Retirement Income Covenant Position Paper Response

SuperEd submission to the Government's consultation

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SuperEd is pleased to have the opportunity to provide its views on the Treasury's consultation paper on the proposed Retirement Income Covenant.

SuperEd[1] is a digital advice company with a mission of "improving the retirement incomes of all Australians." We were founded with the goal of making better decision-making capability available to superannuation members around the very challenging responsibility of providing for their own retirements. So, we are closely aligned with the motivations behind the consultation paper.

Our submission will be a brief and very focused paper supporting the majority of recommendations in the paper while addressing concerns and opportunities to improve the Retirement Income Covenant approach.

I. Overview

We strongly support the Retirement Income Covenant proposal, and appreciate the substantial progress Treasury has made since the proposal for Comprehensive Income Products for Retirement was first tabled in December 2016.

In particular, we support the idea of a covenant in the SIS Act requiring Trustees to promulgate a Retirement Income Strategy. This is consistent with the Government's objective of the superannuation system being to "provide income in retirement to substitute or supplement the Age Pension." The industry has been too slow to change from a focus on accumulation phase to a "whole of life" approach, covering the distribution phase needs of the swelling ranks of Australian retirees, and inclusion in the SIS Act will mandate necessary change.

We are also strongly supportive of the requirement for funds to engage their members to help direct them to retirement income solutions that meet their needs and preferences. Treasury has responded effectively to the comments in submissions to the previous paper[2] that retirees are a diverse group and "one-size-fits-all" approaches are unlikely to match retiree needs.

The proposal also recommends what we believe are workable and sensible default retirement income solutions, under the rubric of CIPRs. We thought the framing of the CIPR as a flagship retirement income product that the fund can offer to its members as a standard for comparison was an inspired idea. We are pleased that Treasury suggested up to 3 CIPRs to recognise differences among those who may get a full, partial or no Age pension. And that funds would be encouraged or at least free to offer personal advice so members could compare choices that might be more tailored to their needs.

So, we are strongly supportive of the overall program. We do identify in this letter some areas of concern for further refinement.

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[1] More information on SuperEd is available at www.supered.com.au

[2] See Comprehensive Income Product for Retirement Response to Treasury Discussion Paper (15 December 2016): "Development of a framework for a Comprehensive Income Product in Retirement" by Professor Deborah Ralston

We also support the proposed timing for introducing the Covenant and CIPRs as we feel it gives the industry enough time to prepare while being well overdue on arrival. We would hope the government would move quickly to clear the uncertainty so that if funds wish to move faster in developing and implementing their retirement income, engagement and product strategies, they will not be reluctant to do so.

2. Principles Review

In this section, we review each principle, noting support and expected challenges.

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.

SuperEd position: fully support this requirement and believe it should be embodied in the SIS Act. It is a natural corollary of the purpose of superannuation. We believe the industry has been too slow to change to address the maturing of the superannuation membership base and this aspect of the Covenant should have the required impact of requiring trustees to change service offerings to better meet the needs of retirees.

Further, the Treasury has identified the eight key considerations trustees should pay attention to and is to be congratulated for including three factors -- member needs and preferences, expected eligibility for the Age Pension, and cognitive decline -- which are often overlooked. Treasury has made it clear what factors should be considered and that will serve to point the way for trustees to develop appropriate solutions.

We agree with the carve outs for defined benefit funds and SMSFs.

Principle 2. Engagement

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

SuperEd position: fully support this requirement because:

a) Australia's accumulation-plan based retirement system, for all its strengths, puts a tremendous burden on members to decide on how to manage their retirement savings to achieve a lifetime income. As investment uncertainty and uncertain life expectancy must both be addressed, the challenge of getting the investment program and spending behaviour right is a very substantial one.
b) Funds are in an excellent position to help guide members to an appropriate solution because they can begin the guidance early in the life of a pre-retiree and continue to guide the member throughout their retirement

c) Funds are well placed to offer an array of guidance capabilities, including digital tools which provided personalised help through to personal advice provided by a mix of human and digital capabilities.

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)

-- some access to capital

SuperEd position: support the notion of a compulsory CIPR to be used as a flagship offering. We believe funds offering a CIPR will enable members to see a benchmark product, with well described features and then determine whether that is suitable for them compared to other approaches they may consider -- either on their own or in an advice setting. We think the three enumerated core requirements of the CIPR are correct.

