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the voice of super

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Manager, CIPRs
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The Treasury
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via email: superannuation@treasury.gov.au

18 June 2018

Dear Sir \ Madam,

Retirement Income Covenant Position Paper
Stage one of the Retirement Income Framework

The Association of Superannuation Funds of Australia (ASFA) would like to lodge this submission in response to the consultation on the *Retirement Income Covenant Position Paper* (Position Paper).

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.

A. General comments

We make the following general observations about the Position Paper.

1. Retirement covenant

ASFA supports funds a retirement covenant being inserted into the *Superannuation Industry (Supervision) Act 1993* (SIS Act). Any such covenant should be principles-based and not prescriptive.

ASFA agrees with the need for trustees to develop a retirement income strategy and framework for their fund.

2. Comprehensive Income Products in Retirement (CIPR)

ASFA does not support compulsion for trustees to develop and offer a CIPR that contains a longevity component.

Given that CIPRs will be 'opt-in' for individuals, we do not believe there will be sufficient member demand to make offering a CIPR with a longevity component a cost effective, viable option for many superannuation funds.

ASFA believes there are considerable risks in mandating the development and wide-spreading offering of a 'mass-customised' CIPR product:

- a CIPR may not be appropriate for a large portion of members, and so the trustee would not be acting in the best interests of those members to offer it to them
- allowing three CIPRs may not be sufficient to mitigate the risk that a product is not suitable for a number of members
- the likely low, at least initially, demand will result in products that are not cost effective to operate, and that ultimately will become legacy products.

3. Productivity Commission's Draft Report - Draft Finding 4.4 should be noted

The Productivity Commission, in its draft report *Superannuation: Assessing Efficiency and Competitiveness*, *April 2018*, made the following draft finding: -

> 'DRAFT FINDING 4.4
> *A 'MyRetirement' default is not warranted. The diversity in household preferences, incomes, and other assets when approaching, and in, retirement means there is no single retirement product that can meet members' needs. The most important task remaining is to improve the quality of financial advice to guide members among the various complex products, especially where members may decide to make the mostly irreversible decision to take up a longevity (risk pooled) income product'.*[1]

ASFA agrees with the Productivity Commission's findings with respect to this.

As we stated in our submission to Treasury on the December 2016 Discussion Paper:

> *'The Discussion Paper appears to be taking the approach whereby the CIPRs framework effectively will 'mirror' (in reverse) the MySuper framework.*
>
> *There are, however, three material differences, which render this premise questionable and lead to some anomalous outcomes:*
> 1. *the accumulation phase is materially differ to the retirement phase*
>   - *in the accumulation phase there is a common objective of maximising savings for a reasonable/appropriate level of risk;*
>   - *in retirement*
>   - *the circumstances, needs and objectives of individuals, which determine drawdown needs, will vary greatly*
>   - *the effect of drawdowns is substantially different from that of contributions;*
>   - *there is a greater range, and uncertainty, regarding the likely time periods over which drawdowns will occur*
> 2. *unlike MySuper - where the consequences of being in an unsuitable product are reduced net returns, which can be remediated by rolling-over to another product - the consequence of being in an unsuitable CIPR can include the loss of access to capital / reduced death benefits and may be difficult, or impossible, to remediate*
> 3. *unlike MySuper, CIPR products will be an 'opt-in' regime, where members apply for a product, as opposed to a 'default' regime'.*[2]

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[1] Productivity Commission, *Draft Report, Superannuation: Assessing Efficiency and Competitiveness*, *April 2018*, Page 207 (word version)

[2] ASFA, Submission to Treasury re Consultation on the *Discussion Paper: Development of the framework for Comprehensive Income Products for Retirement*, 7 July 2017, Page 5

4. Transformation to products with a longevity component is a medium to long term proposition

As the development of a CIPR with a longevity component reflects a demand driven strategy, it will need to allow sufficient time to effect a paradigm shift, possibly necessitating a generational change, away from the current consumer thinking about accumulating a lump sum towards thinking in terms of purchasing an income stream with a longevity component. There is likely to be subdued demand until such time as the system is fully mature, with retirees who have accumulated benefits over a full working life.

CIPRs should be solving for the retirement income needs of members who will have been in the superannuation system for their whole working life, i.e. those retiring in 20 years when the system has matured, rather than in the next 10 years when average superannuation balances will still not provide sufficient income to substitute for the age pension. It may be difficult to suggest a CIPR is in a member's best interest if they could become entitled to a full age pension at some point during their retirement, which would provide sufficient longevity protection.

