First State Super - Submission

Retirement Income Covenant Position Paper

Stage one of the Retirement Income Framework
May 2018

Consultation announced in the 2018-19 Budget

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1 Introduction

First State Super is one of Australia's largest profit-for-members superannuation funds. The Group, including StatePlus, is responsible for the savings of over 750,000 accumulation members and the pension savings of over 100,000 retirees. As at May 2018, First State Super manages approximately $90 billion in funds, which includes the funds of StatePlus.

We work to achieve a better financial future of our members, the people whose lives are dedicated to helping others – nurses, teachers, emergency services workers and public servants. We are committed to our member community and to the national interest as they are intrinsically linked.

We submit this response to the Treasury's Retirement Income Covenant Position Paper (the Position Paper).

As a preliminary comment, we note that it is proposed to legislate the covenant by 1 July 2019 and delay commencement until 1 July 2020. We consider it essential that "delay commencement until 1 July 2020" means that:

- a Trustee must have their retirement income strategy determined by 1 July 2020; and
- implementation could occur during the two years after 2020, including:
  - choosing or designing the CIPR(s);
  - putting in place the necessary administration infrastructure; and
  - implementing suitable information, education and decision support tools, communications, and advice for members
- this would not prevent early mover implementation.

2 Responses to Covenant Principles

Principle 1. Retirement income strategy

Trustees should assist members to meet their retirement income objectives throughout retirement by developing a retirement income strategy for members

We support this principle, and were one of the advocates of such an approach in our response to the December 2016 discussion paper on Comprehensive Income Products for Retirement (CIPRs).

We note that the Position Paper states that "...the strategy should focus on the collective needs of members..." and refers to a primary focus on "...delivering retirement income solutions that are appropriate for members as a whole or for large cohorts of members." However, we consider that neither members' needs nor retirement income solutions conform to a "one size fits all" method of operation, and that offering a solution for "members as a whole" will prove to be challenging.

We therefore remain convinced of the need for member segmentation based solutions, which may require different products or combinations of products for different segments. We accept that not all funds may be able to provide segmented solutions due to scale or other issues; however, we note that regulations should not constrain a fund from implementing both its best ideas and the solutions that meet members' best interests.

The Position Paper allows for financial advice at different levels. We agree that it will be very important to provide financial information, at-the-relevant-time education, and advice nudges through multiple channels. This support is vital for most retiring members, especially those who may be reluctant to seek and pay for personal advice.

We note the Position Paper included factors that trustees would need to consider when determining their retirement income strategy, and agree with the items set out. We consider that the following factors should be added:

- The demographic groupings and other membership segmentation deemed by the trustee to be relevant;
- The financial literacy, capability, and behavioural biases of members;
- Provision for the appropriate timing, form and cost of information and advice (that is, the Lifetime engagement envisaged under future considerations in the Position Paper should be part of the initial set of covenant principles); and
- The risks of legacy products (that is, the legacy products envisaged under future considerations in the Position Paper should be part of the initial set of covenant principles).

Principle 2. Engagement

Trustees should assist members to meet their retirement income objectives by providing guidance to help members understand and make choices about their retirement income products offered by the fund.

We support this principle in general.

We also believe that considerable consultation will be needed between government and the superannuation industry to determine the most appropriate form of the guidance. Nonetheless, we believe there should be a clear distinction between the provision of advice and the provision of information that could help a member to make a decision themselves. The use of the word "guidance" could blur this distinction. It is in neither trustees' nor members' best interests to have members seeking to reverse a decision based on a view that they were guided into the wrong solution because the trustee ought to have asked for more information in what could turn out to be a sub-optimal advice experience.

For example, CIPRs can be very complex and difficult to communicate. We acknowledge Treasury's intention to allow for simpler communications about the proposed MyRetirement products. We favour relatively simple communication, acknowledging that such information must be correct and not misleading.

Also, we note that the Position Paper foreshadows regulations that "...clarify a limited range of factors that are classified as intra-fund advice." Details of these regulations should be shared as soon as possible. There is a potential risk that the areas of liability for trustees are substantially widened.

Most CIPRs, as envisaged by the Position Paper, will require substantial guidance or information to be given to members as a minimum, and many members will need advice. We consider that it may be difficult to determine the point at which guidance and information become advice, noting Treasury's intention to clarify intra-fund advice. (Through AFSLs with our subsidiaries, we currently provide face to face personal advice, phone based personal advice, as well as intrafund advice.)

In summary, we think that advice will be a core component of successful offering of CIPRs. We expect to see continued introduction of digital advice or guided interactive questionnaires to help as many members as possible make appropriate retirement decisions.

Principle 3. Definition of a Comprehensive Income Product for Retirement

> ***A CIPR is a retirement income product which is designed to provide:***
>
> ***- efficient, broadly constant income, in expectation;***
>
> ***- longevity risk management (income for life); and***
>
> ***- some access to capital.***
>
> ***A 100 per cent allocation to an ABP alone would not meet the definition of a CIPR.***

We agree with the definition of a CIPR.