We also think it's appropriate for Trustees to include the Age Pension as a leg of the retirement income "stool" when considering the structure of the CIPR, since some 70% of current Australian retirees receives a full or partial Age Pension, and the participation is expected to continue to be high, albeit lower, as the superannuation system matures. It's important that Trustees can model and help their members understand the interactions between super and the Age Pension, via means testing.

Further, Treasury allows for couples planning for retirement together by encouraging the availability of reversionary benefits. As some 75% of retirees enter retirement as a member of a couple, this is a very important characteristic.

We do have some serious reservations about the expectations Treasury sets for the CIPR's characteristics. In particular:

a) We think Trustees should focus on delivering constant **real** income streams, and not nominal income streams. The paper does not draw enough of a distinction.

   Inflation has an insidious impact over time. Remember that a constant nominal income stream, at 2.5% inflation rates, would only deliver 78% of the initial real income in year 10, 61% after 20 years, 48% after 30 years, 37% after 40 years. Allowing a focus on constant nominal income fosters a form of "money illusion" that individuals are ill-prepared to deal with. Trustees are much better able to provide a focus on real income sustainability.

b) We are concerned the narrow bands recommended by Treasury (+/- 2.5% from the initial income in the first year) are unrealistic expectations. We provide an historical example in the Appendix which demonstrates a more likely expectation is +/-3% **per year** in real income with very substantial change over four decades in retirement.

i) We do not believe these expectations adequately appreciate the volatility of investment markets through changing economic regimes likely to be encountered in a retirement spanning 20-40 years.

c) The requirement to have an expectation that the constant income stream will endure until age 105 also encourages conservative payout streams, which is not consistent with the intent to facilitate higher income drawdowns and to avoid legacy benefits.

d) More generally, we are concerned about whether realistic expectations are being created for CIPRs. In the first consultation paper, one of the benefits of CIPR was touted as being higher drawdown rates than minimum withdrawal levels. Minimum withdrawal rates commence at 5% for age 65-74. And in the current paper a 6% initial withdrawal rate is given in an example in Appendix A.

1) If the objective is to give a constant **real** income to Age 105, these numbers seems unrealistic in the light of:

(a) Various studies of "safe withdrawal rates."[3]

(b) The low current interest rate/expected return environment, which makes providing high sustainable retirement incomes very challenging.

Further, we draw Treasury's attention to the **absence of two considerations** in the paper:

1) Will a member in a CIPR be exempt from minimum withdrawal requirements? That is not explicitly stated in the paper but we believe it should be the case.
   a) First, actuarial analysis should show that it may not be reasonable to expect a sustainable **real** income withdrawal rate of more than 5% of starting capital for a period of 40 years. A nominal income may be sustained at that level, but we have argued above that the focus should be on real and not nominal incomes.
   b) The paper argues the Age Pension should be taken into account. So, the target constant income stream is to be derived with regard to a series of "income layers"--one layer should not be arbitrarily constrained by a minimum withdrawal rate in the CIPR approach.
   c) If longevity products are to be funded, how should the minimum withdrawal calculation be addressed?
2) What will be the trigger event for a CIPR offering? Is it the member stating their intention to retire and meeting the conditions of release? Or is it something else?

[3] See for example, Drew, M, and Walk, A, (2014), *How Safe are Safe Withdrawal Rates in Retirement? An Australian Perspective*, Finsia (Financial Services Institute of Australasia), Sydney. Their table on safe withdrawal rates is included in the Appendix. For consideration of the impact of a lower rate environment, see *Low Bond Yields and Safe Portfolio Withdrawal Rates (2013),* by David Blanchett, Michael Finke, Wade Pfau. This paper, using the US context, puts the chances of earning a constant real income over 30 years at the 4% initial withdrawal rate from a 50-50 stock/bond portfolio at less than 50%.

Principle 4. Offering a flagship CIPR

All trustees should offer a flagship CIPR to members at retirement, subject to limited exceptions.

SuperEd position: fully support this approach.

We think any APRA licensed fund should be of size, scope and capability to be able to offer a CIPR to members either alone or in conjunction with third party providers. Given the mission of superannuation, this seems like a natural requirement. We particularly like the idea that the CIPR is positioned as a benchmark against which the member can assess other alternative retirement income approaches.

