COMMITTEE FOR SUSTAINABLE RETIREMENT INCOMES

Making Income the Goal – a regulatory framework for the retirement income system

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Executive Summary[1]

The development of a retirement policy position needs to be carried out within the context of the objectives of superannuation. CSRI considers that an appropriate objective for the superannuation system is: "*to provide adequate income through all the years of retirement for all Australians in a sustainable way*". It is acknowledged that this objective is different to the Commonwealth government's objective of "To provide income in retirement to substitute or supplement the Age Pension". However it is appropriate for the government's objective to set a minimum standard, and at the same time for Australians to have more aspirational goals.

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 retirement incomes would improve the effectiveness of the retirement income system and make it sustainable in the face of population aging.

If the objective for the retirement income system is to be achieved, we need to refocus superannuation from being about wealth accumulation and make it clearly directed towards the provision of secure retirement income. In effect, we are seeking to develop a post retirement system that builds on the benefits of the accumulation phase in superannuation, being predominantly prefunded defined contribution (DC) plans, by providing outcomes in retirement more akin to defined benefit (DB) arrangements. In the past, the low account balances of people in retirement has led to little focus by superannuation funds on the post retirement phase. However, baby boomers retiring with larger superannuation balances increases the priority for now developing the post retirement system.

Setting income as the goal of the superannuation system is the first step in moving from a wealth accumulation focus to a broader focus on retirement income sustainability. The system needs to encourage new delivery mechanisms for longevity protection and pooled products, life cycle products and continuous engagement between advisers and their clients and superannuation funds and their members which will not treat retirement solutions as set and forget.

For many Australians, particularly those who commenced work before the Superannuation Guarantee regime started, their main form of lifetime savings is their home. Despite this, housing wealth has not often been considered in the context of retirement funding. However, the significant increases in the value of housing and the economics of financing an ageing population have drawn attention to the need for policy reform options to improve access to home equity to supplement retirement incomes and improve adequacy. This is discussed in *Position Paper 1: Adequacy*, however some additional policy measures to facilitate the development of the market in equity release products are discussed in this paper.

Complexities of managing risks

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

Many retirees experience significant difficulties in managing the complex risks they face in retirement including longevity, investment 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?

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

- 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?

Despite this complexity, it is estimated that only 20% of retirees seek advice from a financial planner. Evidence shows that most retired members are conservative in their drawdown while a significant proportion also makes withdrawals at an unsustainable rate. The simple reality is that no retiree knows how long he or she will live, meaning that an optimum drawdown/investment strategy is not possible.

On this basis, the regulatory framework needs to accommodate three decision pathways:

- *Member-directed choice* – with or without the assistance of professional planner.
- *Trustee-guided choice:* Options could range from limited through to active member involvement progressively involving a more detailed assessment of needs, and more customised solutions.
- *Defaults:* Members who don't make a choice are allocated to the default retirement product. Similar in concept to MySuper, although it would preferably be on an opt in basis.

Income Streams

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, longevity and inflation risks. Composite products combining exposure to market and longevity protection are needed to mitigate these risks. Accordingly, it is imperative that retirement income solutions include marshalling more effective ways of pooling to hedge longevity risk and lessen reliance on the Age Pension.

Factors impeding innovation in post-retirement offerings and take up of longevity products include:

- Current low interest rates make annuities an unattractive proposition when viewed as an investment.
- Adverse selection by members in the choice of income stream products based on pooling of longevity risk make these products more expensive.
- Regulatory impediments contribute to the lack of 'fit for purpose' products although the Government has announced it will remove these. In particular, the government proposals would facilitate the development of deferred annuities and investment linked annuities.

The Financial System Inquiry (FSI) identified the potential of longevity protection in a composite retirement solution with an ABP to maintain exposure to the market and provide flexibility. It proposed that trustees be required to preselect for their members a Comprehensive Income Products for Retirement (CIPR). It is intended that these CIPRs will help to provide members with suitable retirement income which properly manages the principal retirement risks identified above.

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.

