Mercer

Mercer (Australia) Pty Ltd
ABN 32 005 315 917
Collins Square
727 Collins Street
Melbourne, VIC Australia 3008
GPO Box 9946 Melbourne VIC 3001
+61 3 9623 5464
Fax +61 3 8640 0800
david.knox@mercer.com
www.mercer.com.au

Superannuation@treasury.gov.au

Retirement, Advice and Investment Division
The Treasury
Langton Cres
Parkes ACT 2600

6 August 2021

Subject: **Retirement income covenant and the related Position Paper**

Dear Sir/Madam

Thank you for the opportunity to respond to the Treasury's Position Paper dated 19 July 2021 titled *Retirement income covenant.*

Support for the overall directions within the position paper

Mercer strongly supports the introduction of a retirement income covenant into the *Superannuation Industry (Supervision) Act 1993*. After all, and as noted on page 11, the primary purpose of retirement savings is to provide income for consumption in retirement. That is, superannuation is not just about building up wealth or a nest egg. Therefore, we believe that the introduction of the covenant should change the underlying focus of the superannuation industry over the longer term. Some of our comments and suggestions in this submission reflect that desirable direction.

Mercer also supports the principles-based approach adopted within the position paper. The financial needs of retirees vary considerably and a single product is not the best approach. Inevitably there will be considerable variation between members of different funds as well as between members within the same fund. Hence, the lack of any prescription defining a particular product, or suite of products, is welcomed.

The listing of the three overall objectives that a retirement income strategy should encompass is also a positive step forward. Again, it highlights the considerable variation that exists between the financial needs and risks of individual retirees and therefore the need for flexibility within the development of a fund's retirement income strategy. The legislated covenant and related guidance from APRA and ASIC will also need to balance this requirement for variation within the industry while at the same time retaining focus on the three objectives.

Notwithstanding our strong support for the introduction of the covenant, we have several concerns and suggestions to ensure that the overall outcome for retirees will provide them with a higher standard of living during their retirement. These are grouped into three broad sections:

- Comments on the position paper
- Broader suggestions which will help the desired outcomes to be achieved
- Suggestions about future guidance from the regulators, primarily APRA and ASIC

Comments on the position paper

The future timeline

The position paper states that the covenant will take effect from 1 July 2022, subject to it being legislated. This is consistent with current government policy which Mercer supports. However it will require a considerable effort from all stakeholders, as trustees will be required to develop and implement their retirement income strategy by that date. Therefore, it is recommended that:

- *Draft legislation relating to the covenant be available for consultation before 31 October 2021 and presented to Parliament before 31 December 2021.*
- *Draft guidance relating to the operation and compliance of all aspects of the covenant be available from APRA and ASIC before 31 December 2021.*

These dates are important as there is considerable work for trustees of superannuation funds to carry out before the commencing date of 1 July 2022. Without clear guidance and direction, it is very likely that some superannuation funds will be unable or unwilling to meet the requirements.

How is it best to assist members?

As the position paper correctly notes, retirees struggle to develop effective retirement income strategies due to the complexities involved in the multiple decisions and difficult trade-offs. As page 4 notes, the covenant should improve this situation by creating an obligation for trustees to assist members to meet their key retirement goals. However this is not straightforward.

As noted on page 5, guidance to members can range from factual information through to personal financial advice. It is also noted that the Quality of Advice Review to be conducted by Treasury will not be completed until after the covenant becomes effective. Hence, the assistance required to members will need to be provided under current rules.

Yet the position paper is somewhat confusing as it notes on page 4 that “appropriate guidance and disclosure will evolve” whilst noting in Box 1 that “the strategy should identify how trustees intend to assist their members”. Page 14 suggests various actions that could be developed to assist members including the introduction of default settings or ‘nudges’ but page 4 notes that “guidance in this context does not mean defaulting members into particular products”. That is, default settings could be used to assist members but defaulting members into particular products is not considered appropriate. This apparent contradiction needs to be clarified.

In addition, the ongoing development of robo-advice and more sophisticated calculators provides great opportunities for superannuation funds to provide better assistance to their members as they approach retirement, with the information provided taking into account the individual’s circumstances.

Allowing for these different circumstances also leads to the need to broaden the concept of intra-fund advice. In particular, this assistance to members could be greatly improved if this form of advice could include Age Pension eligibility and the superannuation available to a member’s partner, subject to the partner’s permission (of course).

The current barriers preventing the provision of appropriate advice to members include the uncertainty arising from the recent High Court case where certain financial institutions were deemed to have breached the Corporations Act by providing personal financial product advice in calls made to customers as neither company was licensed to provide personal financial advice.