The idea of funds being able to offer up to three CIPRs reflecting access to the Age Pension is also a concept we support.

Principle 5. Third party products

Trustees can fulfill their obligation in part or in full by using a third party.

SuperEd position: fully support this approach.

Principle 6. Consent

Consent should be required for a CIPR to commence.

SuperEd position: fully support this approach.

As a key principle of the Covenant (#2) is that Trustees should engage with members to ensure retirement product choices meet member needs, it is wise to solicit member consent before default.

In particular, we think a CIPR should only be offered to a member after a “fact find” is conducted to understand whether the member would be suitable for a CIPR. The fact find would include basic information about the member’s situation, which would be helpful in particular to identify longevity issues and likely Age Pension eligibility.

A sample proposed fact find is included below. We anticipate that this would be completed online by members or as part of a telephone interview.

Diagram 1. A sample fact find

The MyRetirement Wizard

The Fund knows basic member data.

Needs to know more:

- Other assets and income
- Age pension eligibility
- Partner status
  - planning as couple?
- Housing
- Debt
- Longevity expectations

Martha, the Acme Super fund retirement solution for you depends on the following information. So, please be as accurate as you can.

I am a 65 year old woman and I am single.

I am retiring with a balance of $260,000 in my Acme Super account. I also have $44,000 with other super funds.

I own my home and I do not have a home loan or other loans.

My other assets include:

-- Investment assets outside super: $75,000

-- Personal assets: $35,000

I do/do not plan to spend some of my super to pay off debts, to make a purchase or go on holiday.

My health is good and I can reasonably expect to live a long life.

It is important to me/not important to me to leave money f[...] children or other beneficiaries when I die.

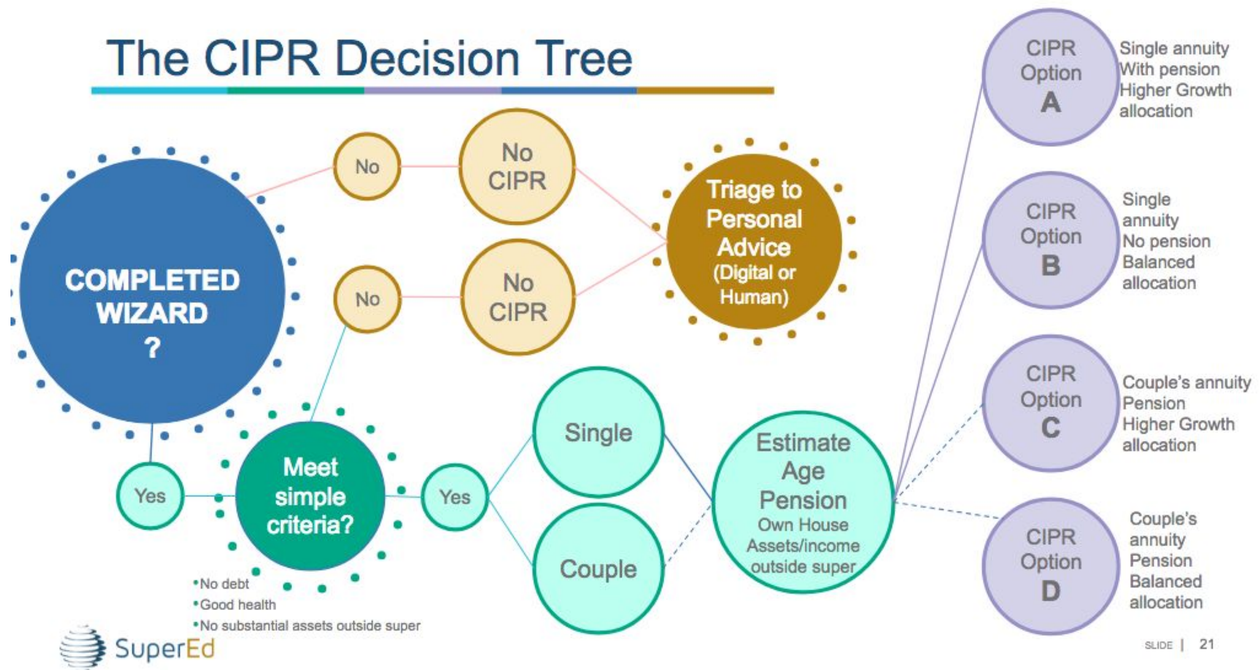
Confirm

SLIDE |

We further believe that funds can usefully deploy decision trees to identify which members should be accepted into a CIPR default and who should be “triaged” to an advice channel for further help.

