COMMITTEE FOR SUSTAINABLE RETIREMENT INCOMES

C

Making Income the Goal: Developing a Regulatory Framework for Post Retirement Solutions

CSRI Policy Discussion Paper
Consultation Draft October 2016

Prepared by Patricia Pascuzzo

Contents

What are the problems to be solved?

Experiences in retirement

Successive studies have shown that Australian pensioners are living cautiously in retirement – many are maintaining or even building up their balances during retirement and then leaving unexpected bequests to their heirs (Wu, Thorpe and Wang 2014). While high income earners leaving bequests is to be expected, the fact that low income earners are not using their superannuation balances effectively suggests the system is not working as well as it should. The superannuation system (including both compulsory and voluntary elements) was established to provide income in retirement not to facilitate the leaving of bequests.

A recent study commissioned by the Actuaries Institute showed that 49% of members across all ages are drawing only the minimum income required, with the proportion drawing the minimum being much higher for members aged under 75. This indicates that many members are living more frugally than they need to. At the same time, the study showed that 20% of retirees are withdrawing from their super at an unsustainable rate.

It reflects the difficulties people face in managing consumption when they don't know how long they will live (ie longevity risk). This is not surprising given the complexities associated with managing investment, inflation and longevity risk are difficult enough for financial professionals to manage let alone for the average person in their twilight years who doesn't have an actuarial degree. Cautious consumption behavior reflects that retirees are concerned about outliving their savings and/or having funds available to meet major unexpected expenses.

A 2013 study conducted by National Seniors Australia revealed that:

- Retirees become more conservative during retirement and look at risk as whether the money will be there when it is needed, rather than volatility
- Retirees want an income stream that is able to be maintained throughout their lives, and to be able to meet health and related expenses.

The Productivity Commission found that

- about 1/3rd of older Australians are uncomfortable with their own retirement planning.
- financial planning decisions / activities of older Australians are impacted by imperfect information and cognitive constraints (as well as a reluctance to plan for ill health and end of life).
- there appears to be a reluctance to seek advice along with poor knowledge of the decisions that need to be made, as well as available options and government policies. This can lead to the family home becoming a form of self-insurance.
- the further the person is away from retirement, the more that the person expects that they will be able to maintain their current standard of living after they retire.[1]

There is a need to improve the efficiency with which superannuation balances are used to generate income in retirement. This would help provide security in retirement and contain the extent to which people rely on the age pension for longevity insurance, particularly where they should have sufficient assets at the point of retirement to self-fund all or a substantial part of their retirement.

If superannuation members do not make a conscious choice upon retirement, their funds remain invested as they were during the accumulation phase. Most retirees' superannuation balances are invested in Account Based Pensions (ABPs) with investments usually in balanced funds. ABPs do not

[1] Productivity Commission 2015, *Housing Decisions of Older Australians,* Commission Research Paper, Canberra

generally provide any longevity protection although some options are available on some platforms for members to invest in lifetime annuities and/or group self-annuitisation investments. Only around 20% of superannuation members at retirement seek full financial advice to be able to plan for the full range of complex matters that should be contemplated – this leaves the vast majority of members looking for defaults or simple choices that are being treated as "set and forget".

While current products and retirement planning approaches have generally performed reasonably in recent years, these can't be relied upon as sustainable going forward, especially as superannuation balances continue to rise and more retirees are increasingly self-funded. Given the compulsory and tax supported nature of superannuation, the government also has an interest in ensuring that superannuation provides sustainable incomes through all the years of retirement.

This issue of retirement income will be of increasing concern as increasing numbers of people enter retirement and the superannuation system continues to mature – the median household superannuation balance for couples approaching retirement is less than $200,000[2], but will continue to rise dramatically in coming years as individuals retire with longer periods of employment under the Superannuation Guarantee framework. This raises the importance of ensuring balances are used to provide income at retirement on an effective and efficient basis to ensure individuals' financial well being and to alleviate pressure on the age pension.

Barriers to effective retirement planning

All retirees need secure income, access to capital and inflation protection but each individual retiree needs these in varying quantities depending on their particular circumstances. Managing their superannuation benefit to finance their retirement in an optimal manner is a complex exercise that poses a significant challenge for most individuals. The issues to be managed include:

Behavioural Bias' - The research literature suggests a series of factors that may explain why people have difficulties in planning for retirement and choosing retirement products. The main factors include lack of general financial knowledge, lack of domain-specific knowledge and various psychological biases that undermine people's ability to plan ahead, save for retirement and take other related decisions. These biases and their implications on retirement decision making are discussed in a separate CSRI Discussion Paper.