5. In short term, emphasis should be on 'strategy' not 'product'

Until such time as a paradigm shift towards income streams with a longevity component largely has been effected there is likely to be subdued demand for a product with a longevity component. Accordingly, we believe that, in the short-term, the focus should be on trustees developing a retirement income strategy and framework for their fund and supporting their members to develop a personal retirement income strategy suited to their circumstances, needs and objectives, that may include the acquisition of one or more products with a longevity component.

6. Considerable risk with the mass customisation of a CIPR with a longevity component

As we stated in our submission on the December 2016 Discussion Paper, there is significant concern about the concept of one or more 'mass-customised' products in retirement phase.

As we stated in our submission on the Discussion Paper:

> *'In the accumulation phase the target is to maximise returns for a level of risk reasonably appropriate for the members.*
>
> *By way of contrast, in retirement*
> - *the circumstances and objectives of individuals, which will determine drawdown needs, will vary greatly*
> - *the effect of drawdowns is different to that of contributions*
> - *there is a greater range and uncertainty over likely time periods over which drawdown will occur.*
>
> *Accordingly, in retirement, every member's financial circumstances, needs and objectives will vary significantly. Furthermore – and importantly - these largely will be unknown to the provider.*
>
> *Providers will face considerable difficulty in designing an appropriate single, 'mass customised', retirement product – especially given restrictions on access to capital – that will meet the proposed Australian Government Actuary income efficiency tests and be suitable for their members.*

It is unclear how a provider could determine that a CIPR would be appropriate for most members, in particular where there are a number of significant – unknown – personal circumstances which affect this, including assets/income; debts/liabilities; health and family longevity; social security entitlements and dependants.

- *Design – we query whether it will be possible for a trustee to 'mass customise' an appropriate income stream product without knowledge of their members' financial and personal circumstances? In retirement - by way of contrast to accumulation - one size most definitely does not fit all.*
- *Distribution – we query whether it is possible for a trustee to 'nudge' certain members into a 'mass customised' retirement income stream product without knowledge of those members' financial and personal circumstances'.*[3]

7. 'Design and Distribution Obligations' regime a prerequisite to CIPRs regime

A prerequisite to the introduction of a CIPRs regime should be the development and implementation of the 'Design and Distribution Obligations' regime. A CIPRs product arguably will be one of the most complex financial products offered to members; significant sums of (mandated) superannuation guarantee benefits potentially will be invested in them and the consequences of a member ending up in an inappropriate CIPR could be quite severe, including an inability to exit the longevity component of the CIPR.

Accordingly, it is imperative that the 'design and distribution' obligations are clarified, designed and implemented prior to the introduction of the CIPRs regime.

8. 'Safe harbour' defence

The need for 'safe harbour' defence reveals a concern that a CIPR may not be suitable/appropriate for some members, may not meet their expectations or may even fail, thereby giving rise to potential liability on the part of the trustee. A number of member funds have expressed their concern that there is a considerable risk that many members may accept the offer of a CIPR, simply on the basis that they trust the trustee/fund, without assessing whether it is suitable for them or fully understanding how the CIPR works. Some time later they may find it is not appropriate for their needs but they are unable to withdraw from the longevity component. Providing a 'safe harbour' defence to trustees, while helpful, does not assist affected members whose expectations have not been met and, as a consequence, have lost trust in the trustee and in the superannuation system.

9. Clarity around what it means to 'offer' a CIPR

It is necessary to provide clarity – both as a matter of law and of practice – as to what precisely it means to 'offer' a CIPR to a particular member or cohort of members. Will it be sufficient simply to have a CIPR available on a website or does the act of 'offering' necessitate a more proactive step, such as sending an email to a member?

It could be argued that, as a matter of law, it would be legally more accurate for the act of making a CIPR available, through the provision of a Product Disclosure Statement (PDS) or otherwise, should be categorised as an 'invitation to treat', not an 'offer'. The member, in making an application for the CIPRs, would be making an offer to acquire the product that, in issuing the product, the trustee would be accepting.

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[3] ASFA, *Submission on the Discussion Paper*, Op cit, Page 7

10. Advice is key

Advice will be key to member outcomes, including mitigating the risk of members ending up in a CIPR that is not appropriate for their circumstances, needs and objectives.

Accordingly, it will be critical for government to address issues with respect to the definition of personal financial advice, including evaluating the possibility of modifying the advice rules, whether amendments would be effective in striking the right balance between protecting consumers and facilitating trustees being able to give appropriate advice in the context of designing and distributing CIPRs.

As funds are expected to offer a 'mass-customised' CIPRs with a longevity component to large tranches of their membership, the effective provision of advice to members on CIPRs will be crucial.

