that protect against longevity, inflation, market, sequencing and cognitive risks and which provide income for life. The lack of an appropriate level of competition for the provision of such products can lead to potential counterparty and agency risks.

Potential framework for retirement income streams

- funds which have a MySuper product should consider whether to offer a retirement income stream product
- a CIPR may not necessarily include a longevity component
- for some funds it may not be appropriate to offer a CIPR with a longevity component
- there is a need to recognise the market is immature with respect to longevity products.

2.3. Activities that could improve income in retirement

- It was observed that there are activities that could improve income in retirement, other than offering longevity risk products, including:
    - providing projections of income on member statements, to start effecting the shift in thinking from 'accumulation of a lump sum' to 'entitlement to an income stream'
    - improving financial literacy and educating Australians about superannuation, including the benefits of compounding returns and other benefits with respect to investing for retirement. This could extend to inclusion in school curriculums, with reinforcement in senior school as young Australians enter the workforce for the first time and receive contributions to superannuation
    - improving the provision of information and advice to members, especially in the form of projections, guidance and information as to their level of superannuation as compared against default or selected benchmarks, as an engagement strategy
    - provide more guidance and advice at the time of, and after, retirement, including how to manage the various investment risks and how to invest, and drawdown, appropriately through retirement.

Activities that could improve income in retirement

There are activities that could improve income in retirement, including

- providing projections of income on member statements
- educating people about superannuation, commencing at school; and
- improving the provision of advice to members.

2.4. <u>CIPRs – 'Opt-in' to acquire a CIPR</u>

- Set against the background of an 'accumulation / lump sum' paradigm, the success of a CIPR regime will be a function of the level of member take-up / acquisition of CIPRs.

2.4.1. Barriers to acquisition of a CIPR with a longevity component

- Acquisition of a CIPR can be a long-term decision about an uncertain future – in particular life expectancy, health care needs and future expenses, including capital expenses and increases in non-discretionary living expenses. This is especially significant with respect to a CIPR with a longevity component that has to be acquired, thereby reducing capital and restricting or denying members' access to capital should a life event require capital expenditure beyond the means available to them.

- Members have a legitimate and well-founded desire to retain access to capital – especially to cater for a circumstance where there is a need to access residential aged care or pay for the costs of medical care. Added to this is interest rate risk with respect to the annuity rate at time of purchase, counter-party and agency risk, the need to provide for a surviving spouse's income requirements, and a desire to leave a bequest (especially if a member were to die prior to life expectancy). In addition, many retirees seek an element of flexibility, control and access over their retirement savings, including how they are invested, at least in the earlier stages of their retirement.

Barriers to acquisition of CIPRs – in particular the desire for access to capital
In designing a retirement income stream framework and forecasting the likely rate of uptake by members of CIPRs with a longevity component, regard will need to be had to the barriers to acquisition – in particular members' desire to retain access to capital.

2.4.2. Consequences of likely low take up rates

- Given the above there is a likelihood that member take up of CIPRs with a mandated longevity component may be low, at least initially. As a result, creating and offering CIPRs that require sacrificing some access to capital in exchange for longevity protection may not be cost effective / efficient and presents a significant risk that 'legacy' products will be created.

- Legacy products pose considerable difficulty for trustees to deal with in fund mergers (and for product providers in mergers and acquisitions) and, accordingly, there is potential for CIPRs to create barriers to exit and thereby introduce further structural inefficiencies at a system level.

Consequences of low take up rates
If the likely take up rate of CIPRs with a longevity component is low
- offering CIPRs that require sacrificing some access to capital in exchange for longevity protection may not be cost effective/efficient
- there is a significant risk of 'legacy' product proliferation; and
- as legacy products pose considerable difficulty for trustees to deal with in fund mergers, there is potential for CIPRs to create barriers to exit and introduce further structural inefficiencies.

2.4.3. Need for incentives to acquire a CIPR with a longevity component

- Given the desire to retain access to capital, there may be a need to offer some form of incentive or inducement to members to select a CIPR with a longevity component.

- Such an incentive could take the form of concessional assessment under the Age Pension asset and income tests or reduced rates of deeming applied to expected returns.

- It has been observed that uncertainty around the CIPRs framework, the DSS's current and proposed assessment of retirement income stream products and the public's general lack of appetite for longevity products have contributed to a relative lack of innovation with respect to the development of retirement income stream products by funds and other stakeholders, especially those with a longevity component. ASFA made a submission to the Department of Social Services (DSS) on the Means Test Rules for Lifetime Retirement Income Streams in February 2018 that identifies some issues with the proposed DSS treatment.

https://www.superannuation.asn.au/ArticleDocuments/711/201805_DSS_Longevity_Products.pdf.aspx?Embed=Y

> **Need for incentive – social security treatment of income streams for assets test**
> The rate of take up by members may be enhanced by a more favourable social security treatment for a retirement income stream with a longevity component than that currently being considered by the DSS.

