UniSuper

31 March 2014

Financial System Inquiry
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Dear Sir or Madam

UniSuper submission to Financial System Inquiry in issues raised by the terms of reference

On behalf of the Management of UniSuper, I'm pleased to present this submission in response to the issues raised by the Inquiry's terms of reference.

The submission focusses on the need for consideration of new retirement income products to address the needs of an ageing population. We strongly encourage the Inquiry to give due consideration to making recommendations that offer funds more flexibility to develop new products, such as deferred annuities and collective defined contribution (CDC) schemes.

The submission also highlights UniSuper's role as major investor in infrastructure, and our thoughts on the best way to encourage, but not compel, funds to take long-term stakes in the nation's key infrastructure projects.

We would be happy to expand upon any of the comments made in our submission or to answer any questions you may have. Please contact Benedict Davies, National Technical Adviser, on 03 9910 6670 or benedict.davies@unisuper.com.au should you wish to discuss our submission further.

Yours faithfully

Kevin O'Sullivan

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Positioning the financial system to meet Australia's evolving needs: the need for new retirement income products

Financial System Inquiry

Submission by UniSuper – 31 March 2014

About UniSuper

UniSuper is the superannuation fund dedicated to people working in Australia's higher education and research sectors. With more than 440,000 members and $40.0 billion funds under management (as at December 2013), UniSuper is one of Australia's largest superannuation funds and has one of the very few open defined benefit schemes.

UniSuper is delighted to participate in the Financial System Inquiry, and is pleased to provide this initial submission on the issues raised in the terms of reference. This submission has been prepared by UniSuper Management Pty Ltd (ABN 91 006 961 799), which acts as the administrator of the Trustee, UniSuper Limited (ABN 54 006 027 121).

UniSuper Management Pty Ltd would welcome the opportunity to discuss the submission further and to provide additional information in respect of the comments made in this submission. Should you have further queries, please contact Benedict Davies, National Technical Adviser on (03) 9910 6670 or benedict.davies@unisuper.com.au or Luke Barrett, Head of Investment Law and Compliance on (03) 9910 6145 or luke.barrett@unisuper.com.au.

Initial comments

UniSuper recognises that an efficient, competitive and flexible financial system is important to support Australia's economic growth. We also recognise that the users of financial products – in our case, the members of our fund – require financial stability, prudence and confidence in the system. But most importantly of all, we submit that super fund members require one fundamental thing: a financial system and products that deliver adequate income in retirement.

Over the past few years, there has been a significant amount of industry consultation. The reviews into the tax system (Henry), pensions (Harmer) and superannuation (Cooper) all contain recommendations and acknowledgement of the need for post-retirement products. But as an industry, we are still awaiting one thing: more flexibility to develop new and innovative retirement income streams to meet the needs of an ageing population.

We submit that that the Inquiry should give due consideration to canvassing new forms of retirement income products in its Interim Report.

UniSuper

Impediments to developing new retirement income products

While the term "retirement income product" is not used in superannuation law, the sole purpose test ensures that one of the core purposes of a regulated super fund is the "provision of benefits for each member of the fund on or after the member's retirement".[i] Benefits on or after retirement most commonly include commencing a pension or purchasing an annuity or making a lump-sum withdrawal. The first two of those benefits are typically identified as post-retirement products; however, since the removal of "compulsory cashing"[ii] rules in 2006, all superannuation holdings serve a post-retirement purpose.

Most people in retirement, however, will have to draw on their superannuation in the form of a regular income stream. The two main retirement income streams, pensions and annuities, are defined in the SIS Regulations. These regulations give effect to how these products operate, stipulating minimum (and sometimes maximum) permissible draw downs, rules for accessing capital, rules for indexing payments and so forth.

Retirement income products, therefore, are equal parts government policy and industry responding to the identified needs of retirees.

While the pensions and annuities regulations are designed to create uniformity, certainty and consumer protection for retirees, there is a strong case to be made that these rules have the potential to stifle product innovation.[iii]

Currently, the most common post-retirement products currently available are:

- Account-based pensions (e.g. allocated, term allocated)
- Annuities (e.g. term, life)
- Defined-benefit pensions (indexed pensions, typically for life)

It is important to remember that retirement income products are not exclusively superannuation products. Many other financial products are also post-retirement products e.g. annuities purchased with non-superannuation monies, pensioner deeming accounts etc.

