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To whom it may concern

Retirement Income Covenant Position Paper

Background

This submission is in response to the Department of Treasury's call for submissions regarding the Retirement Income Covenant Paper (the Paper) released by the Government following the 2018-19 Budget.

The Government has announced its intention to introduce a Retirement Income Covenant into *the Superannuation Industry (Supervision) Act 1997* as a first stage to implement its Retirement Income Framework. This framework outlines requirements and obligations for superannuation trustees to improve retirement income outcomes for individuals.

To support the development of this Retirement Income Covenant, the Paper also outlines supporting principles. Most notably, the supporting principles have defined the requirements for a Comprehensive Income Product in Retirement (CIPR).

We are supportive of the Retirement Income Covenant as we believe further development of retirement income strategies will improve retirement income outcomes for fund members. However, we have identified several potential issues with the principles in the Paper primarily relating to structure and implementation of the proposed CIPRs framework. Consequently, we have made suggestions to assist addressing these issues.

Achieving the aims of a CIPR

The prime aim of a CIPR is twofold:

- To enable Australian retirees to increase their standard of living in retirement by increasing their annual income in retirement, and therefore their consumption.
- To maintain income should they be amongst the 50% of retirees who live past their life expectancy at the point of retirement (usually more than 20 years).

These aims can only be achieved together by leaving a lower bequest on death. That would also ensure that the efficiency of the system of superannuation concessions is improved (as the benefit would be used for retirement income and not for estate planning).

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A feature of a CIPR is to pool the mortality of retirees to fund the benefits of those who live beyond life expectancy. In other words, like any insurance pool, those who claim a benefit by living longer are subsidised by those who die earlier (and make no claim).

There are many reasons why CIPRs have not been developed under normal market forces and the Government has been forced to legislate to nudge the system to meet its desired outcome. One of these reasons is the high long-term real rates of return earned under the Australian superannuation system, which has been a result of holding high levels of growth assets, including equities and unlisted assets which generate a further illiquidity risk premium. As a result, retirees investing in products with asset allocations like those held by the large MySuper products can continue to earn real returns through retirement.

In many cases, they can draw down the same income as would be paid on (say) a life annuity, whilst retaining access to most of their capital. Of course, if they draw the minimum required pension payment, they are likely to defer utilising any capital until later life and many will then leave a large portion of their benefit as a bequest on death.

Conversely, guaranteed annuity products and many self-annuitisation products hold low levels of growth assets. Over long periods of time, the mortality pooling is less valuable than the higher returns from a simple account-based pension.

Further, many members approaching retirement have relatively modest retirement benefits, say less than $150,000. Most of their retirement income will be annuitised in the form of the Age Pension. It makes sense for retirees in this position, and for many with larger benefits, to maintain a small cash reserve for pension payments and emergencies and to invest in a balanced fund.

Consequently, longevity products have had low take-up rates and are not currently considered to be viable by most superannuation funds. Modelling included in this submission shows that emphasising the provision of income for life through longevity products sacrifices returns over a member's retirement.

If the aim of the CIPRs framework is to increase income of retirees throughout their life and reduce the bequest they leave, there are ways to do this without necessarily precluding most (or even all) assets being invested in growth-orientated strategies via an account-based pension at various stages of retirement. We have given an example of this in Appendix A (Comparison of retirement income product outcomes) to this submission and suggest that the CIPR rules might be modified to be guidelines in some cases.

Our key insights are outlined below and detailed views, issues and further questions regarding each section of the Paper are covered in the remainder of this submission.

Appendix A (Comparison of retirement income product outcomes) to this submission also outlines a number of products that would achieve the same objectives as a CIPR. We seek clarification as to whether these products could constitute a CIPR in the current framework. Modelling is included in this section to illustrate the retirement income outcomes provided by these products.

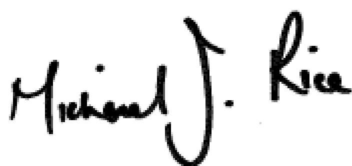
Key insights and recommendations

- We are supportive of the proposal requiring trustees to develop retirement income strategies for retirees.
- If trustees are required to offer a CIPR product, we believe a modest level of compulsion to purchase would be required for CIPRs to succeed. The product could be offered as part of a superannuation fund's default retirement product. If this is not the case, we expect the level of adoption by members will continue to be low.