Another hurdle relates to the inconsistent regulatory treatment between individual projections and online calculators. The problem can be set out as follows:

- The only way a fund can provide a projection to a member, without it being considered advice, is to follow ASIC Class Order 11/1227
- However CO 11/1227 uses a prescriptive formula and data set, and is thus inconsistent with most online projection calculators that allow for:
  - The increases to the SG over time
  - Modelling the Age Pension as a single person
  - The impact of the means tests over time
  - An appropriate long-term return for the member's investment strategy
  - Retiring at ages other than age 67
  - The forward-looking fees and costs charged by their fund
- Hence when funds use the CO they are providing projections that are inconsistent with their calculators, which is a poor experience for members and can be very confusing

To enable improved assistance to members and provide better retirement outcomes, it is recommended that:

- *ASIC provide clear guidance to trustees as to the permitted role of default products or nudges.*
- *ASIC provide clear guidance to trustees as to the role of robo-advice and calculators within the scope of financial advice.*
- *the results from individual projections should be consistent with the results from the fund's online calculator*
- *individual projections should be permitted to reflect the individual data known by the fund and to reflect the products that the individual member is invested in*
- *The development of such products, including the application of cohorts, by a fund in line with any ASIC guidance results in safe harbour protection for the fund's trustees.*

<u>Income projections</u>

Many superannuation funds already provide income projections for their members in line with relevant ASIC guidance. Indeed page 14 of the position paper lists income projections as a possible action to assist members to balance their retirement income objectives.

Indeed, industry experience shows that the provision of income projections significantly improves member engagement and thereby assists members in understanding their possible financial position when they reach retirement. Yet, it must also be recognised that projections are just that; they are not detailed forecasts as considerable uncertainty remains.

It is therefore recommended that

- *Income projections be required to be provided to all pre-retirees above the age of 45, as well as retirees, thereby reframing their perspective from lump sum to an income focus.*
- *Income projections be required to indicate a range of possible results thereby highlighting that the future is not certain.*

<u>Defined benefit schemes</u>

Page 6 of the position paper notes that trustees of DB schemes that offer a DB lifetime pension are not required to develop a retirement income strategy. This exclusion is too generous. Many DB schemes that offer a lifetime pension also offer members the right to commute this pension into a lump sum, thereby potentially placing retirees in the same position as most other retirees. This exclusion should only apply to DB pension schemes where no commutation of the pension is permitted.

Terminology

The use of the term "retirement income" has its limitations as many individuals perceive income to include wages and investment earnings such as interest, dividends and rental. Even unrealised capital gains are often not perceived to be income as they are not received or taxable. This may be one reason why retirees accumulate wealth during retirement and do not draw down their superannuation assets.

Therefore we need to change the community's understanding and orientation.

One approach may be to use an expression such as "your retirement spending money" which would include any Age Pension as well as any earned income, investment earnings (realised and unrealised) and some drawdown from their capital. Without such a significant reorientation within the community, there is a danger that the covenant will not significantly increase the living standards of retirees.

Desirable or required behaviour?

The position paper highlights many actions that a fund's trustees will need to carry out in the development and application of their retirement income strategy. However the paper often uses the term "should" whereas one would expect the term "must" would be used, if it was a requirement. Here are a few examples, including inconsistencies between the main paper and the Appendix:

- On page 2, "The strategy should reflect a trustee's broad understanding of their membership", yet without an understanding of their members, it is difficult to see how an appropriate strategy could be developed.
- In Box 1 on page 6, "the strategy should identify how trustees intend to assist their members", whereas Appendix 1 states that "Trustees must consider how they intend to assist their members".
- On page 7, "The retirement income strategy should be made publicly available to members" which seems to contradict the desire for improved transparency to, and understanding by, members.
- On page 8, "The strategy should be formulated for all members of a fund who are retired or approaching retirement" whereas Appendix 1 states that "Trustees must ensure all members of the fund in retirement, or approaching retirement, are covered by the strategy."
- On page 10, "Trustees should also consider any entitlement to the Age Pension", whereas Appendix 1 states that "Trustees must consider, at a minimum, members' interest in the fund, and Age Pension … when analysing retirement income."
- On page 11, "The objective to maximise retirement income should be balanced with the other objectives" whereas Appendix 1 states that "Trustees must consider how to balance the objectives of the strategy".
- On page 12, "trustees should consider the following risks", whereas Appendix 1 states that "Trustees must consider how to assist members to manage risks".
- On page 13, "Trustees should consider how they will assist their members have some flexible access to their savings during retirement", whereas Appendix 1 states that "Trustees must consider how they will assist their members have some flexible access to their savings during retirement".

Whilst such details should form part of the guidance to be provided by APRA and ASIC, it is important for regulators and trustees to appreciate the differences between actions that are a requirement in the development of a strategy and where there is some discretion available to a fund's trustee. Without a clear set of requirements or obligations, there is a danger that some of the longer term desirable outcomes of the covenant will not be achieved.

Suggestions to improve the outcomes for retirees

The uncertain future

One of the major fears confronting retirees is the uncertainties relating to how long they will live (longevity risk) and their future investment returns (investment risks). Both these risks are addressed in the position paper.