One of the most significant post-retirement products to emerge in the last few years are reverse mortgages / shared appreciation schemes that "liquidise" the equity in retirees' family homes.

Some retirement income products of the future include:

- Deferred income products, such as deferred annuities purchased at or around retirement that allow retirees to defer receipt of income for 15 to 20 years as a form of longevity insurance (see below).
- Collective risk-pooling arrangements, such as collective defined contribution schemes, which do not necessarily need to be purchased at retirement. They have similarities to deferred annuities but typically have a pay-out at retirement and over retirement. These arrangements remove some of the "age lottery" associated with retirement dates.
- Products to "liquidise" housing wealth.

How retirement income products currently work

Retirement income products are ultimately designed to replace income from employment with income from retirement savings, primarily via a superannuation income stream. A second purpose of post-retirement products is to augment an income with lump-sum withdrawals of capital to fund things such as home improvements or to cover things such as health and aged care costs (e.g. paying an accommodation bond) in later life.

Retirement income products, therefore, are needed to facilitate an orderly drawdown of a person's retirement savings over their remaining lifetime while, if possible, maintaining some access to capital to pay for miscellaneous expenses.

One of the challenges faced by retirees (and those designing post-retirement products) is working out exactly how long retirees have to live. This is essential to planning an orderly decumulation of assets - and the concomitant challenge of drawing against those savings at a sustainable rate. This is something that is almost impossible for an individual to know with any sense of certainty.

What are the costs and risks of retirement income products? Who bears these risks?

Consumers of financial products need to consider a number of risks including legislative, operational investment, market, liquidity and inflation. With post-retirement products, two of the most important risks to consider are longevity risk and sequencing risk.

Major risk number one: Longevity risk

The move away from the pooling of risks, as exists in defined benefit funds and annuities, to account-based pensions has moved more risk to individuals. One significant risk is that retirees outlive their savings. The most commonly used post-retirement product, the account-based pension, requires pensioners to bear the longevity risk. Annuities or defined-benefit pensions, on the other hand, require risk pooling so annuitants / pensioners are able to share those risks with others.

Of course, there are costs associated with pooled products, including the opportunity cost of not having access to capital.[iv]

There is a complex trade off at work here between tying up capital to protect against longevity risk and the opportunity cost of not having access to capital.

The Henry Review made some very interesting observations on this challenge:

> As long as the Age Pension continues to provide a longevity insurance safety net, it is not necessary to impose a requirement that people invest in additional insurance.
>
> A reasonable basis for policy design is the presumption that, having accumulated retirement savings, people are generally in the best position to determine how they use their assets during their retirement. Some people may prefer a higher standard of living at the beginning of their retirement, with high draw-downs from their superannuation during this time, before relying on the Age Pension later in their life. Other people may prefer a stable and secure income over their entire retirement. A voluntary system ensures that both these groups can insure up to the level of income they want over their retirement.
>
> Some submissions suggest that people should be required to use part of their superannuation to purchase longevity insurance. Such a requirement could help to overcome one source of market failure in longevity insurance markets related to access to information. These markets may fail to yield efficient outcomes because a person may have more information on how long they are likely to live than insurers do. This may mean that the only people who purchase these products are those who consider they are likely to live longer than average. Insurers can react to this 'information asymmetry' either by not selling the products or by pricing them at a level that discourages most people from purchasing them. This is one of the reasons for the unpopularity of life annuities.
>
> A mandatory system would remove this market failure by ensuring that the people in the insurance pool reflect the average life expectancy within the community as a whole. This would allow insurers to sell these products at a lower price because the capital of the people who die early in their retirement supports those people who live for longer.[v]

Longevity risk, therefore, we think is an issue for industry to address rather than government. After all, provided that government provides an appropriate safety net in the Age Pension it is really up to industry to develop products to help those with longevity insurance above and beyond that provided by the Age Pension.

Key points

The government's Age Pension provides a safety-net for longevity risk.

Financial products to provide a higher level of protections against longevity risk can be developed by industry with the appropriate policy settings.