- Given the complex nature of people's personal financial circumstances, financial advice will need to be provided to offer a CIPR product under the proposed framework. This will likely make these products relatively more expensive which will reduce the take-up of these products.
- Regulations to support the Retirement Income Covenant should require APRA to assess trustee's retirement income strategies at a defined interval (perhaps every five years).
- Our main issues with the proposed CIPRs framework are:
  - Trustees should not have to offer a CIPR product if there is no compulsion for the member to take it up.
  - The proposed framework should allow for flexibility in the product design and types of products that provide longevity protection (for example, not every retiree will want constant income throughout retirement).
  - The proposed design and provision of CIPR products does not adequately consider the personal and financial circumstances of members.
  - The proposed definition of when funds would be required to provide financial advice when offering a CIPR is unclear and may be problematic to implement. The legislation could allow funds to assist members with their decisions with regards to CIPRs through the intra-fund advice channel. This would require a broadening of the intra-fund advice parameters to allow the fund to deliver the advice cost-effectively.
  - The relatively short deadline for implementation will likely result in limited product innovation and limited opportunity for additional competition from new entrants.
- To allow sufficient time to resolve these issues, the Government should consider delaying the implementation of CIPRs, at least until the design and distribution obligations for financial products have been determined.

We hope you find this information useful as part of the policy development process. We are also happy to meet to discuss issues raised in this submission.

Yours sincerely



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Retirement Income Covenant Principles

Retirement Income Strategy

Under the proposed Retirement Income Covenant, trustees would be required to develop, review and regularly give effect to a Retirement Income Strategy to assist members.

We are supportive of this proposal. As the superannuation system continues to mature and a higher proportion of people move into the retirement phase, many funds will need to increase their focus on retirement income strategies and retirement income products to improve outcomes for members.

Regulations that support the proposed Retirement Income Covenant should ensure that APRA is required to assess the Retirement Income Strategies of funds at specific intervals (for example, every five years).

However, the Paper notes that a Retirement Income Strategy should focus primarily on delivering retirement income solutions that are appropriate for all members, or for large cohorts of members. In practice, a superannuation fund can only develop such a structure by making broad assumptions as to the needs of its membership. The fund will not obtain sufficient details of its members without undertaking comprehensive advice which considers other assets held outside superannuation as well as the financial position of any partners.

In addition to these concerns, we note that the Government is currently implementing the proposed design and distribution obligations for financial products, and we believe it would be prudent to resolve the final design of the CIPR framework once these have been settled. In the short term, the emphasis should be on implementation of retirement income strategies, and not on product development.

If take-up of CIPRs is to be optional for members, then there is a danger of setting up many sub-scale products. Consequently, funds should not be compelled to provide a CIPR unless it is part of their default retirement strategy (which funds would need to develop). We believe funds should provide a CIPR and then let members make their own decision as to its suitability for them. This will ensure that there are sufficient members to provide a sound statistical base for mortality pooling. It will also ensure that a market for CIPRs grows, and that members who do not like the product (perhaps based on financial advice) will have the freedom to opt out.

We would also question why those in SMSF's will be required to have a Retirement Income Strategy but will not be required to consider a CIPR product. If (for example) this exclusion is due to the relatively high balances of those in an SMSF then we would suggest that a similar exclusion be provided to those with similarly high balances in APRA regulated funds. This exclusion of SMSFs could potentially result in increased movements of members to SMSFs even if these products are not considered suitable, if some level of (unpopular) compulsion to purchase were applied to CIPR products in future.

Engagement

Trustees will be required to assist members meet their objectives by providing guidance or intra-fund advice tools to help members understand and make choices about retirement income products offered by the fund. We are supportive of increased member engagement to assist members to better understand how they can meet their financial goals in retirement.

However, we are concerned that the Paper states that trustees could provide this guidance without financial advice. We believe that providing guidance based on a member's needs and preferences constitutes financial advice and would therefore need to be provided under an AFSL. Further, the majority of members (about 70%) have a partner at the time of retirement and their superannuation benefit, access to the Age Pension and the family's other assets need to be taken into account.

Clearly, the issue of tailoring a strategy to a member's personal circumstances is a matter which should be dealt with by the member and not the fund. Hence, our view is that a broad-based CIPR should form part of a default retirement product structure with the member needing to consider if it is appropriate for their own circumstances.