Development of post-retirement regulatory framework

Trustee requirement to offer CIPR

The FSI recommended that superannuation trustees be required to pre-select a CIPR. The Government has accepted this recommendation and CSRI likewise endorses it. 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 specialists including financial planners, to better meet the diversity of member needs in retirement. In the absence of such a requirement, 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 will further hasten the development of the retirement incomes market and reduce complexity for members and planners.

Supporting trustees' ability to support retirees

A trustee's ability to innovate superior approaches based on specialised advice should not be unduly inhibited. At the same time, allowing unfettered flexibility is unlikely to be conducive to faciltating demand and creating a market. If the regulatory framework is too open ended, the results 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 to avoid the need for a rebuild and to ensure that they protect the interests of their members.

The framework should encourage trustees to take necessary steps to provide CIPRs that enable some customisation to members needs and circumstances. If the compliance requirements are set too high, it would have the adverse consequence of encouraging trustees to simply offer a single default which would not further the interests of their members.

On that basis, the regulatory framework for CIPRs should include the following:

- The legislation would specify minimum product requirements for CIPRs.
- Trustees would have discretion to decide the number of CIPRs, and the extent of customization, to offer the fund membership.
- Members are informed of the existence of CIPRs and their main features and then offered the choice.
- Members are offered advice to assist is making their choice.
- If more than one CIPR is available and the member makes no choice, the trustee must identify one CIPR that the member should consider selecting (soft default).
- Trustees would need to comply with both the CIPR design requirements and financial advice requirements.
- After a period of time, say five years, the experience of CIPRs would be reviewed and the arrangements would be modified as needed depending on outcomes.

CSRI considers that this approach would encourage the development of solutions that better meet the range of member needs on a customized basis.

CIPR Minimum Product Requirements

Development of minmum 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, at least in relation to the default option. There again, a single product would not be capable of meeting the needs of the majority of members.

On that basis, a composite product is prefered while recognising the need to be realistic about the ability to meet all of retirees needs. The following design principles for CIPRs are proposed:

- Longevity risk protection – while CIPRs would not require guaranteed income for life, they would involve the payment of a portion of income sourced from some form of mortality pooling arrangement.
- Regular and sustainable income streams.
- Ability to take account of cognitive impairment at older ages - involving 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.
- 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.

Supporting Retirees’ Ability to Make the Right Choices

The complexity of retirement decision making suggests that most members would likely benefit from impartial financial advice. Given the significant constraints in providing tailored advice to all retirees in retirement, it is envisaged that the provision of CIPRs would be enhanced through the use of cost effective processes for delivering improved outcomes. These requirements are provided for under the existing financial advice regime for full service, scaled advice and intra-fund advice (although further modifications or guidance may be called for as referred to below).

The CIPR regulatory framework should be suitable for both highly engaged and disengaged members by assisting members to navigate product choices. 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 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.

Key features of member engagement on CIPRs:

- 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. Advice provided within existing advice regime - full service, scaled and intra-fund advice.
    - Offer member the soft default retirement option (opt-in) if they do not wish to make a selection.

- inform member of projected income in retirement using that default
- Provide appropriate warnings – circumstances in which the default is not suitable.

Members who do not engage in the process would be offered a soft-default CIPR option. (Member would have to make conscious decision to opt-in, unlike MySuper opt-out arrangement). There may be more than one option however the only customisation would relate to objective information that a superannuation fund would hold for any member - such as account size and age and additional information sought from members (eg, such as whether the member has a dependent spouse).

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. Furthermore**,** 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.[2]

Additional protections would be provided to minimize the risks of placing individuals in an inappropriate CIPR. First, the triage process would ideally screen out individuals for whom this approach would not be suitable. Filtering criteria could include high debt levels, significant health issues, and multiple dependents. While it is beyond the scope of the trustees' responsibilities to seek information on such matters from members, it is not beyond the scope of financial advisers (or trustees acting in a financial advisory capacity) to do so.[3] An underlying premise of this approach is that CIPRs would be provided under advice.

Second, reviews or refresh would ensure that the default remains appropriate for the members' circumstances at different stages of retirement.