Uncertain life expectancy – People don't know how long they will live and how long their savings need to last although they tend to underestimate their longevity. At the same time women have higher age expectancy which raises particular issues as they have lower balances on average.

Managing drawdowns – Factors that need to be managed in the drawdown their superannuation include:

- The complex interactions between pension and aged care requirements.
- Changing expenditure needs as retirees move through the different phases of retirement from the active to the less active years with implications for capital and income needs.

Retirement risk zone and sequencing risk – Designing a strategy that converts from accumulation to drawdown on a set point in time risks locking in low income if there is a fall in the market in the lead up to retirement. The risk of significant market event needs to be managed.

Managing these risks is highly complex and beyond the capability of the average retiree. In reality many people lack the necessary financial literacy, motivation and engagement. Default arrangements have been developed in accumulation to deal with these complexities, however retirement is much

[2] For all households with super the median household balance for 60-64 year olds was $184,000. Source ABS 2013-14 survey.

more complicated. In a perfect world, members would have a personalised plan developed for them and they would be actively managing their investment and consumption in accordance with the plan.

Personal advice provided by financial planners is tailored to the needs of the individual or couple. It takes into account the individual's goals and interactions with the tax, superannuation and social security rules to maximise income. It can also be ongoing so will involve active management of inflation, market and longevity risk as well as changing expenditure needs. However, only 20% of the adult population seeks professional financial advice (Investment Trends, 2014).[3] Reasons include lack of understanding of the purpose of financial planning, perceptions that it is only for the wealthy, and lack of trust.[4]

System complexity exacerbates the difficulties associated with retirement planning. In designing the regulatory framework for post-retirement, a key priority is to minimise the level of complexity to make it easier for consumers to make choices.

Trustee Risk Management

Given the financial advice regime in Australia, trustees normally limit themselves to providing 'factual information' or 'general advice' about their fund to members or prospective members. General advice can include providing education tools such as calculators. Trustees can also provide intra-fund advice to members (eg, advice about the fund's investment options or insurance arrangements) under certain conditions.

Personal advice to individuals can only be provided within rigorous regulatory requirements, and trustees will refer their members to financial planners to receive personal advice. Many trustees have an association/ongoing referral arrangement with a financial planning organisation in place. A trustee has limited protection in providing members directly with personal advice.

Preselecting a CIPR for members could be construed as providing advice and trustees could be open to claims by individual members if the default turns out not to have been the "best" option for a particular member.

The experience with MySuper in the accumulation phase involved trustees setting a default for compulsory superannuation contributions. A MySuper could only be offered after rigorous development to meet regulatory requirements and receive APRA approval (and meeting ongoing requirements), allowing trustees to be confident in offering a default.

The risks of establishing a default in the retirement phase are much greater given the increased complexity (see discussion above). If trustees are to provide default retirement income solutions, they would be doing so with a mixed understanding of personal circumstances of the bulk of their members, and how these circumstance change over time. If funds were to establish a range of different default retirement solutions for different members cohorts they would then need to channel members into what the trustee considers to be the most appropriate product for members who are unable to chose for themsleves. In this situation, trustees could potentially be subject to claims by members of inappropriate selection or recommendation of products.

Trustees will require clarity about their responsibilities and how they can ensure that they have met them to avoid potential exposure if a member subsequently claims to have been placed –or encouraged – into the "wrong" solution for them.

[3] Investment Trends, Advice and Limited Advice Report, Sydney December 2014.

[4] ASIC Report 224: Access to Financial advice in Australia Sydney December 2010.

Regulatory barriers

The development of other annuity style retirement products is currently hindered by regulatory settings. The barriers were identified in the 'Retirements Income Streams Review' paper (Treasury, May 2016).

A key barrier is that in order to qualified for the tax exemption on earnings derived from assets supporting a superannuation income stream, the rules currently require that products make a minimum annual payment (ie, the annual minimum drawdown requirements) and prohibit non-account based products from paying an income that varies from year to year other than in line with CPI, average weekly earnings or a constant percentage factor. Accordingly, the current requirements do not provide earnings tax exemption on products such as deferred annuities or group-self-annuities (GSA's) unless part of an ABP. Treasury recommended changes be made to the requirements for earnings tax exemption to allow for these and other annuity-style products that may develop.