Supporting principles for the Retirement Income Covenant

Definition of a comprehensive income product for retirement

The Paper states that a key feature of the Retirement Income Covenant would be a CIPR. We are broadly supportive of the need for retirees to have some level of longevity protection. We noted in our submission to the previous consultation process on CIPRs (July 2017[1]) that it is desirable to nudge retirees into deferring consumption of some of their retirement benefit to later in life. Obtaining more certainty about their financial position later in life could also encourage retirees to consume more of their benefit each year. Without mortality pooling or setting aside part of the benefit for later life, retirees would need to increase consumption in the early years of retirement to ensure they make better use of their superannuation benefit.

We do however have issues with aspects of the proposed CIPRs framework outlined in the Paper. Our main concerns with the current framework for provision of CIPRs products are:

- We do not believe it is necessary for the CIPR framework to suggest the types of products that would likely be incorporated in an CIPR.
- Trustees should not have to offer a CIPR product if it is not part of a default retirement structure.
- The current design proposals for CIPR products do not adequately consider the personal and financial circumstances of members (particularly the value of longevity protection for members with low balances, who already have suitable coverage via the Age Pension).
- The definition of when funds would be required to provide financial advice when offering a CIPR is unclear and may be problematic to implement. If funds ultimately decide they need to provide financial advice to offer a CIPR, this will make the product more expensive and relatively unattractive should members not want to pay for financial advice.
- The relatively short deadline for implementation will likely result in limited product innovation and limited opportunity for new entrants to provide additional competition.

The proposed framework states that a CIPR product should provide income for life with an expectation that a CIPR product would incorporate one or more of a range of pooled lifetime products such as group self-annuitisation products or guaranteed lifetime annuities. We do not feel it is necessary for the framework to prescribe what types of products would be required to provide longevity protection.

[1] Rice Warner 2017. Submission to the Department of Treasury: Development of the framework for *Comprehensive Income Products for Retirement* (CIPRs). http://www.ricewarner.com/wp-content/uploads/2017/07/Rpt-Rice-Warner-Submission-Development-of-the-framework-for-Comprehensive.pdf

The proposal allows trustees to choose whether or not to incorporate expected Age Pension income in determining whether income is broadly constant for life. Given the majority of people will still receive some level of Age Pension over the course of their retirement, not including the Age Pension in this calculation could result in an increasing real income over the course of retirement. This would not be a desirable outcome, as financial needs often decrease through retirement (prior to increasing later in life when Aged Care costs might be incurred). Including the Age Pension in a CIPR strategy would mean that it would not be possible to have broadly constant income over retirement without having decreasing income from superannuation assets over time.

Furthermore, given the complex interaction between the Age Pension, superannuation and the tax system, including the Age Pension in a CIPR strategy would mean members would require personal financial advice. We also note that a superannuation fund will not know of any individual member's personal circumstances, nor the details of their partner's superannuation and other financial assets.

The recent Productivity Commission (PC) Report Assessing the Efficiency and Competitiveness of the Superannuation system argued that a *MyRetirement* default is not warranted. The PC noted that the diversity in household preferences, incomes and other assets of people mean there is no single retirement product that can meet all members' needs. Nonetheless, we consider a default product including a CIPR can be developed as a means of nudging members to consider longevity issues.

Offering a flagship CIPR

Under the proposed framework, funds will be required to offer a *flagship* CIPR at the point of retirement. Trustees may be able to offer up to three flagship CIPRs based on account balance without the offer constituting financial advice. The Paper states that this would allow funds to design a CIPR product for a person who will spend most of their life on the maximum rate of pension, most of their life on a part-rate pension and most of their life self-funding their retirement. We regard this as too complicated, given the fund will not know the Age Pension applicable to individual members (unless they have an account balance at retirement above about $800,000).

Our previous submission noted that making CIPR products non-compulsory for trustees to offer and an opt-in product for retirees to purchase would hamper the growth in the market for CIPRs. At the time, we suggested requiring a modest level of compulsion (say 15% of balance at retirement for those with assets between $200,000 and $1,000,000) would ensure the success of CIPR products and have the following benefits:

- Ensure the growth of a non-selected mortality pool of sufficient size.
- Allow for a more appropriate long-term investment strategy supportive of long term returns.
- Reduce the flow of assets to both voluntary and unintended bequests.
- The performance of these pools would provide a solid base from which to attract voluntary purchases (although the pricing would still need to reflect the nature of the purchase).
- The combination of a standard account-based pension with the mortality pooled CIPR would provide the flexibility for access to assets that retirees desire as well as greater flexibility of asset allocation.