11. Risk of legacy products

At a time when the industry is being encouraged to consolidate funds, there is considerable risk that

- in the short term – funds will be forced to develop CIPR products for which there is likely to be little demand, and so will not be cost effective
- in the medium term – this will result in a proliferation of legacy products.

12. Income projections

While facilitating trustees to provide retirement income projections during accumulation phase would be worthwhile and could prove useful for members, it would be worth exploring the feasibility of the ATO performing the function of providing retirement income projections, given it holds all of the superannuation account data for all individuals, as well as their income/assets and personal circumstances.

B. Specific comments on the supporting principles

We make the following observations about some of the supporting principles and other issues contained in the Position Paper.

1. Retirement covenant

It is proposed to legislate the covenant by 1 July 2019 and delay commencement until 1 July 2020. We submit that it is important that Trustees should have until

- 1 July 2020 - to determine their retirement income strategy; and
- 1 July 2022 - to implement the strategy, given the complexity involved in designing and giving effect to the strategy.

It is essential that the final phase of the retirement income regulatory framework is fully developed and that the details of all of the elements of the regulatory framework, including the safe harbour, an approach for managing legacy products and the certification requirements, are finalised prior to the covenant being inserted into the SIS Act.

Member funds have identified that the factors listed are too prescriptive and that ideally the retirement income covenant should be principles-based in line with the existing covenants in the SIS Act.

In particular, the word 'preferences' should be removed from the fifth factor and the last two factors should be redrafted to better reflect the underlying intention, that a strategy can be designed to address these factors structurally.

2. Possible prescription of minimum account balance (e.g. $50,000)

We have concerns about the suggestion of prescription of a minimum account balance, above which the trust should be 'offering' a CIPR. We believe this is a matter, which should be left to the trustee to determine, as a function of designing a CIPR and determining to whom it should be offered.

If an amount is to be prescribed, in a regime that may compel a trustee to offer a CIPR, we are concerned that $50,000 is too low an account balance for a product with a longevity component. We submit that, instead, it may be appropriate to cross-refer to an external, related, objective amount, such as the age pension asset test threshold for a single home-owner ($258,500), or even that for a single, non home-owner ($465,500).

3. 'Expected income broadly constant'

Utilising nominal income may be inappropriate over the medium to long term unless allowance is made for an increasing age pension.

There may also be issues where actual income does not match expected income in a longevity pool where not only are the investment returns variable but so are the mortality credits, especially in a circumstance where there was a significant medical breakthrough with resultant material improvements in morbidity and life expectancy.

The Position Paper states that a small 'expected' buffer is permissible, with an example provided of +/- 2.5% of real or nominal income in the first year. The paper recognises that, in practice, actual income may not be broadly constant due to variations in investment returns and longevity outcomes.

Member funds have advised that the range of variability of income needs to be broader than 2.5% of income in the first year - given the factors involved, it is not realistic/feasible for the range to be set this narrowly. While there is no requirement to provide either a full or partial guarantee of income payments, it may well be the case that this may create a consumer expectation that their level of income will be constant over the years, notwithstanding that the likelihood of variability has been disclosed and explained to them. This is not a desirable outcome.

To achieve a broadly constant income for life, the trustee will need to determine not only the split between the product component but also the drawdown rates, and potentially even conflict with minimum drawdown rates, in order to meet this requirement. This means that the member will not be free to choose their income drawdown from the account based component of the CIPR, and potentially restrict their access to capital, which would make the CIPR less attractive.

The trustee will be required, at the time of offer, after considering average investment returns and longevity outcomes, to inform the member of the annual income payable from the CIPR. Given the variability of investment returns and longevity, over a long time horizon, let alone the possibility of disruptive event, such as the Global Financial Crisis or a significant medical breakthrough, this is not only onerous but may cause trustees to be overly conservative.

The trustee can also choose to incorporate any age pension income when determining the 'broadly constant income'. Given the member's entitlement to the age pension may change over time, and indeed the age pension itself may alter, member funds have indicated that this could prove difficult over the medium to long term.

Some member funds have advocated that the level of income a CIPR is expected to deliver (on a real or nominal basis) should not be prescribed but should be left to the discretion of the trustees based on the known preferences of the majority of their members.

4. 'Income for life'

We would advocate against the use of the terminology 'income for life' as it may serve to create an expectation among consumers of a 'constant' income for life, even if the potential degree of variability in income is disclosed to consumers. This is especially the case when coupled with the concept of 'broadly constant income' above.

It would be preferable to refer to the concept of longevity risk management, such as referring to managing the risk of living longer. A consumer, on being advised they were to receive 'income for life', is likely to assume that the level of income will be constant, even where that is not the case.

