COMMITTEE FOR SUSTAINABLE RETIREMENT INCOMES

Making Income the Goal – A Regulatory Framework for the Post Retirement System

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CSRI Leadership Forum

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Introduction[1]

The development of a retirement policy position needs to be carried out within the context of the objectives of the retirement income system. The Committee for Sustainable Retirement Incomes (CSRI) considers that an appropriate objective for the whole retirement income system is: "*to provide adequate income through all the years of retirement for all Australians in a sustainable way*". The Commonwealth government is seeking to enshrine the objective for superannuation as *"to provide income in retirement to substitute or supplement the Age Pension*".

People need sustainable retirement incomes for all the years of retirement to reduce the risk that they will run out of savings and fall back on the Age Pension or, as is more likely, live excessively frugally so that they don't outlive their savings. A focus on secure incomes would improve the effectiveness of the retirement income system and make it sustainable in the face of population aging.

In effect, we are seeking a post retirement system that builds on the benefits of our predominantly prefunded defined contribution (DC) system with a framework that provides for outcomes in retirement more akin to defined benefit (DB) arrangements. Until now, there has been little focus by superannuation funds on the post retirement phase given the low account balances of people entering retirement reflecting the immaturity of the superannuation system. With the baby boomer generation now entering retirement with larger superannuation balances, this makes the development of the post retirement system an important priority.

The Financial System Inquiry (FSI) identified the potential for longevity protection to provide greater income security for retirees. It proposed that trustees be required to preselect for their members a Comprehensive Income Products for Retirement (CIPR) to provide members with suitable retirement income which properly manages the principal retirement risks faced in retirement (including investment, sequencing, longevity, and inflation risk.)

A trustee's ability to innovate superior approaches based on specialised advice should not be unduly inhibited. At the same time, allowing unfettered innovation is unlikely to be conducive to faciltating demand and creating a market. If the regulatory framework is too open ended, the outcome may be slow progress, costliness and excessive complexity making it difficult for members to compare options and make choices. Many trustees themselves will be seeking clarity on their obligations before they develop their pension offering to avoid the need for a rebuild and to ensure that they protect the interests of their members.

Over the past twelve months, the CSRI has progressed a collaborative policy development process focused on the post retirement system. This document was originally prepared the CSRI Leadership Forum on 12-13 October 2016 with a view to promoting discussion about the key features of a post retirement regulatory framework based on the research and discussion from the above initiative.[2]

The paper is structured in two parts: The first section outlines the problems that we are seeking to resolve and the second section outlines the main features of a post retirement policy framework.

[1] [1]This paper has drawn on research prepared by experts for a roundtable convened by the CSRI in April 2016. It has further benefited from subsequent consultations with government officials, regulators and other experts.

[2] The Discussion Paper was subsequently updated.

Issues to be addressed

Complexities of managing risks

While wealth accumulation is necessary to improve retirement incomes, it is not a sufficient condition for achieving financial security in retirement. How accumulated superannuation balances are translated into income streams is critically important.

Many retirees experience significant difficulties in managing the complex risks they face in retirement including longevity, investment, sequencing and inflation risks. Each retiree's circumstances are unique, and there are many issues to contemplate in managing money in retirement including:

- How to avoid the risk of outliving your savings?
- How much money from superannuation and savings to drawdown?
- How should funds be invested?
- How to maximise the Age Pension and other Social Security benefits?
- How to manage volatility of investment markets?
- How to manage the risk that investment markets are poor at the time of retirement?
- How to finance future health and aged care?

The simple reality is that no retiree knows how long he or she will live making it difficult to determine an appropriate drawdown/investment strategy. Despite this complexity, it is estimated that only 20% of retirees seek advice from a financial planner[3]. Evidence shows that most pensioners are conservative in their drawdown while a significant proportion of retirees make withdrawals at an unsustainable rate, demonstrating the difficulties faced in managing their retirement income.

Financial Advice

Managing money in retirement is complex and financial advisers need to be fully across matters such as options for investing superannuation monies, social security entitlements (and interaction with other investments), relevant taxation law and the many and varied aged care funding models. As more individuals retire with greater superannuation balances, more financial advisers should be encouraged to develop competency with all retirement matters. However, even if there were more financial advisers specialising in retirement and more individuals open to receiving full financial advice, there would still be gaps between the need for advice and the accessibility of advice.