Given the proposed framework in the Paper does not require any compulsion for members to purchase a CIPR product, we question whether the market will ultimately succeed. If trustees are required to offer a CIPR product, we believe a modest level of compulsion would be appropriate.

We are not opposed to funds offering a range of CIPRs, though this will dilute membership of each and make it more likely that all will fail from insufficient numbers. While it appears rational to differentiate between members who might start retirement as self-sufficient, a part pensioner or a full Age Pensioner, the funds will not have information to differentiate with sufficient accuracy to steer members to the right CIPR. Further, circumstances change throughout retirement as the superannuation benefit is reduced.

We stress that financial advice will be needed and most members will not pay for this! Consequently, the complexity will ensure that most members will take the simple option of leaving all their benefit as an account-based pension.

Offering an alternative retirement income product through advice

It is not possible to offer financial advice collectively to a cohort of people as financial advice must consider the diverse range of personal circumstances, preferences, income and wealth of members at retirement.

If a member takes financial advice (through any channel), it is up to them to consider appropriate products to meet their own needs. We do not consider the fund needs to make provision for the wide range of solutions likely to be required.

Third party products

Under the proposed CIPR framework, trustees will be able to fulfil their obligation of offering a CIPR by using a third-party provider. We support funds being able to utilise third party providers.

The current market for annuity products in Australia is reasonably underdeveloped. Given the relatively short timeframe for implementation of this CIPRs framework, allowing trustees to utilise a third-party provider will likely result in limited product innovation and development of CIPRs. Ultimately, limiting this product innovation could result in relatively poorer outcomes for members. We suggest extending the deadline for implementation to allow funds more time to develop these products, and to provide the opportunity for new entrants to increase competition.

Exception for individuals for whom a CIPR is unsuitable

It is the responsibility of the member to decide whether a CIPR is suitable or not. As discussed, if the CIPR is part of the default, the trustee can list circumstances where the product might not be suitable. However, it is up to each member to assess this for themselves.

The Paper notes that some members will not find a CIPR to be suitable and gives the examples of those in poor health or with small balances.

As funds will not have the full set of personal information for a retiree, it will be impossible for them to ascertain whether their member would receive limited benefit from longevity protection due to ill health.

The Paper notes that retirees with balances less than $50,000 would receive limited benefit from longevity protection via an annuity. We believe this threshold is set too low (and, in any event, the fund will be unaware of the other benefits or assets held by the member). A person with less than $150,000-$200,000 in superannuation assets would receive adequate longevity protection from the Age Pension (as they would spend most of their life on the maximum rate of pension). A fund could default members into a CIPR if they have an account balance between (say) $150,000 and $800,000 and give the option for other retirees to join if they so choose.

Future considerations

Lifetime engagement

We support the consideration of continued engagement with members throughout their retirement. It is difficult to see how this can be done without becoming involved in personal financial advice.

Legacy products

The Paper notes that Treasury should work with regulators (ASIC and APRA) to ensure legislative and regulatory frameworks include provisions about how legacy retirement income products should be managed. New retirement income products would be required to incorporate a plan for how the product would be treated should the product prove unviable or the superannuation fund is merged with another.

We support this requirement as there is a significant risk that the proposed CIPRs framework (without compulsion for members to purchase CIPRs products) will result in many unviable products being created, having legacy products in time.

Furthermore, Industry consolidation is likely to continue over the coming years. We suggest deferring the implementation of the CIPR framework until this has occurred in order to limit the number of legacy products.

Safe harbour

Under the proposed framework, trustees could qualify for safe harbour (in limited circumstances) provided they act diligently and comply with all relevant obligations in designing offering a CIPR.

We believe this safe harbour provision is inappropriate for CIPR products given the proposed framework. If members need to obtain financial advice, then *caveat emptor* should prevail.

Inclusion of this provision indicates that it is worthwhile revising parts of the proposed CIPR framework prior to implementation.