Major risk number two: Sequencing risk

A second and possibly more important risk is sequencing risk. This has received little focus in policy discussions to-date and needs to be considered when appraising the policy settings for post-retirement products.

Sequencing risk can be thought of as the "worst returns in the worst order".[vi] For defined contribution-style plans, sequencing risks is heightened by the greater a member's portfolio balance; this risk is typically at its highest as a member approaches retirement and in the early years of retirement i.e. late accumulation and early decumulation. This can be thought of as "portfolio size effect".[vii]

It should be recognised that defined benefit schemes are generally better placed to deal with these risks. That is because the main advantage of a defined benefit scheme is a cost effective smoothing of investment returns, achieved through the collective sharing of risk. This enables members to capture the return premium of investing in growth assets over defensive assets, with limited exposure to the potential detrimental impact of high return volatility on retirement savings.

While, in theory, an individual defined-contribution member can achieve a similar outcome by remaining invested in growth assets long enough, this does not necessarily hold true in the superannuation environment. This is because the very design of defined contribution schemes requires the a balance to be built up slowly over a person's working live and then drawn down in retirement, leading to the critical 15 years window, typically between age 55 and 70, where adverse returns can significantly worsen an individual's retirement outcome.

Key points

Sequencing risk is an underestimated risk in defined contribution-style products.

Defined benefit schemes are generally better placed to deal with sequencing risk.

Can these risks be addressed by Collective defined contribution (CDC) schemes?

UniSuper submits that many of the benefits of defined benefit schemes can equally be applied to accumulation-style settings provided that there is investment pooling and the associated collective sharing of risk. One way to achieve this would be through Collective Defined Contribution (CDC) schemes. CDCs operate overseas and adopt a "bonus" or "with-profits" approach to investment whereby, under actuarial guidance, strong returns from good investment years are held back and then distributed in years of poor returns. This process is called "smoothing". Australian defined benefit schemes have significant experience in this type of long-term investment planning and could easily develop new pooled arrangements to address these post-retirement risks.

Currently, legislation is an impediment to the development of new collective, risk-sharing products.

Collective risk-pooling happens in other countries and new forms of collective risk-pooling are an emerging international trend. UniSuper encourages the Inquiry to give consideration to how the best features of overseas pensions systems in the Netherlands and Canada could be emulated in Australia. A similar exercise has been undertaken by industry and government in the UK[viii] and these ideas are also under discussion in the United States.[ix]

Key points

Collective defined contribution (CDC) schemes can help address both longevity and sequencing risk.

Existing legislation is an impediment to the development of new, collective risk-sharing products.

UniSuper encourages the Inquiry to give consideration to how the best risk-pooling features of overseas pension systems could be emulated.

What can be done now to encourage better take-up of retirement income products in the short and medium-term?

There have been numerous inquiries and reviews over the years that brought to light many interesting suggestions to encourage post-retirement products. These suggestions include both the "carrot and the stick" e.g. mandating some (or all) of a person's retirement savings be taken in the form of lifetime income stream or arguing for increased incentives for lifetime income streams (either tax or social security or both).

All of these suggestions have some validity. However, one of the biggest impediments to a large-scale take up of post-retirement products is the small size of many retirees' account balances.

For those retirement balances of under roughly $150,000, there is little benefit in having account-based pension. Many of these retirees could be equally well served by holding monies in bank accounts or term deposits. For those with lower balances, the tax and social security concessions are reduced by the combination of the Senior Australians Tax Offset (SATO) and income free areas under Social Security rules. These two concessions mean that lower balances are typically neither taxable or Income / Assets tested anyway so a post-retirement product might add little more than increased costs.

Therefore, we submit that helping people to grow their account balances is one of the biggest single things that can be done to encourage the take up of post-retirement products.

There are numerous ways to achieve larger account balances: via compulsion (e.g. 12% superannuation guarantee (SG)), via tax incentives (e.g. increasing tax incentives or things such as refund of contributions for tax for low income earners) and via industry efficiencies that reduce costs and grow balances (e.g. StrongerSuper).

The quantum of contributions to superannuation and how those monies are invested, however, are the two biggest influences on the size of a person's retirement savings.

We think, therefore, that encouraging contributions has the long term effect of encouraging the take up of post-retirement products as retirees will have larger balances and will benefit more from these products.