We are concerned with the statement in the Position Paper that "The method of certifying CIPRs...would be determined at a later date." In previous correspondence with the Australian Government Actuary we found difficulty in meeting the guidelines published during 2017, for a product that we believed met the substance of the requirements for a CIPR. This is a very important issue, and should be resolved as soon as reasonably possible.

We assume that the "broadly constant income" test will be met if applied to the CIPR alone. We note that the Position Paper allows Trustees to choose whether or not to incorporate expected Age Pension income in determining "broadly constant income". We intend to proceed on the basis that the income test could be applied to total retirement income, including income from both the CIPR and Social Security. While income components from an account based pension will reflect market movements, they will also contribute to a total income stream.

There are some implications of CIPRs that should be acknowledged:

a) generally, the benefit payable on death is less than the benefit that would be payable from an Account Based Pension;

b) generally, withdrawal from a CIPR will incur a penalty compared to withdrawal from an Account Based Pension;

c) generally, a CIPR will not be fully portable (rather, we anticipate that the longevity component will be almost impossible to offer as portable at any reasonable cost-benefit to the member);

d) to the extent that a CIPR provides guaranteed protection for the risks of longevity and/or investment return and/or inflation, there is a cost – which is generally not obvious to the consumer – to providing that guarantee.

Collectively these factors mean that the purchase of a CIPR could be viewed as a high regret decision. This could lead to significant complaints from members and distrust of the retirement system as a whole if retirees feel they have been trapped into a poor solution. These implications inform the comments that we make in the next section.

Interactions of Principles 4, 7 and 8

Principle 4. Offering a flagship CIPR

All trustees should offer a flagship CIPR to members at retirement, subject to limited exceptions (see principles 7 and 8).

Principle 7. Offering an alternative retirement income product through advice

Trustees may offer an alternate CIPR or another retirement income product to a particular person or cohort of people through any form of personal financial advice, including scaled personal advice, intra-fund advice, or full financial planning.

Principle 8. Exception for individuals for whom CIPRs are unsuitable

Trustees may choose not to offer a CIPR at all to a particular person if the trustee has reliable information that a CIPR would not suit that person.

Principle 4. Offering a flagship CIPR

The notion of "flagship" is the area of greatest difficulty for us.

In our view, the requirement to offer a flagship CIPR to most members, except for those in very limited circumstances, runs counter to the whole philosophy of developing a suitable retirement income strategy for members:

- Covenant Principle 1 – retirement income strategy – rightly requires the trustee to consider the retirement income needs of the fund's membership and then to determine the appropriate strategy, acting in the best interest of members; which implies identifying segments and solutions to suit their needs.

- However, Covenant Principle 4 – offering a flagship CIPR – constrains the actions of the trustee to a very significant degree. Contrary to usual trust practice, the Trustee's discretion appears to be fettered.

We also note ASIC's recent concepts of aligning good product design with segments' needs.

Trustees of superannuation funds strive to build trust between themselves and their members. This is vital in superannuation, where members' balances are significant for their financial well-being and where the environment is so complex. If a trustee offers a product or solution branded "flagship" and if, in the words of the Position Paper "...it should be clear that the flagship CIPR offering is the starting point for members", then many members will accept the product on the basis of trusting the trustee. Subsequently they may find that it is not a suitable product, and that there are penalties on withdrawal. It will be cold comfort to the trustee that the legislation provides a "Safe Harbour", if the bond of trust has been broken.

The Position Paper states: "Trustees would be required to offer a CIPR to all members at retirement." However, the Trustee may not be in a position to know when a person has retired, except to the degree that, when a person commences an income stream, they inform us that they meet the SIS definition of "retirement". There is not a simple age based trigger.

We observe that "retirement" is an increasingly flexible concept, and that many people have no fixed intention of retiring. Of those who have firm plans, there is a clear trend for people to move gradually into retirement rather than at a particular point in time. Others retire after age sixty-five and a half[1]; that is, after the age when they automatically become eligible for a retirement income stream or Age Pension.

We are curious as to what the term "offer" entails and the implementation implications of that, such as prominence of positioning on website, advice offering, mention by call centres etc. We note there is an implied default here.

Principle 8 Exception for individuals for whom CIPRs are unsuitable

Under **Covenant Principle 8**, the Position Paper indicates that an unsuitable balance for offering a CIPR is less than $50,000. We consider this limit is too low.

Our research indicates the following for people who are fully dependant on the Age Pension (those with assets under $250,000 for singles and $380,000 for couples):

- After taking into account Social Security benefits, an Account Based Pension (with minimum drawdowns) provides a higher expected benefit than a CIPR. These calculations are based on the recently announced Social Security means test treatment for pooled lifetime income products, and assumptions used by the Australian Government Actuary in the position paper "Means Test Rules for Lifetime Retirement Income Streams".