Appendix A Comparison of retirement income product outcomes

We do not believe it is necessary for the CIPR framework to mandate the types of products that would be included in a CIPR. As part of the framework, the paper notes that a 100% allocation to an account based pension would not constitute a CIPR product. The products we have outlined below seek to demonstrate how a product could include a 100% allocation to an account based pension type product **at some point in retirement** and still provide:

- efficient, broadly constant income, in expectation
- longevity risk management (income for life)
- some access to capital.

We therefore seek clarification as to whether the following structures qualify as a CIPR product. We have included modelling to show their impact on retirement income outcomes. Details of the assumptions used to produce this modelling are included in Appendix B (Modelling assumptions).

Option 1 – Deferred purchase of an immediate life annuity

Under this option, a member would:

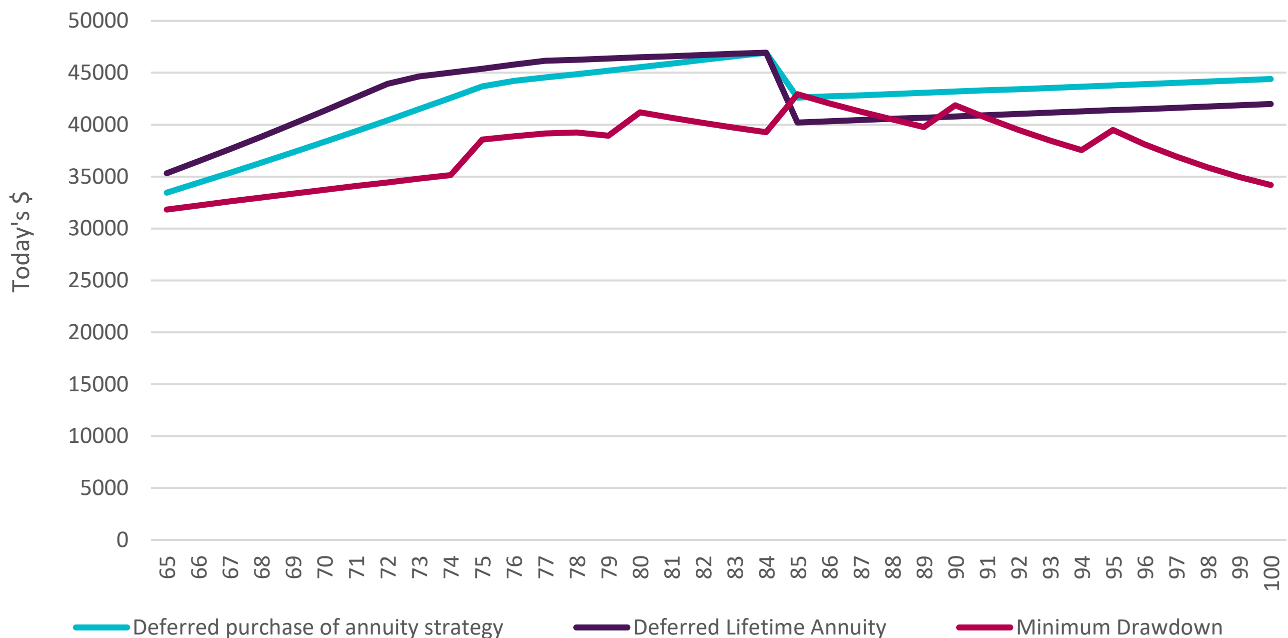
- Allocate (say) 85% of their funds to an account-based pension at retirement.
- Set aside 15% of their balance at retirement into an account-based pension option, with vesting in 20 years, with the goal of defaulting into an immediate annuity at age 85. This money should not be subject to minimum drawdown requirements (as it cannot be accessed for 20 years) and could be invested in high growth investments.

We believe this option still provides the longevity risk management required in the CIPR framework. However, we are seeking clarification as it may not technically satisfy the requirement that 100% of funds cannot be invested in an account-based pension. Given the CIPRs framework is designed to increase lifetime retirement income, we believe it is reasonable that investment decisions can be taken with a similar lifetime view.

Graph 1 shows the total retirement income outcomes provided by this strategy for a retiree aged 65 who lives to age 100 and purchases an immediate annuity at age 85. Outcomes for this option are compared to total retirement income under the following options:

- Purchasing a regular Deferred Life Annuity (DLA) at age 65 (with a 20-year deferral period).
- All funds are invested in an Account Based Pension drawing down at minimum drawdown rates.