An example of such a decision tree is shown below (Diagram 2). As can be seen in the diagram, if a retiring member does not provide the required information, they are triaged to other forms of help provided by the fund. Similarly, the member must pass the simple criteria stage gates to be eligible for a CIPR.

Diagram 2. A sample CIPR Decision Tree



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 intra fund advice, or full financial planning.

SuperEd position: fully support this approach.

Given that individuals vary so much in retirement, we think it is best to think of the CIPRs as a flagship or benchmark default choice, well designed by trustees but not suitable, or necessarily the best choice, for all members. Accordingly, members should be encouraged to compare the CIPR solution with other options they may have. Advice to select the best solution for the member should be available at reasonable costs via intra fund advice, with access to digital and human capabilities.

A key to successful comparison will be developing a disclosure framework that facilitates comparison of retirement income products. We consider that is an important next step for the government in consultation with industry. Collectively, we should help consumers compare products across the key dimensions covered in the proposal paper(on page 4).

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.

SuperEd position: fully support this approach.

As noted in the decision tree in Diagram 2, we believe it is inappropriate for the fund to issue a CIPR to someone who has not completed the information requirements. It is also inappropriate to offer to someone who does not pass simple tests, including health (as a proxy for life expectancy) and debt.

Further, we support the notion that funds should not be required to offer a CIPR to someone with a small balance. We think a $100,000 minimum would be more appropriate for the compulsory product than the $50,000 proposed. Funds could set a lower minimum if they so chose.

Future Considerations

Lifetime engagement

SuperEd fully supports the notion that funds should engage with their members throughout their lifetimes to help them prepare for a retirement income stream that meets their needs. A key to success is encouraging an understanding of “likely destination” via regularly offering ***retirement income projections*** to members throughout their working lives. Currently, there is too much industry focus on account balances and insufficient focus on likely income stream in retirement.

Further, we believe that retirement income streams are best characterised for pre-retirees as a range of forecast outcomes, rather than as a point estimate, which is going to be wrong. Members are better served to understand the impact of uncertainty from an early age.

Legacy products

We do not have a fully formed position on this challenging aspect of design.

Safe harbour

SuperEd view: we believe it is appropriate for government to provide a safe harbour, under appropriate conditions, to encourage trustees to offer CIPRs in the best interests of members.

We would add, however, that there is much work to be done in the regulatory realm to facilitate funds providing appropriate advice so that members get solutions best suited to their individual circumstances.

3. Wrapping up

SuperEd believes it is the interest of retiring Australians to move forward with the proposed plans for the Retirement Income Covenant on an expeditious basis. Doing so will provide clarity and motivation to the industry to make progress in this very important area. The principles proposed are sensible and would promote a constructive approach to creating a retirement income solution regime which would serve members well, while allowing individual choice if the flagship option(s) did not meet their needs.

Thank you for the opportunity to submit this response. If there are any questions, please call Jeremy Duffield on 0403 187 657 or write to jeremy.duffield@supered.com.au.

4. Appendices -- Constant Income? and Safe withdrawal rates

We do think it's critical that trustees, members, and the Government have realistic expectations about what outcomes can be driven dependably in retirement income solutions. Without making an exhaustive presentation on what are realistic expectations, we would opine that some of the expectations articulated to date are unrealistic - a bit too much of "having our cake and eating it too." Higher initial withdrawal rates, flexible access to capital, constant real income to age 105, longevity protection -- that's a tall order. Trustees will have to think through the tradeoffs carefully.

We address two questions here with short, incomplete answers:

a) Is the proposed +/- 2.5% change in income level through age 105 reasonable?
b) What withdrawal levels may be sustainable over a long retirement?

Income Volatility

It was not clear to us whether the recommendation for a +/-2.5% change in "constant income level" was to be achieved over an annual period or a cumulative period of 40 years. The latter is clearly only achievable with a full annuity product or full reliance on the Age Pension. And an annual level of real income constancy of that magnitude is only likely to be achieved by (i) a high level of annuity product (or a very high dependency on the Age Pension) or (ii) artificially by maintaining a constant payout structure in the face of changing economic conditions, while chancing a higher runout risk.