- If these retiree(s) invest in an Account Based Pension, expected Social Security benefits have a greater value than the Account Based pension. That is, more than half of the combined income from Social Security and Account Based Pension is provided by Social Security. This provides longevity, investment and inflation protection. (In this calculation total income is constant in real terms for 25 years.)

[1] Noting the scaled increase in age which requires that currently, people born after 1 July 1952 must be 65 and 6 months to be eligible for the Age Pension; with eligibility age ratcheting up to age 67 from 1 July 2023.

If we were required to offer a CIPR to every member with a balance in excess of $50,000 then our trustee would be placed in an impossible position.

For a member with a balance of say $60,000, our modelling shows that the trustee, acting in the member's best interest would advise the member not to accept the CIPR (see box). However, this would substantively mean that the trustee was not complying with the government's requirements.

A member uses $60,000 to open an account based pension.

The income stream from this account provides 12.5% of the member's total retirement income – the balance of her income is from the Age Pension.

The member's longevity component is the Age Pension.

The example in the Position Paper in Covenant Principle 4 illustrates how complex CIPRs may be. The actual terms of the CIPR could depend upon:

- Age of member
- Gender
- Characteristics that determine likely longevity
- Whether reversionary benefits are payable or not
- The guarantees provided
- The age at which the guaranteed pension commences (for deferred annuities)
- Expected rate of investment return.

This complexity, plus the potential downsides identified in respect of CIPRs, points to the need for financial advice to be provided to members, rather than a CIPR (especially a flagship CIPR) being offered automatically as the primary solution.

Principle 7 Alternative CIPR under advice

Covenant Principle 7 provides that a trustee may offer an alternative CIPR or another retirement income product to a person or cohort, through advice. However, there are challenges with covenant principle 7 in relation to the roles of trustees.

As noted earlier, we hold an Australian Financial Services Licensee (AFSL) for general advice, and our subsidiary StatePlus has substantial capability to deliver full financial advice now and in future. We provide guidance and comprehensive advice face to face, and intrafund advice over the phone.

We would like to see the scope of intra-fund advice relaxed enough to allow for basic 'guided pathways' which would help members to identify their basic needs and point to either further advice or a simple solution; we think this will help us provide better advice, through multiple channels or media, to lower balance members.

While we have capacity and capability to meet a wide range of advice needs, under the current rules many trustees would be limited in their ability to gather sufficient information about a member to confidently advise that an alternative CIPR or retirement income product would be preferable to the flagship CIPR.

Even if the current intra-fund rules are slightly relaxed (as foreshadowed in the Position Paper) it is still very unlikely to give trustees sufficient information to nudge a member into a CIPR. On current rules, we would most likely refer members to our advisers where possible, although we note the challenges of providing advice to large numbers of members at present, let alone with a complex CIPR where we think members need to understand the trade-off decisions.

In theory, any trustee could apply for an AFSL for providing full financial advice. This however raises some issues, as the potential scope of liability of the trustee is materially widened, as is the expertise required.

Substitute for principles 4, 7 and 8

In light of the above, instead of covenant principles 4, 7 and 8, we propose the following:

"All trustees shall consider, in good faith, the merits of offering a CIPR or CIPRs to their membership.

Trustees may offer a CIPR (or CIPRs) to all members, or to cohorts of members. The purpose of the CIPR (or CIPRs) is to provide members with a better starting point at retirement and assist members to achieve their retirement objectives.

Where the trustee chooses not to offer a CIPR (or CIPRs) to all or to a cohort of members, the trustee must document through the Retirement Incomes Strategy why the decision is in the best interest of members.

All trustees shall make a CIPR (or CIPRs) available to their membership."

Principle 5. Third party products

Trustees can fulfil their obligations in part or in full by using a third party.

We agree with this principle.

Principle 6. Consent

Consent should be required for a CIPR to commence.

We agree with this principle. We note that such consent should be captured for evidence that informed consent has been given and that digital / electronic signatures be considered with appropriate consumer protections.

3 Conclusion

First State Super generally supports the Position Paper's intentions of providing for a better retirement outcome for members. However, we observe that there are substantial difficulties with mass-customisation of inherently complex solutions for retirement needs, where individual solutions take over from the default savings regime of superannuation accumulation.

Once individuals start to consume their savings, a wide range of personal needs and decisions come into play. We fully support encouraging individuals to take income streams in preference to lump sum payments. However, we are also aware that there are many competing demands on the family purse, including for example, maintenance of accommodation, health costs, retirement of mortgages, assistance to family members etc. We expect that if funds are required to offer what are effectively "default" CIPR solutions which contain even a degree of inflexibility of capital, there could be a backlash from consumers.

Also, from the perspective of operationalising CIPRs, we request sufficient time to understand impacts on members and the best way to implement CIPRs.

This submission has suggested alternative solutions which we believe would achieve the intent of the Position Paper in a measured manner where all aspects of the superannuation system are considered.

We are happy to discuss this paper with Treasury and to provide further information to help design better solutions for all members.