Graph 1. Comparison of total retirement income - deferred purchase of annuity vs DLA vs Min Drawdown from ABP



Prior to age 85, total retirement income is higher under the regular deferred lifetime annuity option. The regular deferred lifetime annuity is subject to the new means testing arrangements of pooled lifetime income products. Therefore only 60% of the purchase price is subject to the assets test prior to age 85. However, under the deferred purchase of annuity strategy, our understanding is that the funds set aside to purchase an immediate annuity at 85 would not be subject to these means testing arrangements prior to age 85. Hence 100% of these funds are subject to the assets test, resulting in lower age pension income prior to age 85.

This example illustrates that the DSS treatment of longevity products is not product neutral as was originally intended. An argument could be made that the new means testing arrangements for longevity products could be applied even though mortality pooling in this product occurs from the point of life expectancy (say, age 85) rather than the point of retirement.

After age 85, the higher returns achieved by the deferred purchase of immediate annuity strategy result in higher income beyond age 85 (compared to both the regular deferred annuity strategy and account-based pension with minimum drawdown rates).

Option 2 – Pooled product allowing return of capital but not interest

Under this option a member would:

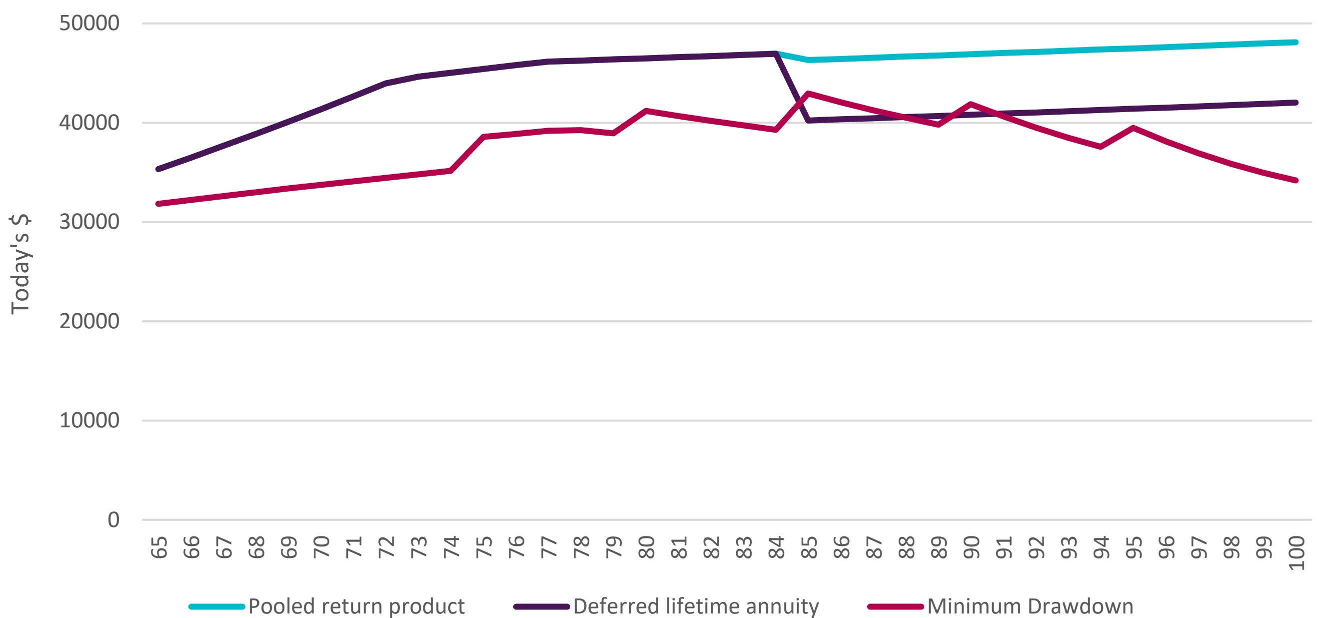
- Invest (say) 15% of their balance in a pooled product that would invest in growth assets for 20 years. Income provided would not be guaranteed. If the member withdraws from the product or dies during the 20-year period they would only receive the lesser of their initial capital investment or account value. Their residual benefit and any future investment returns would be added to the pool.
- The capital and returns from the product would be defaulted into an immediate annuity at the end of 20 years (age 85 if they retire at 65).
- The remainder of the funds at retirement (85%) would be invested in an account based pension.

