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Director
Retirement, Advice and Investment Division
Treasury
Langton Cres
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By email: superannuation@treasury.gov.au

Dear Director

RETIREMENT INCOME COVENENT POSITION PAPER CONSULTATION

Thank you for the opportunity to provide feedback on the retirement income covenant.

AIA Australia supports the Government's intention of legislating the retirement income covenant to codify the requirements and obligations for superannuation trustees to improve retirement outcomes for individuals, while enabling choice and competition in the retirement phase.

It is our view that this will lead to the development of more innovative retirement income products and provision of better guidance for members, which will lead to better retirement outcomes for more members.

Our feedback focuses on key aspects of the proposal paper we believe could lead to better outcomes for members:

- Ensuring the focus is on the member's expected lifetime in retirement;
- Recognition of inflation risk in managing the sustainability and stability of retirement income;
- Ensuring a level playing field between product solutions;
- Greater legislative certainty for trustees on how they provide advice and guidance; and
- The use of stochastic modelling in tools designed to assist members.

Retirement income strategy principles

We support the principles-based approach that has been proposed. Given the financial needs of individual retirees differ significantly, the lack of prescription of particular products for use in retirement will provide greater flexibility for trustees in better meeting member needs.

The proposed retirement income strategy principles, shown in Box 1 in the position paper, illustrate the competing priorities for any retiree; we welcome the requirement that trustees acknowledge how competing objectives impact the retirement income of their members, as this will provide greater transparency for member decision-making.

However, we believe these objectives could be improved to deliver better outcomes, through an explicit confirmation that objectives should be assessed over the expected lifetime in retirement – to avoid a focus on short-termism. We have proposed amendments to the retirement income strategy principles – shown in red below.

Box 1: Proposed retirement income strategy principles

Trustees are required to formulate, review regularly, and give effect to a retirement income strategy for the retired members of their fund, and the members of their fund approaching retirement.

The strategy can be formulated for:

- all members in generality, or
- cohorts of members in generality, as identified by the trustee

The strategy should outline how the trustee intends to assist their members to achieve the following objectives:

- maximise their retirement income over their retirement lifetime (taking into account the Age Pension and any other relevant income support payments identified by the trustee paid under the Social Security Act 1991 or the Veterans Entitlements Act 1986)
- manage risks to the sustainability and stability of their income over their retirement lifetime
- have some flexible access to savings during retirement

Where these objectives compete, the strategy should identify how trustees intend to assist their members to balance these objectives and whether the trustee's intended assistance is likely to increase or decrease the retirement incomes of their members.

Managing risks to the sustainability and stability of retirement income

We strongly support the proposed principle that the retirement income strategy articulates how it manages risks to the sustainability and stability of their income. As noted above, trustees should be required to consider this over the expected time in retirement.

The position paper notes trustees should consider longevity risk and investment risk. Our view is that trustees should also consider inflation risk, together with longevity and investment risk, as they deem it relevant, to better manage risks to sustainability and stability of retirement income.

Although inflation has been modest in Australia over the past fifteen years, it's important for trustees to consider the possibility that such low inflation rates will not persist over the period of a member's retirement – which could be 25 to 30 years.

The risk of losing the purchasing power of income over time is a material risk. While some income solutions can address the challenge of longevity risk and investment risk, they may still introduce significant exposure to the erosive effects of inflation on the income over long periods of time.

Increasing access to certain products

There are different capital requirements between products like deferred lifetime annuities, issued by life insurance companies, and products like group self-annuitisation products issued by other financial services providers. The effect of this capital difference is to limit the attractiveness and accessibility of these life insurance solutions for members. This makes it harder for trustees to meet the objectives in their retirement income strategy, particularly managing risks to the sustainability and stability of their income over their retirement lifetime.

Guaranteed lifetime income products are captured under APRA's Life and General Insurance Capital (LAGIC) capital requirement standards for life insurers. These standards require regulatory minimum capital to cover investment and longevity risks. The capital requirements for life insurers are higher than other comparable products issued in the OECD and for those issued by Australian banks for "like" products such as term deposits. The effect of this higher capital charge on the investment risk is to reduce the yield that could be provided to members as shareholders are compensated for providing capital.

We consider the capital standards under LAGIC should be set at a level which considers the required levels of capital providing security versus the cost, in order to support the provision of attractive retirement solutions, and maximise social benefit. The aim is to ensure that products are sustainable and give consumers confidence their income is secure but are set at a level that still provides a good level of income. We recommend Government and Treasury consider changes to LAGIC capital standards which will promote sustainable and competitive guaranteed lifetime income products issued by life insurance companies.