There is an imperative to develop more cost effective means of delivering financial advice in forms other than face to face, including intra fund and robo advice to assist members in planning and managing their retirement.

Regulatory Impediments

Superannuation income streams are intended to provide a higher standard of living than retirees would achieve if they were totally dependent on the safety net of the Age Pension. Post-retirement assets are currently concentrated in Account Based Pensions (ABPs) which do not provide adequate security against the principal retirement risks and therefore require retirees to manage all market, sequencing, longevity and inflation risks.

Composite products combining exposure to market and longevity protection have the potential to better mitigate these risks. Accordingly, it is important that retirement income solutions enable more effective ways of pooling to hedge longevity risk and lessen the reliance on the Age Pension.

[3] Investment Trends Research.

Factors impeding innovation in post-retirement offerings and take up of longevity products include the current low interest rates environment that make annuities an unattractive proposition when viewed as an investment rather than as insurance against the risk of outliving lifetime savings.

Current regulations also inhibit the development of certain pooled products. The Parliament has passed legislation to remove regulatory impediments to the development of post retirement products that would involve the introduction of an additional set of income stream product rules. Products such as deferred annuities and pooled products, which are excluded by the current regulatory framework, would be able to qualify for the earnings tax exemption.

While a more accommodating tax environment is scheduled to be introduced in 2017, means testing restrictions that impede the take up of these pooled products remain unresolved.

Development of the regulatory framework

Overview

In early consultations on the development of post retirement regulatory arrangements, it is clear that there are a range of views about CIPRs. A spectrum of possible options (each with progressively increasing levels of trustee involvement)

- Product offer and member choice with no default
- Guided choice – with opt in default
- Pre-selected offer

The first option, which is essentially the status quo, does little to assist the members choice. The second option is more difficult for the trustee to implement and still leaves a heavy onus on the member to make choices. The third option may be the preferred option as it could reduce the burden on both members and trustees. The rationale for this position is as follows.

A range of composite products will likely be needed, rather than a single CIPR option, to meet the diversity of retiree needs and circumstances (including in relation to age pension level, homeownership, other assets, outstanding debt, household situation, health status and gender). The majority of members would therefore need guidance to make a selection from a menu of CIPRs.

This shouldn't mean that every retiree needs to receive comprehensive financial advice as the cost would be highly prohibitive. Only a small proportion of retirees seek financial advice at this time.

To avoid members being confronted with complexity of choice, trustees would pre select one CIPR per member. Segmentation strategies already exist under MySuper, so the same could apply to the pension phase.

While the absence of cost effective mechanisms for delivering advice are not widely available at this time, the introduction of CIPRs would hasten the development of such solutions.

It is important that the framework should be developed to encourage trustees to take necessary steps to provide CIPRs that enable some mass customisation for members needs and circumstances. The regulatory framework should support and encourage trustees who seek to better meet the members needs rather than taking the easier option of providing standard option for all.

These principles are further discussed below.

CIPR Minimum Product Requirements

Development of minimum product requirements would give trustees greater certainty and enable faster development of CIPRs. At the same time it would allow trustees discretion to develop products to better meet the needs of their membership.

The FSI recommended that CIPRs should be "comprehensive" in the sense that they should meet the totality of member's retirement income needs in terms of income security, inflation protection and access to capital.

Given the complexities of providing a comprehensive product that meets all retiree needs, an alternative viewpoint is that a CIPR should be focussed solely on managing longevity risk.

CSRI takes a position somewhat between these two extremes. A composite product, rather than a single product, would better meet the needs of the majority of members however it would be impossible to meet all of retirees needs on a mass customised basis.

The following design principles for CIPRs are therefore proposed:

- Regular and sustainable income streams.
- Longevity risk protection – while CIPRs would not require guaranteed income for life, they should involve the payment of a portion of income sourced from some form of mortality pooling arrangement.
- Low cost commensurate with the benefits to the member.

Another important design feature is flexibility, particularly in relation to meeting members' needs over the course of retirement. This feature is best addressed in the range of CIPRs offered and as part of the process for guiding members' choice of CIPRs, rather than as a minimum requirement for each CIPR product.