Future developments in medical science and technology could result in significant improvements in life expectancy, which could affect the design, pricing, and ultimately the viability, of the longevity component of CIPRs. To mitigate this risk, consideration could be given to allowing a maximum age/life expectancy to be applied to the longevity component.

5. Some flexibility – access to capital

Frequently access to capital is required later in life - in particular to pay for residential aged care or other major capital expenditure such as home maintenance or a significant health cost. This may be put at risk if there is an expectation by government that, in designing a CIPR, by the later stage of life a member's account based income stream will be exhausted and the member will be in receipt of a longevity product only which, at that stage, is likely not to allow access to much capital, if any.

Member funds have indicated that, to the extent members are able to draw down at a higher rate or to access capital, the broadly constant income for life objective will not be achieved. The only way to achieve this will be to:

- limit drawdowns to a set rate each year, denying the member the choice to draw down at a higher rate; and
- severely limit, or even prevent, access to capital.

Trustees may adopt a very conservative investment strategy, to minimise the risk of capital losses, and offer an income either at the minimum drawdown rate, or at a rate even lower than the minimum. This will produce an outcome that conflicts with the assertion that CIPRs will provide a 'higher level of income' for retirees who make no decision.

Member funds have raised concerns that flexibility will be reduced to such an extent that a CIPR is unlikely to be attractive to many members. From a consumer's perspective, member funds are concerned there will be little consumer demand for a product that provides little or no flexibility in income, limited or no access to capital and, other than a DLA/annuity, no guaranteed income. This is especially the case with respect to full age pensioners who, given they can have an account based income stream and lifetime income from the age pension, are not likely to consider acquiring a CIPR.

6. Offering a 'flagship CIPR'

There is a lack of clarity as to what precisely what it means to 'offer a CIPR at retirement' – both in practice and as a matter of law.

The Position Paper suggests that the member's account balance could be used as a 'proxy' as to whether a person may be eligible for the age pension, however, there are a number of (unknown) factors that will affect eligibility, including marital status, whether they own a home and their assets/income outside superannuation. Furthermore, age pension eligibility can change over time as asset/income levels increase or decrease (e.g. the member receives an inheritance or downsizes and has a surplus) or in the event of the death of a member/spouse or a separation/divorce.

It is also unclear, with respect to the three flagship CIPRs, whether a member's account balance can be the only criteria used for distinguishing between the different CIPRs. Member funds have suggested that a trustee should be able to offer CIPRs based on a broader range of factors including a member's gender.

Furthermore, the example indicates an adjustment based on the member's age, but it is unclear as to whether this remains a CIPR in these circumstances where the allocation is changed. The example also states that a CIPR can be modified based on characteristics that affect life expectancy by adjusting price but not other characteristics, such as investment allocation/deferral period, yet in the example both the allocation and deferral period of the product offered to Felicity have been adjusted.

Member funds have indicated that the requirement to offer a CIPR as the 'starting point' implies that the CIPR is in the best interest of the member or is more suitable than other products. In the absence of personal financial advice, however, the trustee has no knowledge of the member's circumstances and has no basis for offering the CIPR as the 'starting point' over other, potentially more suitable, retirement income products.

With respect to members who enter retirement as full age pensioners, or who are likely to receive the full age pension from some point in their retirement, trustees may struggle to ensure that the offer of a CIPR is in the best interests of those members, especially where access to capital is likely to be a priority for them.

Member funds have raised concerns that, even where trustees have provided education and general advice about CIPRs, there would be considerable risk in allowing the average member, without the requisite financial capability, to make such a critical decision, which effectively locks away a portion of their money, without receiving personal financial advice about the suitability of the product. Consumers may end up in a CIPR that they do not fully understand and by the time they realise that they are stuck in a CIPR with no ability to exit, increase their income or access their capital it is too late.

7. Offering an alternative retirement income product through advice to a member or a cohort of members

It is not realistic to offer advice to a cohort of members. While the concept of a cohort is appropriate when designing a product, advice is based on an individual's circumstances, need and objectives.

Finally, while it is appropriate to impose on a financial adviser an obligation to ensure that a retirement income product is in the best interests of the member, it is not appropriate to impose this obligation on trustees that have made the CIPR available. While all care, skill and diligence may have been applied in the design of the CIPR, it is impossible for a trustee to determine whether acquiring the CIPR would be in the best interest of a member without undergoing a process akin to providing personal financial advice, including determining the member's circumstances, needs and objectives.

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Should you have any queries or wish to discuss any aspect, please do not hesitate to contact me on (03) 9225 – 4021, 0431 490 240 or via fgalbraith@superannuation.asn.au.

Yours sincerely

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