While there are numerous ways to encourage contributions, the halving of the concessional contributions cap in the 2009 Budget, has resulted in many people questioning the value of contributing to superannuation. We think it is important that policy makers revisit the issue of caps on contributions in light of the fact that over the long term these tax concessions have the benefit of reducing reliance on the Age Pension.

Key points

Helping to grow account balances is one way to encourage the take-up incomes streams.

Contribution caps need to be revisited.

UniSuper offers a full suite of pension products but could offer even more

UniSuper has a long history of providing retirement incomes to its members, and we currently offer a full-suite of pension products currently allowed in law i.e. account-based pensions, defined benefit pensions and a commercial rate indexed pension (effectively a purchased annuity). We are strongly committed to developing new post-retirement products and submit that the Inquiry should give due consideration to giving funds more flexibility to develop new and innovative retirement income products.

Funds need more flexibility to develop new retirement income products

> **Henry Review Recommendation 21**
>
> The government should support the development of a longevity insurance market within the private sector.
>
> The government should issue long-term securities, but only where this is consistent with its fiscal obligations, to help product providers manage the investment risk associated with longevity insurance.
>
> The government should make available the data needed to create and maintain a longevity index that would assist product providers to hedge longevity risk.
>
> *The government should remove the prescriptive rules in the Superannuation Industry (Supervision) Regulations 1994 relating to income streams that restrict product innovation. This should be done in conjunction with the recommendation to have a uniform tax on earnings on all superannuation assets.* (emphasis added)

In traditional consumer goods markets, change comes through a process of entrepreneurial experimentation after a consumer need has been identified and products have been developed that address those needs. Sometimes, these products miss the mark or even fail. The superannuation market, however, is different. While pensions have their origins in widows' mutuals and life insurance companies, the modern superannuation industry has been influenced by a number of factors, including financial innovation driven by industry, industrial negotiations driven by employers and employee representatives and government policy. As such, the normal process of product experimentation and innovation has been less prominent. Government regulation over the past 20 years has had as much, if not more, influence on product design than industry-lead ideas. Thus, Henry's recommendations on removing the prescriptive rules in SIS are a good starting point.

Key points

Funds need more flexibility to develop new retirement income products.

Traditional deferred annuities should be considered an immediate policy priority, although they cannot easily address sequencing risk.

New forms of collective risk pooling, such as Collective Defined Contribution (CDC) schemes should also be considered a priority because they can help address longevity and sequencing risk.

Other impediments to product innovation and acting in the best interests of members

In the previous section, we outlined some of the regulatory constraints which have the effect of impeding the development of innovative pension and longevity products.

More broadly, we have observed a recent trend towards increasingly more prescriptive regulatory requirements and proposals which threaten to impede the products which can be offered by superannuation funds more generally. These potentially jeopardise the ability of superannuation trustees to operate their products and their funds in the best interests of members which, of course, is the fundamental and paramount duty of a trustee. One point of contention is that these recent regulatory developments have been enacted through subordinate requirements which, in the hierarchy of things, are junior to the duty to act in the best interests of members.

For example, the regulator has recently introduced an obligation for superannuation products to be marketed on the basis of 'return targets' which have been defined in a very particular way. A problem arises when superannuation funds are offering products, or wanting to develop products, which are designed to pursue an entirely different kind of investment objective in order to meet the financial needs of particular members. Since disclosure documents must obviously not mislead or deceive members, this creates pressure for superannuation funds to abandon products which are designed to achieve objectives which do not fit what is, on any view, a particularly narrow 'mould'. Under these new regulatory requirements, superannuation products essentially have to pursue an investment objective which is defined by reference to CPI. This does not bode well for the development of products designed with other kinds of investment objectives in mind.

Along similar lines, the regulator now collects increasingly more granular data from the superannuation industry about the investment strategies which have been adopted for each superannuation product. This data has to be provided by populating prescribed templates which have been designed by the regulator. This in itself does not pose any threat to product innovation. The issue arises because there is now also an obligation for investment strategies to be marketed (or disclosed) to members in the same way that the investment strategy data has been provided to the regulator. This creates problems for products which have novel investment strategies which are not capable of being explained using the 'boxes' or terminology which appear in the forms sent to the regulator. Again, this creates pressure for superannuation funds to abandon products or to make substantial changes to their investment strategy, and discourages innovation of new products with novel investment strategies, as a consequence of what essentially began with a data collection form.