We provide a worked example to make the case that the natural level of volatility is higher than indicated:

In the following historically-based stochastic simulation, we show the outcomes for a member who starts retirement with a super balance of $500,000 at Age 65 in 1973. The member has a CIPR with 25% in an immediate annuity and 75% in a 70/30 balanced fund and is eligible for a part Age Pension. (Current age pension conditions and constant return assumptions are assumed.)

The charts below show the range of stochastic income forecasts the person would see each year if they reforecast based on market events over the historical period and covering a life maturing from 65 to 105. All income numbers are expressed as real numbers.

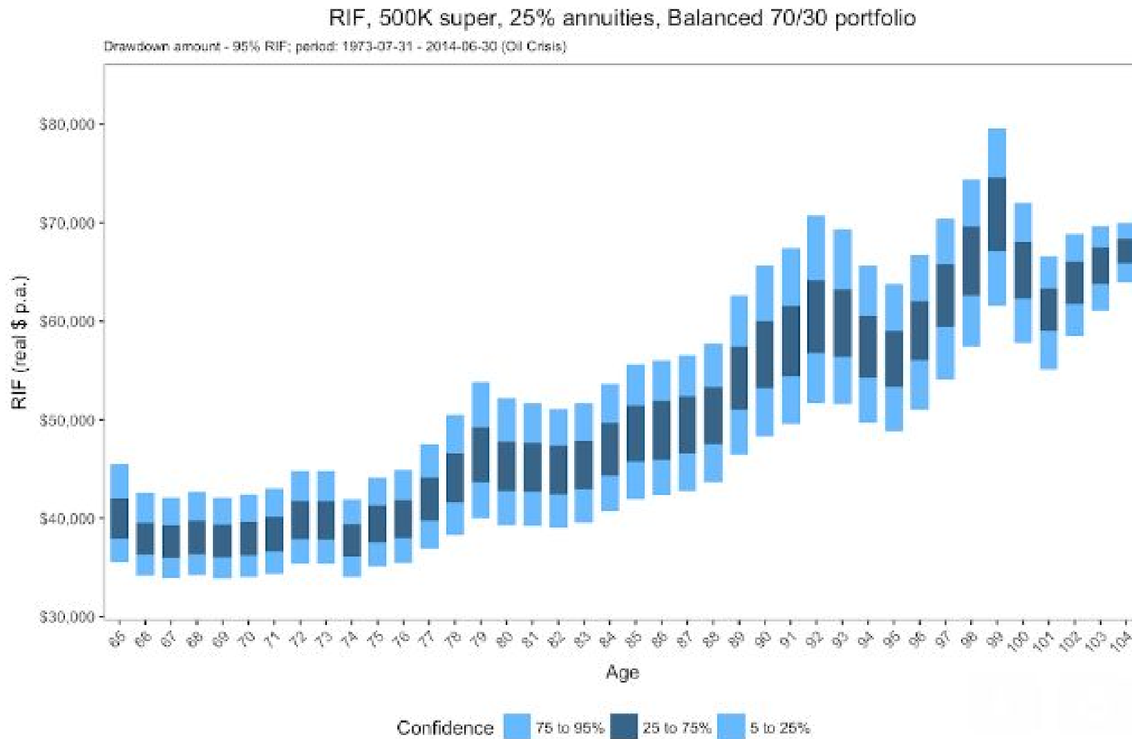
The first chart shows a range of sustainable incomes forecast at each year looking forward --ranging from 5% to 95% probability. In this example, the level of available income rises because generally the markets were strong and the member spent conservatively (at the 95% level of confidence.)