We believe this product would constitute a CIPR as it could provide broadly constant real income, longevity risk management and access to capital.

Graph 2 shows the total retirement income provided by this pooled return product for an individual who lives to age 100. Outcomes for this option are compared to total retirement income under the following options:

- Purchasing a regular deferred life annuity at age 65 (with a 20-year deferral period).
- All funds are invested in an Account Based Pension drawing down at minimum drawdown rates.

Graph 2. Comparison of total retirement income – pooled return strategy vs DLA vs Min drawdown from ABP



Prior to age 85, total retirement income for this pooled lifetime product is equal to the income provided under the regular deferred lifetime annuity. Both these products are subject to the same asset test arrangements for pooled lifetime products (as announced in the 2018-19 Budget). Hence, the income from the Age Pension is equal under these two options. Income from the account-based pension assets are equal prior to age 85 as these pensions are drawdown to age 85 at the same rate.

Beyond age 85, the increased returns provided by the pooled income product result in a higher total retirement income under this strategy. Projected retirement income under this pooled product is also higher than the deferred purchase of annuity option beyond age 85 (examined above) as this product receives the benefit of:

- higher returns from investing in growth assets
- pooling of returns from the product pool.

Total retirement income for this pooled return product is higher than the account-based pension under minimum drawdowns at every age.

Cohort analysis

In making the above comparisons we concede that the typical individual is unlikely to live to age 100. Table 1 compares the expected net present value of each product based on a maximum lifespan of 100 years and reflects the average experience of a product entrant. Overall it reflects that products with pooled returns and a deferred purchase of annuity provides the highest expected lifetime value to the members as it takes advantage of the equity risk premium and mortality pooling over the members' retirement. This occurs even though Age Pension payments are higher under the DLA option.

Table 1. Expected present value of income sources (between ages 65 and 100) – CPI Deflation

Strategy	EPV Age Pension	EPV Super Income	EPV Longevity Income	EPV Total Income	Bequest	Total Inc. Bequest
		($)				
Minimum Drawdown	415,500	353,500	-	769,000	201,000	970,000
DLA	450,500	368,500	68,000	887,000	64,000	951,000
High growth then immediate annuity	413,000	368,500	80,500	862,000	110,500	972,500
Pooled return product then immediate annuity	445,500	368,500	84,500	898,500	84,000	982,500

A discount rate of our CPI assumption of 2.5% p.a. was used to calculate expected present values (EPV). For the purposes of calculating EPV for the pooled return product, it has been assumed that policyholders do not exercise the withdrawal option.

All the products shown significantly reduce the bequest left compared to the account-based pension with minimum drawdown.

Table 2. Expected present value of income sources (between ages 65 and 100) – Wage Deflation

Strategy	EPV Age Pension	EPV Super Income	EPV Longevity Income	EPV Total Income	Bequest	Total Inc. Bequest
		($)				
Minimum Drawdown	366,500	319,000	-	685,500	172,000	857,500
DLA	400,500	339,000	53,500	793,000	59,000	852,000
High growth then immediate annuity	366,000	339,000	64,000	769,000	105,500	874,500
Pooled return product then immediate annuity	396,500	339,000	66,500	802,000	78,500	880,500

A discount rate of our wage growth assumption of 3.5% p.a. was used to calculate expected present values (EPV). For the purposes of calculating EPV for the pooled return product, it has been assumed that policyholders do not exercise the withdrawal option.

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Appendix B Modelling assumptions

Table 3. Assumptions

Assumption	Value
Superannuation benefit at retirement	$400,000
Mortality	ALT2010-12 Male life with 25-year improvements rated down 3 years
Pooled product withdrawal rate	1.5%
Growth option return (Net of fees and tax)	5%
High growth option return (Net of fees and tax)	7%
Fees	1%
Deferred annuity payment rate (at age 65)	30.0%
Immediate annuity payment rate (at age 85)	15.0%
Price Inflation	2.5%
Wage Inflation	3.5%
Age Pension Status	Homeowner
Annuity indexation	Price Inflation