Yet, uncertain future government policies relating to the Age Pension, health costs and aged-care costs over the next three or four decades represent one of the biggest concerns for retirees. While page 13 correctly notes that "health and aged-care costs are heavily subsidised", there is no guarantee that this outcome will continue.

Indeed, with the economic discussion around the financial consequences of an ageing population, as well as the funding shortfall in aged-care identified by the recent Royal Commission, it is not surprising that many retirees are risk averse and save funds for their future health and aged care costs. Furthermore, recent Mercer surveys suggest that most retirees expect that the Age Pension will become harder to obtain in future years.

Without clear policy announcements from both the Government and the Opposition, it is to be expected that many retirees will be risk averse and not consume most of their retirement savings. This represents rational behaviour given these uncertainties.

Inflation risk may also again become more significant than in the recent past, and should be considered as part of a retiree's uncertain future.

Minimum product development

As noted above, the position paper does not prescribe any particular products and this represents the best way forward. Nevertheless, it would be appropriate to develop some guidance for trustees relating to the extent of any required or expected product development.

For example, it could be expected that all funds would offer members (either directly or through a third party) a hybrid retirement product that encompassed some longevity protection. It may be argued that some funds with low average balances do not need to develop such a product. However such a conclusion, based on averages, does not recognise the diversity of individual circumstances. For example, an individual with a low balance may not be eligible for the Age Pension due to their other income or their partner's assets. Notwithstanding their relatively low balance, they may be very interested in some longevity protection.

Whilst it would be inappropriate to include such detail in the covenant, APRA could suggest a minimum level of product development as a guideline or benchmark in their guidance.

Access to data held by the government

Page 8 of the position paper notes that trustees should develop strategies that reflect their broad understanding of their members. This could be based on member surveys, key policy settings or broad demographic information. Yet the Government, through the superannuation data held by the ATO and Age Pension data held by Centrelink, has access to considerable data that could be very valuable to trustees developing their retirement income strategies.

Page 9 of the position paper recognises that trustees are already expected to understand their membership composition, and construct cohorts of members under APRA's SPS 515. Whilst it is relatively straightforward for trustees to construct cohorts based on age, gender and account balance, some of the other important data points are not readily available, including partner status, home ownership and mortgage status, and the member's intended or likely retirement age. Further, the Design and Distribution Obligations as introduced to the Corporations

Act (and noted on page 5) will lead to trustees wanting to know these membership attributes as they consider whether their retirement products are likely to be taken up by their target market.

It is therefore recommended that the ATO provide data to each trustee including

- *the percentage of their members aged between 60 and 70 who have a partner*
- *the average superannuation balance held by the partners of their non-retired members aged over 55*
- *the average superannuation balance held by their non-retired members aged over 55 held in other superannuation funds*

It is also recommended that Centrelink provide aggregate data showing

- *the level of financial assets (broken down into superannuation and non-superannuation assets) and home ownership for a range of Age Pension levels for singles and couples*

Future guidance from APRA and ASIC

As indicated above, it is essential that APRA and ASIC issue guidance (at least in draft form) before the end of 2021. Furthermore, to ensure that the whole process is not reduced to a box-ticking exercise for trustees, the following recommendations are made.

The APRA guidance:

- *indicate under what circumstances it may be appropriate for a trustee not to develop a retirement income strategy*
- *describe their expectations relating to the development of a retirement income strategy*
- *provide some indication as to how the competing objectives could be balanced*
- *indicate the extent of product development that would be expected over coming years*
- *indicate that a performance test would not be applied in the future, given the likely diversity of retirement income products*
- *describe their requirements for the regular review process*

The ASIC guidance

- *indicate the permitted activities under the current financial advice rules so that trustees may assist their members in improving their outcomes during retirement*
- *enable the development of improved calculators and projections, including the ability to show a range of results*
- *provide a safe harbour for trustees in the use of default settings, nudges, calculators and robo-advice*

A transition period is needed

It is also recommended that serious consideration be given to some form of transition period after 1 July 2022. After all, the retirement income covenant represents the first step of a longer term evolution of Australia's retirement income system.

Whilst it is reasonable for trustees to develop a retirement income strategy by 1 July 2022, it is impractical for all the appropriate products to be available from that date, including the development of pooled longevity products. A transition period would also allow the Quality of Advice Review to be completed and before any legislation or ASIC guidance relating to the extent of financial assistance provided by superannuation funds to members is finalised.

It is therefore recommended that

- *APRA and ASIC introduce appropriate transition periods in their guidance.*

As always, Mercer welcomes the opportunity to contribute to improving Australia’s superannuation industry for the benefit of fund members. Please do not hesitate to contact me if you would like to arrange a discussion or need further information in respect of the above matters.

Yours sincerely,

Dr David Knox
Senior Partner