Legislation to give effect to the Treasury's recommendations were passed by the Parliament as part of the 2016 Superannuation package with effect from mid-2017. The treatment of other annuity-style products under the social security means test remains uncertain. The government has announce that this be clarified so that the means testing of different products is neutral, equitable and resilient.

Lack of product solutions

Given the cumulative effect of the foregoing factors, the range of pension products available on the market is limited. In practice, the post-retirement product landscape is currently dominated by Account Based Pensions, with a small proportion of superannuation funds retained in lifetime and fixed term annuities. Given the needs of retirees for a combination of a secure income, access to capital and inflation protection, the availability and take up of different products is clearly lacking.

The following section outlines both the available products and the potential products that could be supplied given a more conducive environment.

Account Based Pensions

The current dominant retirement product solution for superannuation benefits are Account Based Pensions (ABPs) – 94% of retirement monies in superannuation are held in ABPs[5]. ABPs have been viewed as an attractive approach by superannuation members as:

- Product construct is fairly easily understood
- Typically involves as wide a range of investment options being available as there are in the accumulation stage. This means that there is wide choice in the allocation of the account balance between growth and defensive assets.
- Enables investments to be held in a non-taxed environment
- Provides an income stream with the minimum annual drawdown of the account balance and no maximum drawdown[6]
- Allows access to capital – the account balance can be withdrawn in part or in whole at any time
- Financial planners/financially astute members can use the range of investment options to mitigate potential sequencing risk

[5] Plan for Life 2014, Data provided to Financial System Inquiry, 23 June 2014

[6] 4% for ages 55-64, 5% for ages 65-74 and increasing for older ages. The Government had to halve the minimum payment rates for account-based pensions for the 2008-09, 2009-10 and 2010-11 financial years and reduce them by 25 per cent for 2011-12 and 2012-13, in recognition of the impact of the global financial crisis (GFC) on equity markets.

- The account balance is portable – if a member is dissatisfied with their provider, they can transfer it to another provider, albeit that the transfer is not as straightforward administratively as transferring superannuation balances in the accumulation phase over from one superannuation fund to another.

However, ABPs do not generally provide any longevity protection and this likely to be an increasingly important issue as the superannuation system continues to mature and life expectancy also increases. While defined benefit pensions, including privately purchased lifetime annuities, will continue to provide retirees with income for as long as they live, the ability of ABPs to continue to pay income and support the costs of aged care in the later years of retirement is highly uncertain.

Also, ABPs do not ensure a stable income and/or inflation protection – the investment return and consequential income will be subject to investment market returns and whether the account is invested aggressively or conservatively. Sequencing risk can only be mitigated if the portfolio is carefully planned and regularly monitored.

Accordingly, while ABPs have many advantages for retirees, they have sigificant limitations particularly if they are not regularly reviewed.

Other post retirement products

There is a range of other post retirement products available for investing superannuation balances at retirement. Some of the following products have an element of longevity protection but the take up of such products has been low in recent years.

Lifetime annuities – these products are designed to provide an income for the lifetime of the member. There are a range of features that can be included in a lifetime annuity such as an income amount that is indexed each year (a fixed annual amount or for inflation), a guaranteed minimum payment term and/or a proportion of income continuing to a surviving spouse upon the death of the member. Each additional feature will reduce the amount of the income that would be payable for the amount invested. There are currently a limited number of providers in the Australian market, and annuities have been out of favour with retirees since aged pension asset test exemptions were removed. Lifetime annuities are not favoured without tax or social security incentives as they are seen as expensive compared to other investments (effectively, the cost of longevity protection is not valued), are impacted by the current low interest environment and due to loss aversion (individuals believe they could “lose” by dying early). Another challenge is that it can be difficult to change lifetime annuity providers if dissatisfied with the product as there can be considerable penalties to surrender a lifetime annuity to move to another provider. From a provider perspective, the market has limited attraction with limited scale available given lack of demand and the capital reserves that need to be held to back the lifetime guarantee.

Fixed term annuities – where a guaranteed income is provided for a fixed term (such as 2 or 5 years), generally with a return of the capital amount at the end of the period. Fixed term annuities are viewed more favourably by retirees than lifetime annuities but do not provide longevity protection.