The requirements above would also have the ability to take account of cognitive impairment at older ages. This could be through some form of deferred secure income that requires little intervention from the retiree in their senior years or other approaches that achieve a similar result.

Pre-Selected Offer

The CIPR regulatory framework should be suitable for disengaged members. It should mitigate the risk that people who are unable to exercise choice are locked into a default arrangement that is inappropriate for their needs.

The intention is to develop a product preselection process that does not constitute financial advice and all the associated complexities that that entails. There would be more than one option based on segmenting the market on the basis of known and knowable characteristics.

The duty of care attached to offering a CIPR retirement solution would require engagement with the member prior to retirement to determine the appropriate solution for their needs. Indicative requirement for member engagement on CIPRs could involve:

- Engagement with the Member prior to retirement (10-15 years),
    - Inform member of the soft default retirement option (mass customised option)
    - Inform member of projected income in retirement using that default
- Engage with the member at retirement,
    - Make them aware of the range of customised CIPRs on offer.
    - Offer them advice to assist them in their choice consistent with the prevailing advice regime - full service, scaled and intra-fund advice.
    - Offer member the soft default retirement option if they do not wish to make a selection.

- inform member of projected income in retirement using the soft default as the base case.
- Provide appropriate warnings – circumstances in which the soft default is suitable/unsuitable.

- Member is required to opt in for the soft default option or they will remain in their existing accumulation option until such time as they make a choice.

There is the question of whether periodic reviews would be required to ensure that the default remains appropriate for the members' circumstances at different stages of retirement. Such a requirement would obviously add to the cost of providing CIPRs.

The member would have to make a conscious decision to opt-in, unlike MySuper opt-out arrangement. Requiring that CIPRs be provided on an opt in, rather than a more passive opt out, basis would mitigate the risk of members being assigned a CIPR that is unsuitable for their needs. A further reason why opt in is necessary is that trustees will not be aware when a member has met a condition of release (other than reaching age 65) until the member informs them of such.[4]

Additional protections would be provided to minimize the risks of placing individuals in an inappropriate CIPR. A triage process would ideally screen out individuals for whom a CIPR option would be unsuitable. Filtering criteria could include high debt levels, significant health issues, and multiple dependents.[1]

Financial Advice

If on the other hand trustees were deemed to be providing personal financial advice this would increase the cost of offering CIPRs significantly. This would raise the question of how well the current financial advice regulations would accommodate trustees' preselecting CIPRs.

Regulation to support the provision of advice that is limited in scope already exists within the scaled advice regime. ASIC (Regulatory Guidance 244) provides guidance on the best interests' duty and related obligations in the provision of scaled advice. In particular, it ensures that the scope of scaled advice is determined by the needs of the member rather than the party providing the advice. It also provides a series of steps that advice providers may rely on to prove they have complied with the requirements (safe harbor). While this regime already covers the provision of advice relating to retirement income, further guidance specifically in relation to advice on the choice of CIPRs would be called for.

The cost of provision may however serve as a major impediment for trustees to offer scaled advice in relation to CIPRs to all their members, particularly those of low means who are nonetheless exposed to highly complex tax and social security arrangements.

'Intra-fund advice' refers to the types of advice that a superannuation trustee can provide to members where the cost of the advice is borne by all members of the fund whether it is provided by the fund or outsourced. Such advice can be provided over the phone, via email or face to face.

A number of restrictions apply to intra-fund advice that would serve to limit its use for providing CIPRs for members. In particular, it can only relate to a beneficial interest in the fund or related assets and cannot relate to third party retirement income products. As the process for preselecting CIPRs for members would require some understanding of members' broader circumstances (eg debt levels, homeownership etc) it would go beyond the current intra fund requirements. This raises the question

[4] It is also consistent with current regulatory requirements that a member's interest in a MySuper arrangement cannot be transferred without the member's consent (other than through a successor fund transfer).

of whether some broadening of the rules for intra-fund advice to accommodate a limited for of advice for CIPRs would be warrant.

Trustee requirement to offer CIPRs

The above requirements on their own are however unlikely to go far enough in encouraging the development of the retirement income market and improving outcomes in retirement.

The FSI recommended that superannuation trustees should be required to pre-select a CIPR. Such a requirement is needed to promote efficiency and healthy competition in the market for retirement income solutions and enable super trustees, with the support of their advisers, to better meet the diversity of member needs in retirement.