2.5. CIPRs – some of the issues in the Treasury's December 2016 Discussion Paper

2.5.1. Designing a 'mass-customised' CIPR

- It has proven to be possible and desirable to 'mass customise' a MySuper product in the accumulation phase as the desired outcome is simply to maximise the members' accumulated account balance, through managing the risk adjusted returns credited to accounts and the fees/premiums deducted from accounts.

- This is in complete contrast, however, with the retirement phase, where the objectives, financial circumstances and needs of individuals, in terms of their retirement income, are quite distinct and varied.

- Factors which should be taken into consideration when determining the nature, composition and amount of an appropriate retirement income stream for a member include the member's
    - age
    - gender
    - life expectancy
    - health
    - existence and nature of family relationships
    - risk tolerance
    - goals and objectives - what does a 'successful retirement' look like for them
    - total amount of superannuation
    - non superannuation assets and income, including potential inheritances
    - current and likely future expenses and liabilities, including potential need for residential aged care and any outstanding mortgage amounts.

- While trustees are able to access data about members with respect to their superannuation account within their fund - such as the member's age, gender, nominated beneficiary, account balance, investment and insurance history and approximate salary (based on SG contributions to the fund) - they do not have information with respect to the other matters germane to undertaking informed retirement planning and execution. This includes the member's life expectancy, health (except to extent a claim for a disability benefit has been made), risk tolerance, goals and objectives, superannuation in other funds, non superannuation assets and income, and current and future expenses and liabilities.

Significant difficulties in designing a 'mass-customised' CIPR
There are significant practical difficulties in both designing and distributing a 'mass – customised' CIPR. While trustees are able to access data about members with respect to their superannuation account within their fund they do not have information with respect to matters such as the member's life expectancy, health, risk tolerance, superannuation in other funds, non superannuation assets and income, and current and future expenses and liabilities.

2.5.2. One CIPR or multiple CIPRs

- One question is whether funds will be able to offer more than one CIPR, with different CIPRs being able to be offered to different cohorts / segments of the fund membership.

- Given the issues outlined above, if trustees are to offer, or be required to offer, a CIPR it is imperative that:
  - trustees be able to offer more than one CIPR, with different CIPRs being offered to different cohorts / segments; and
  - members must be able to 'dial-up' and 'dial down' the various components, including to zero, to suit their needs.

- In retirement, one size most definitely does not fit all.

Multiple CIPRs / Dial up and dial down
If trustees are to offer a CIPR it is imperative that
- trustees be able to offer more than one CIPR, and
- members must be able to 'dial-up' and 'dial down' the various components.

Distributing a 'mass –customised' CIPR – 'nudge' and 'soft default'

- Predicated on the basis that acquisition of a CIPRS will be on an 'opt-in' basis, if trustees are to 'nudge' / 'soft default' members into a mass-customised CIPR:
  - the concept of a 'nudge' / 'soft default' (as opposed to merely 'offering') will need to be defined
  - there will need to be clarification as to who should, and should not be, 'nudged into' a CIPR
  - the interaction / interplay between a 'nudge' / 'soft default' and the provision of personal financial advice any 'design and distribution' obligations that may be legislated will need to be determined
  - there will be a need for a 'safe harbour' to protect trustees from liability arising from an inappropriate 'nudge' / 'soft default', as a result of 'mass customisation' and there being insufficient information about the member.

- Given the potential difficulties in attempting to distinguish between an offer and a nudge/soft default, and with how a nudge/soft default may interact with the provision of personal financial advice and future design and distribution obligations, there is a question as to the appropriateness of any concept of nudge/soft default. Any nudge/soft default carries with it a considerable risk

- of implying that the trustee has made an assessment of the member's needs and objectives, based on incomplete information
- that the nudge/soft default is perceived as being advice from the trustee
- that the offer is not suitable for the member's circumstances.

Distributing a CIPR – 'nudge' and 'soft default'

If trustees are to 'nudge' / 'soft default' members into a CIPR there will be a need to

- define what these concepts mean
- clarify who should, and should not, be 'nudged into' a CIPR
- determine the interaction / interplay between a 'nudge' / 'soft default' and
    * the provision of personal financial advice
    * any 'design and distribution' obligations that may be legislated
- provide a 'safe harbour' defence to protect trustees from liability.

Given the potential difficulties with the concept of a nudge/soft default, there is a question as to the appropriateness of introducing such a concept.