Deferred lifetime annuities (DLA) – this is essentially a lifetime annuity, but with a deferral period. The development of DLAs has been hampered by the regulatory framework. Previous DLAs have not been successful in the market as individuals were concerned about putting monies aside for potentially no value (ie, dying before DLA commences) as the longevity protection is not valued.

Retirement protection guarantees – some product providers (eg, AMP, MLC) make available a guarantee that income will continue for life under an ABP under certain conditions such as only using a limited range of investment options. The take up of these options has been low due mainly to the costs of the guarantee being seen as unattractive.

Group self-annuitisation (GSA) – under a GSA, members contribute funds to a pool that is invested and regular payments from the pool are made to surviving members. The pooling delivers higher income in retirement than an ABP due to mortality credits, while also providing significantly more protection against longevity risk. GSA are not capital backed and provide no guarantee as such they do not eliminate longevity risk completely. The level of payments will be impacted by investment market returns. GSAs are a new product in the Australia market with only one provider still at early stages of roll out.

Some super funds are providing some of the products discussed above as an investment option on their ABP menu. For example, lifetime annuities and/or fixed term annuities are appearing now on some menus as options available to retirees. Similarly, the GSA product is being introduced onto some ABP investment menus. Other developments include UniSuper announcing that from 2017/2018, it intends to offer FlexiChoice where the default retirement offer will be a lifetime annuity.

Most trustees and product providers however are awaiting details of Comprehensive Income Product in Retirement (CIPRs) requirements before developing their retirement offering further to avoid rebuilding the offer.

Conclusions

Retirees face complex array of risks to manage at retirement and a range of strategies are needed to manage these risk. Improving financial literacy can help to empower members to manage these risks however the effectiveness of compulsory superannuation cannot rely on members becoming financial experts. Financial planners have an important role to play in assisting retirees.

However in the context of highly complex system, behavioural bias' in decision making trustees also have an important role to play in nudging people into appropriate solutions. Default arrangements have been developed for the accumulation phase to help guide members' retirement decisions (My Super regime). A regulatory framework for post retirement is also needed to help people transition to retirement. This is discussed in the next section.

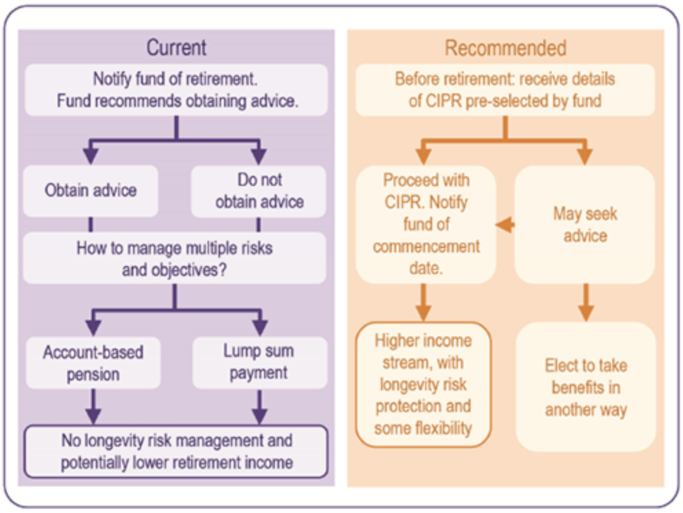
Post Retirement Policy Framework Development

The Financial Systems Inquiry (the Murray Inquiry) considered the retirement phase of superannuation and recommended that:

> *"Require superannuation trustees to pre-select a comprehensive income product for members' retirement. The product would commence on the member's instruction, or the member may choose to take their benefits in another way. Impediments to product development should be removed."* (Financial System Inquiry Recommendation 11)

The Murray Inquiry envisaged that a Comprehensive Income Product in Retirement (CIPR) would represent a combination of products to enable retirees to balance the three desired features: high income, risk management and flexibility. Pooling of longevity risk would give retirees greater confidence to draw income. Alternatively, by improving the superannuation system's efficiency in providing retirement income, people may be able to save less during their working lives to reach a given level of retirement income thereby allowing them to enjoy higher consumption during their working lives.

The Inquiry recommended that a CIPR would be preselected for retirees but would commence only with member's instructions (on an opt-in rather than an opt-out basis) in accordance with the simplified decision tree below.



The Murray Inquiry recommended that the Government set minimum requirement features for CIPRs, with the expectation that a combination of products would be required.