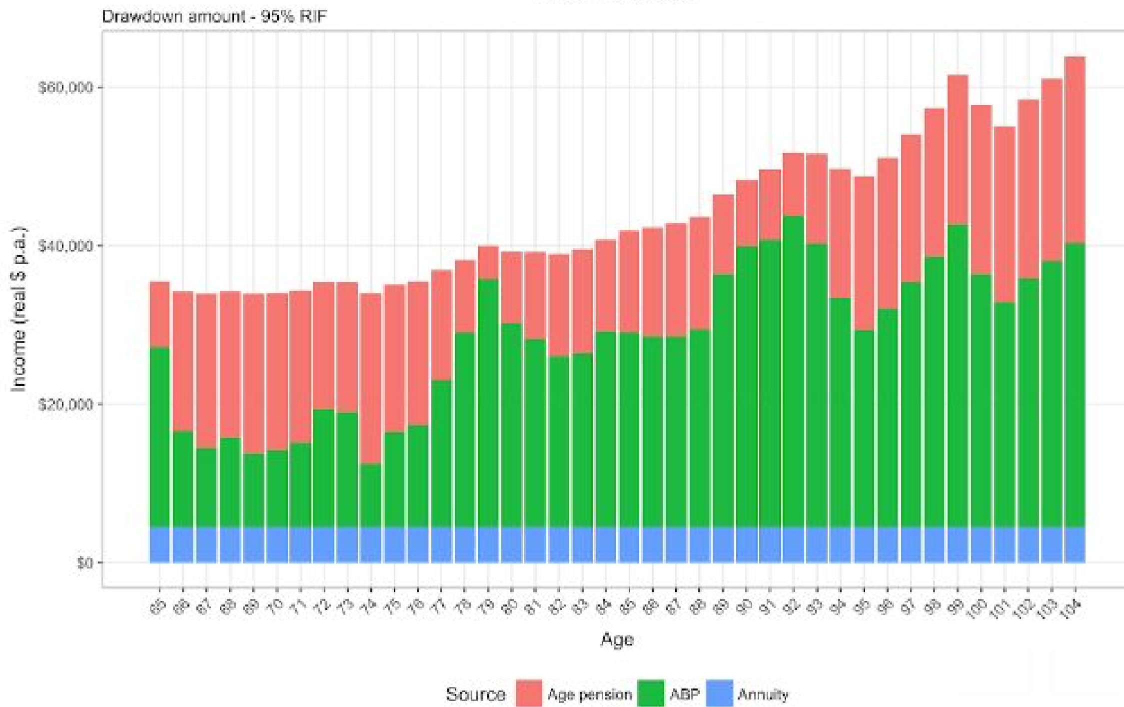
The second chart shows the income that would be received if the individual drew down an amount that they would have a 95% probability of achieving each year until death at age 105. It also shows the breakdown of that income between annuity, Account based Pension (ABP) and the Age pension. The annual variability is +/-3% per year. Over the lifetime the level of real income grew over 80%.

The third chart shows the real balance in the ABP.

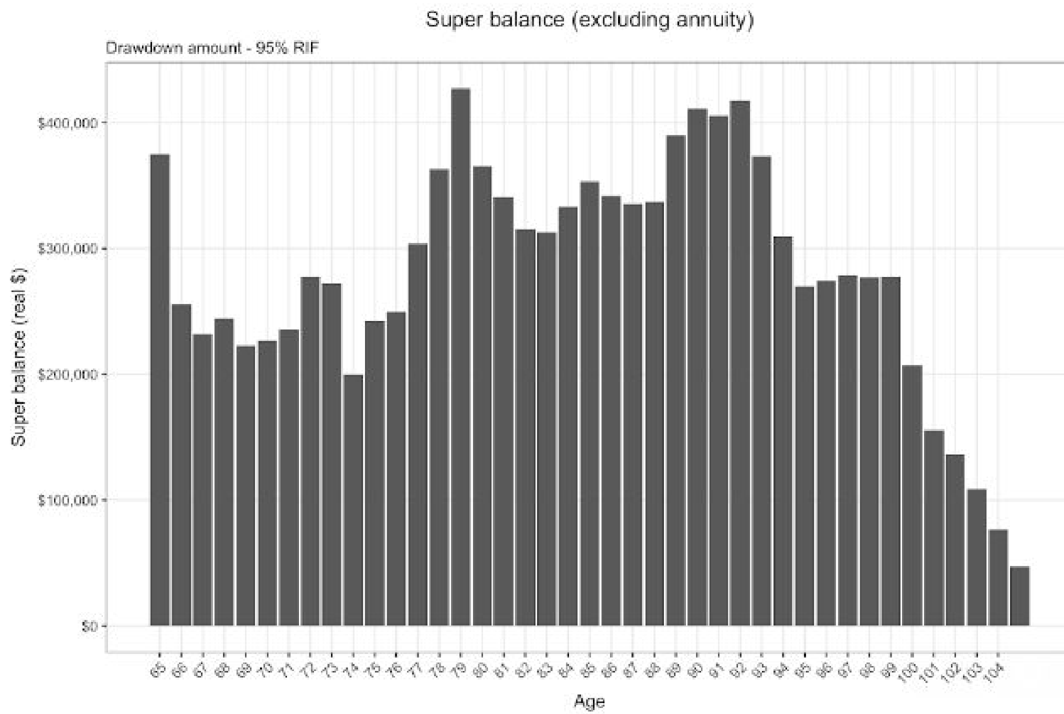
While this is just one example, it does show the “natural” volatility was higher than allowed for in the proposal. Income volatility would be lower for someone with a smaller balance and thus a higher reliance on the Age Pension, and, conversely, lower for someone with a higher balance and less or no dependence on the Age Pension.