As a general proposition, it seems to us that it is essential to the efficient and effective operation of the financial system that regulatory settings are not so prescriptive as to stifle product innovation or to affect the allocation of capital and investment strategies.

For analogous reasons, we – like other parts of the financial system – continue to be concerned by lingering innuendo that superannuation funds should be required to invest some minimum amount in infrastructure or indeed in any other sector – whether that be venture capital or a fledgling local corporate bond market. Our views on this issue are summarised in the following section.

Infrastructure, venture capital and corporate bonds

Under superannuation legislation, common law and APRA's new prudential standards, superannuation funds are required to make investment decisions in the best interests of their members and to formulate investment strategies that take into account all of the relevant circumstances of the fund. Many superannuation funds, including UniSuper, have adopted strategies which provide for investing in infrastructure, corporate bonds, venture capital and other categories of private equity.

Different funds will have determined what constitutes an appropriate appetite for these types of investments, having regard to their particular circumstances – in other words, prudent decisions have been taken as to what level of investments (if any) are in the best interests of their members. Any proposal to prescribe minimum investment levels in infrastructure, venture capital or corporate debt (or indeed in any other sector) would pose a manifest risk to the best interests of members.

If there is a view that some superannuation funds are not sufficiently investing in infrastructure (or other sectors), a better approach would be to investigate why it is that those funds are not investing more.

In the infrastructure context, a so-called Government liquidity facility is sometimes postulated, the idea being to provide comfort to superannuation funds that holding a higher proportion of unlisted assets will not necessarily affect normal operations and transaction processing. For larger funds, we suspect the existence of a Government liquidity facility would be unlikely to result in larger allocations being made to infrastructure investments. Technically, the current superannuation legislation already permits a superannuation fund to borrow in order to continue paying benefits to members. We assume that, like UniSuper, all prudently operated superannuation funds would manage their investments so as to eliminate the likelihood of ever needing to rely on that provision as far as possible. We suspect almost all superannuation funds would similarly want to avoid ever needing to have recourse to a Government liquidity facility and would therefore set limits on illiquid investments to minimise the risk of having to do so (much like they currently do).

With regard to infrastructure investments (especially in the unlisted context), there would be merit in reviewing the approaches adopted by the different State Governments when managing bid processes. In our experience, these are often characterised by lengthy and costly bid phases which have uncertain (and binary) outcomes which, at best, see substantial acquisition costs being incurred (where there is a successful outcome) or, at worst, see substantial costs and loss of internal management time on transactions which are never consummated.

Bidding activity by offshore pension funds and sovereign wealth funds introduces further bidding risk and ultimately affects the potential returns to members of any Australian superannuation funds from these projects.

[i] The policy settings for the post-retirement products should recognise that there is sometimes definitive point at which people retire. Individuals often work in retirement, transitioning between work, self-funded retirement & the Age Pension. Post-retirement products will need to be flexible enough to respond to this.

[ii] If members are no longer required to draw on their balances, funds held in the accumulation phase could also be thought of as a post-retirement product.

[iii] Henry recommendation 21 on Retirement Incomes, for example, argues that prescriptive regulations should be removed because they restrict product innovation.

[iv] This is particularly issue with the current design of aged care funding which envisages a prospective aged care resident liquidating his or her savings to pay an accommodation bond on entry to care.

[v] Australian Government, 'Australia's future tax system: report to the Treasurer: Part two: Detailed Analysis', Chapter A2 Retirement Incomes, pp 121-122, December 2009

[vi] Finsia Research Report, 'Sequencing risk: A key challenge to creating sustainable retirement income', October 2012

[vii] Basu A & Drew M, 'Portfolio size effect in retirement accounts: what does it imply for lifecycle assets allocation funds', *Journal of Portfolio Management*, Volume 35, Number 3, pp 61-72, 2009

[viii] Department for Work & Pensions, 'Reshaping workplace pensions for future generations', November 2013

[ix] Davis R & Madland D, 'American Retirement Savings Could Be Much Better', Centre for American Progress, August 2013