This will increase the range of suitable retirement income products which assist trustees to meet the objectives set in the retirement income strategy, in particular the objective to manage risks to the sustainability and stability of their income over their retirement lifetime.

Supporting appropriate guidance

The proposal paper notes guidance in its various forms is crucial to helping members make informed decisions about how they use their superannuation to provide retirement income. In developing a retirement strategy, trustees will need to consider how they intend to deliver guidance to their members which simplifies decision making and helps them understand their needs, the options available and the incentives to take these up.

There are significant behavioural barriers for consumers to overcome when trading off certainty for a loss of flexibility:

- People overestimate the probability of dying at ages up to 85–90 years — ‘survival pessimism’— thereby underestimating the longevity risk they face (Preventing Ageing Unequally, OECD 2017).
- Consumer aversion to loss of capital arising from premature death reduces the perceived attractiveness of permitted longevity risk management solutions.

Columbia Business School, in its 2010 study on 401k, has highlighted that if members were left to their own accord without guidance from modelled solutions, they would invariably make less optimal choices.

Behavioural biases should be countered by education and enhanced disclosure (e.g. projected income in retirement), and guidance provided by trustees can play a key role.

Despite the recognition of the importance of trustee guidance, the concerns noted in the position paper regarding the current laws and regulations governing guidance and advice are significant, and until these are resolved, it will be unworkable for trustees to develop and implement effective retirement income strategies. For example, the inability of intra-fund advice to provide information on a member’s non-superannuation circumstances risks limiting the value that can be provided to members.

Trustees should have regulatory certainty that their guidance does not cross over into general advice, and that the right protections are in place for trustees when they implement their retirement income strategies.

In addition, the timing of Treasury’s Quality of Advice review, which is not expected to report until the end of 2022, means trustees will need to develop their strategy and build an implementation schedule to deliver against it without knowing whether the review will result in regulatory change.

Trustees may also find value in guidance to assist with implementation of the retirement income strategy, for example:

- How to determine a member’s entitlement to the Age Pension
- How to determine if members have multiple superannuation or retirement products
- The role of the ATO and DSS in providing trustees and/or members with a combined view of income in retirement
- Leveraging the ASIC education and advice initiatives

Modelling retirement outcomes

Most retirement income modelling tools provided by trustees under ASIC’s personal advice relief instrument are based on a straight-line average investment return to life expectancy, and do not cater for volatility in how the averages are achieved. The timing and amount of volatility in investment earnings relative to drawdown patterns can lead to vastly different outcomes for members. Using the standard population mortality tables to estimate life expectancy means it underestimates a member’s lifetime, on average, about half of the time.

Retirement planning should take a more prudent approach and model a range of outcomes up to maximum probable lifespan, where there is a 10% chance of living beyond the age, not merely average life expectancy. For example, a healthy female aged 65, has a 50% chance of living beyond age 87.8 years and 10% chance of living beyond age 96.4 years, so a retirement model should model outcomes up to at least 96.4 years (based on Australian Life Tables 2010-12 with mortality improvements).

Rather than displaying one scenario, based on straight-line average investment returns (which are highly improbable), stochastic modelling provides a range of outcomes and the probability the individual income needs would be met.

We recommend the development of any tools designed to assist members understanding their needs and assess the relative sustainability and stability of their retirement income should be based on stochastic modelling for a range of scenarios and up to maximum probable lifespan. This is likely to provide greater certainty to members to draw down capital and achieve a better lifestyle in retirement, as the risk of outliving their retirement assets has been effectively managed.

Application of a trustee's retirement income strategy to existing retired members

The position paper sets out the proposed retirement income covenant and retirement strategy which will take effect from 1 July 2022. The position paper appears geared towards members who are approaching retirement and are yet to make decisions about how they manage their retirement income.

However, it would be helpful to confirm if trustees are required to consider members who have already taken up a retirement income product, such as an account-based pension. On balance, these members would benefit from access to a broader range of retirement income products and guidance from trustees that may not have been available when they retired.

Should you wish to discuss any aspects of our response, please contact Tom Gordon, Head of Regulatory Affairs in the first instance, on tom.gordon@aia.com or 0404 059 808.

Yours sincerely

Damien Mu

CEO and Managing Director

AIA Australia and New Zealand