Low income volatility can be artificially created by “locking in” a withdrawal level, but as noted that is chancing ruin or runout if markets perform worse than expected. We can’t avoid forever the results of market volatility if return results are less than anticipated. Eventually the income level has to adjust to market circumstances.





Super balance (excluding annuity)



Safe Withdrawal rates

There is a strong literature on sustainable retirement incomes, both overseas and in Australia. For example, the 2014 paper by Michael Drew and Adam Walk, *How Safe are Safe Withdrawal Rates in Retirement? An Australian Perspective*, Finsia (Financial Services Institute of Australasia), Sydney, provides a useful summary based on the concept of "SafeMax."

The table below is excerpted from that study and shows the simulated likelihood of success (not running out of money) for various portfolios with specified withdrawal rates. That shows 5% and 6% withdrawal rates often fail, especially over longer periods. While the research ignores "mortality credits" from longevity products, those credits are usually associated with fixed income oriented portfolios with lower expected returns, more like bonds.

AUSTRALIA

Given the strong performance of Australian stocks over the last century (in concert with the average performance of bonds), those portfolios with greater allocations to growth assets have typically exhibited greater longevity. However, even with this stellar performance, we find success for the 4% Rule in the shortest of timeframes, with horizons greater than a decade exposing the hypothetical investor to some chance of ruin.

Table 5 Portfolio success rates

	Withdrawal rate as a percentage of initial portfolio value									
Payout	1%	2%	3%	**4%**	5%	6%	7%	8%	9%	10%
100% stocks										
10 yrs	100%	100%	100%	**100%**	100%	99%	96%	96%	95%	90%
20 yrs	100%	100%	100%	**98%**	96%	91%	76%	64%	51%	33%
30 yrs	100%	100%	99%	**96%**	90%	72%	61%	45%	27%	16%
40 yrs	100%	100%	97%	**94%**	79%	63%	50%	32%	21%	11%
75% stocks/20% bonds/5% bills										
10 yrs	100%	100%	100%	**100%**	100%	99%	98%	95%	93%	87%
20 yrs	100%	100%	100%	**98%**	93%	85%	65%	52%	41%	24%
30 yrs	100%	100%	99%	**95%**	77%	61%	41%	27%	17%	9%
40 yrs	100%	100%	97%	**88%**	60%	50%	26%	18%	8%	4%
50% stocks/45% bonds/5% bills										
10 yrs	100%	100%	100%	**100%**	100%	100%	98%	93%	86%	82%
20 yrs	100%	100%	100%	**98%**	88%	67%	53%	40%	29%	21%
30 yrs	100%	100%	99%	**82%**	60%	37%	27%	17%	7%	5%
40 yrs	100%	100%	93%	**58%**	40%	28%	17%	7%	4%	1%
25% stocks/70% bonds/5% bills										
10 yrs	100%	100%	100%	**100%**	100%	100%	97%	89%	82%	76%
20 yrs	100%	100%	100%	**88%**	67%	51%	36%	30%	27%	18%
30 yrs	100%	100%	85%	**56%**	33%	28%	17%	10%	6%	2%
40 yrs	100%	94%	63%	**33%**	24%	11%	6%	3%	1%	0%
95% bonds/5% bills										
10 yrs	100%	100%	100%	**100%**	100%	95%	92%	81%	71%	58%
20 yrs	100%	100%	93%	**67%**	48%	35%	29%	28%	26%	16%
30 yrs	100%	90%	49%	**33%**	26%	18%	10%	6%	2%	2%
40 yrs	100%	72%	32%	**24%**	8%	4%	1%	1%	0%	0%