In the absence of a specific requirement on trustees to offer CIPRs, progress will be too slow and there will be insufficient market demand to promote the development of an efficient and effective market. Providing trustees with clarity about expectations and guidance would offer some help in but is not a panacea in encouraging the development of the retirement incomes market.

Flexibility of Choice

There are difficulties enough in developing soft default arrangements to meet the divergent needs of retirees as discussed above. To mandatorily require that a proportion of balances be annuitised would only exacerbate these difficulties and would raise further issues.

The first issue is how to determine an appropriate amount to be mandated that can accommodate the varying needs of retirees.

Second, if mandating were to apply only to retirees with balances within a given size range (eg in the order of $200,000 to $2 million), significant vertical equity implications would be raised as it would be treating people differently depending on the size of their superannuation balance. Moreover, it would provide the greatest flexibility to those who have benefited most from concessional super tax arrangements while limiting flexibility to those for whom compulsory super arrangements have .

Third the implementation issues would be significant given that the majority of members have multiple balances and some may already have a defined benefit pension arrangement.

Fourth, it would also raise claims of making significant changes with retrospective impact given that members have built significant superannuation balances during their working life with the expectation that they would be entitled to choose how to draw down in retirement. This would require consideraiton of transitional arrangements.

Conclusions

Regulatory Architecture

1. CIPRs should be provided on an opt in (rather than a more passive opt out basis) to mitigate the risk of members being assigned a CIPR that is unsuitable for their needs.
2. The regulatory framework should facilitate the provision of multiple CIPRs based on member segmentation and support trustees in preselecting a CIPR for their members in two ways. First by specifying minimum design requirements of the CIPR product. Second by outlining the key process requirements for engaging members in the preselection of a CIPR. If trustees meet the conditions for both of these elements they would be assured of having met their legal responsibilities.
3. CIPR design features - the following design principles for CIPRs are proposed:

- Regular and sustainable income streams**.**
- Longevity risk protection – while CIPRs would not require guaranteed income for life, they would involve a portion of income being sourced from some form of mortality pooling arrangement.
- Low cost commensurate with the benefits to the member.
- Flexibility, particularly in relation to meeting members' needs over the course of retirement, is best addressed in the range of CIPRs offered and as part of the process for guiding members' choice of CIPRs, rather than as a minimum requirement for each CIPR product.

4. Mandatory restrictions on the use of super balances by retirees are not recommended given the difficulties it would present for meeting the diversity of retiree needs and circumstances.

Retirement Income Products

5. The treatment of new income stream products under the social security means test should be clarified to permit product development and allow competitive neutrality among products.
6. For those who can afford them, non-super products which use the pooling of longevity risk to help fund health and aged care will increase self-sufficiency and by doing so reduce fiscal pressures. These products need to be accommodated in health insurance and aged care legislation. Similarly, they also require clarity on their tax and means test treatment.
7. Regulatory authorities should facilitate product innovation by providing a central point of contact for new product development.
8. Aged Care – consideration should be given to facilitating the provision of a single premium aged care lifetime loan product.

Financial Advice

9. Current requirements and guidance in relation to scaled and intra-fund advice ought to be reviewed to determine whether modification or further guidance is needed to facilitate the provision of CIPRs.
10. Strategies to increase the role of financial advice in relation to retirees managing their superannuation balances include:
    - Ensuring training of advisers in relation to retirement related matters (such as annuities, age pension and aged care funding)
    - Setting standards for financial advisers who are advising on retirement matters to ensure competency across the complexity of retirement issues.
    - Regulatory settings to facilitate the rapid evolution of digital advice in retirement matters.

Empowering Members

11. Requiring funds to inform members of their projected income in retirement in member statements is a significant policy development that will encourage members to focus on retirement incomes.
12. Government, industry and consumer should collaborate in:
    a. Developing disclosure requirements suitable for the decumulation phase where retirement income is the goal. Information architecture is needed to enable product comparisons across a range of features to be understood by members including the trade-offs among different products in relation to the strength of guarantees, as compared to a target, and the cost of guarantees.
    b. Providing product agnostic information to assist members in making decisions regarding their retirement benefits; and
13. Government, industry and consumer groups to work together to develop a plan for providing education on the benefits and operation of home equity release schemes.

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