Safe Harbour Protection for Provision of Advice

If trustees are to be required to assist their members in choosing a CIPR, trustees could effectively be providing personal financial advice and would need to be appropriately licensed to do so. This raises the question of whether the current financial advice regulations would accommodate trustees' providing advice that is limited in scope for the purpose of preselecting CIPRs, and based on a limited range of facts.

Regulation to support the provision of advice that is limited in scope already exists within scaled advice. 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).

Cost of advice may however serve as a major impediment for trustees to offer scaled advice to all their members approaching retirement. '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. Intra-fund 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.

- It can only relate to a beneficial interest in the fund or related assets. Therefore it cannot relate to third party retirement income products.

[2] 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).

[3] Trustees' duty to act in the best interests of their members is limited to the member's beneficial interest in the fund. This would limit their ability to ask members questions relating to other financial matters that are important for determining a suitable retirement income product but are unrelated to the fund e.g. number of accounts, debt levels, health, dependents, homeownership etc

- It cannot relate to ongoing personal advice. On that basis it precludes periodic reviews, and monitoring of the implementation of the advice.

The processes for preselecting CIPRs for members would require an understanding of members' situations and involve a limited form of financial advice. Consideration should be given to broadening the current rules for intra-fund advice to accommodate trustees' provision of CIPRs for members.

Mandating use of Super Balances

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

First, how to determine an appropriate amount to be mandated that can accommodate the varying needs of retirees. If mandating were to apply only to retirees with balances 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 super tax concessions.

Implementation issues would be significant given that the majority of members have multiple balances and some may already have a private pension benefit.

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

Conclusions

Regulatory Architecture

1. Superannuation trustees should be required to provide information to members about the selection of a Comprehensive Income Product in Retirement (CIPR). If members do not participate in the selection process, the trustee would be required to provide information about a CIPR option.
2. 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.
3. The regulatory framework would support trustees in guiding their members in choosing a CIPR in two ways. First by specifying minimum design requirements of the CIPR product. Second by outlining the key process requirements for guiding the members' choice of CIPR. If trustees meet the conditions for both of these elements they would be assured of safe harbor protection.
4. CIPR design features - the following design principles for CIPRs are proposed:
    - 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.
    - Regular and sustainable income streams.
    - Ability to take account of cognitive impairment at older ages - involving some form of deferred secure income that requires little intervention from the retiree in their senior years or other approaches that may achieve a similar result.
5. Current requirements in relation to scaled and intra-fund advice ought to be reviewed to determine whether they are adequate for CIPRs or whether modification or further guidance is needed.
6. Mandatory restrictions on the use of super balances by retirees are not recommended.

Retirement Income Products

7. The Parliament should pass the government's bill to remove regulatory impediments to the development of post retirement products. This would involve the introduction of an additional set of income stream product rules, the key features of which should be:
   - 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.
   - Products would not have to meet the minimum drawdown requirements to qualify for the earnings tax exemption, but would have to comply with a diminishing capital access schedule.
   - Effective operation of the products under the alternative rules will require a credible pool size and for income payments to be determined at arm's length. Accordingly, it would not be appropriate for products under the new rules to be offered directly by either SMSFs or small APRA funds.
8. The Department of Social Security should clarify the treatment of new income stream products under the social security means test to permit product development and allow competitive neutrality among products.
9. For those who can afford them, 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.
10. There should be an ongoing focus on the identification and removal of regulatory barriers when identified as impeding the market.
11. Regulatory authorities should facilitate product innovation by providing a central point of contact for new product development.
12. Aged Care – consideration should be given to facilitating the provision of a single premium aged care lifetime loan product through the following:
    - Government guarantee on return of the bond to the life office should apply in the same way as it applies to a resident;
    - Product needs to be assets test treated in the same way as a bond paid by the resident;
    - Resident must be legally capable of assigning to the life office any right to return of the bond so that it can be dealt with outside their estate; and
    - Alterations to the Aged Care Assessment Team (ACAT) assessment criteria must be capable of being monitored so that life offices can understand changes in the risks they are underwriting.

Financial Advice

13. 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

14. 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.
15. Government and industry should collaborate in 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.
16. Government and industry to also work together to develop a plan for providing education on the benefits and operation of home equity release schemes.

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