The October 2015 Government's response to the Murray Inquiry included the following in relation to Recommendation 11:

> "The Government **agrees** to support the development of comprehensive income products for retirement and will facilitate trustees pre-selecting these products for members.
>
> Trustees' pre-selection of such products will help guide members at retirement. Comprehensive income products for retirement could improve outcomes for retirees, including through increased private retirement incomes, increased choice and better protection against longevity and other risks.
>
> The range of products available at retirement is currently narrow and does not always meet individuals' needs and preferences.

We will continue work to remove impediments to retirement income product development.

Further consultation is required to develop a principles based framework for pre-selection of a comprehensive retirement income product by superannuation trustees. This framework will be developed with regard to the outcomes of the Tax White Paper process and the Retirement Income Streams Review."

The Retirement Incomes Streams Review was released in May 2016, and addressed some of the regualtory framework. The Minister subsequently released a discussion paper on CIPRs in December 2016.

Facilitating the Pre-Selection of CIPRs

Since late 2015, the CSRI has been collaborating with industry and academic partners in developing a regulatory framework for the post retirement system. Two alternative approaches to the design of the regulatory framework were considered:
Alternative 1: Minimalist Approach – CIPRs positioned as simply an 'opt in' retirement income product options.

- The legislation would specify minimum product requirements for CIPRs (as outlined below) and require that trustees inform members of the existence of the CIPRs and their main features.
- Trustees would only need to provide one CIPR. A soft default option (requiring the member to opt in) must be offered as a minimum.
- There would be no requirements relating to engagement with members. Advice is not required although it could be provided.
- Trustees would receive safe harbor protection in relation to both product design and product offer.

Alternative 2: Broader approach – would involve two core elements of trustee obligations.

The first would cover the minimum design requirements of the CIPR solution (as per Alternative 1 above) while the second would relate to the key features of the process for guiding the members choice. This would 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.
    - Advice provided within existing advice regime - full service, scale 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 health warnings – circumstances in which the default is not suitable

This process would be excluded from the advice regime.

CSRI considers that the broader approach is preferred over the minimalist approach as it would encourage the development of solutions that better meet the range of member needs on a mass customized basis.

Both for guided choice and defaults arrangements, trustees would be seeking a legal clarity of their responsibilities to protect against claims by individuals that they were placed in an inappropriate solution. Accordingly, it is necessary to have an approval process so that if trustees meet those requirements they can avail themselves of the safe harbour.

There are two interrelated factors that require approval. One is the approval of the CIPR "product". The other is the process for preselecting a CIPR appropriate to their needs. Legal clarity on both of these aspects is needed. The extent to which a safe harbour should apply, if at all, is an important policy question.

In summary, the key elements of the proposed framework are:

- Trustee requirements to offer CIPRs.
- Development of design principles for CIPRs and regulations for assessing products to qualify as CIPRs that meet the diverse needs of retirees while balancing the need for simplicity and scale economies.
- Clarity around guided choice architecture to enable CIPRs to be preselected for members to appropriately manage the range of risks they face in retirement.
- Legislative changes to clarify the trustee duty of care to ensure that members' interests are appropriately protected
- Removal of regulatory impediments to the development of retirement income products that would provide an effective hedge against longevity risk such as to promote healthy competition in the market for longevity protection.

Each of the above elements of the regulatory framework is discussed below.

Product Requirements

The options for CIPR product approval processes, include:

- Leave it to the discretion of trustees on the basis that trustees are already required to act in members' best interests. However, this gives total discretion to the trustee without guidance. This is too open-ended and provides little change from the status quo.
- Some form of market regulation, where trustees are free to design the CIPR solution that they believe is the most appropriate for the membership, with an independent body reviewing all proposed CIPRs and endorsing CIPRs for release. The option envisages that the alternative default super model for accumulation funds could be extended to post retirement defaults.
- Development of regulations or guidelines that trustees must follow in designing CIPRs. This would provide guidance to trustees to enable faster development of CIPRs, and builds on trustees' existing obligations to act in members' best interests.
- CIPRs developed by trustees subject to regulator (APRA) approval, similar to the approach for MySuper. However, this option involves additional steps and potential delays in releasing CIPRs with APRA being required to check compliance with regulations.

The third option is the preferred option, striking a balance between guidance for trustees to facilitate speed of development and allowing sufficient trustee discretion to better meet the needs of members. The following section discusses proposed minimum product requirements of CIPRs.

Comprehensive

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 realaistic about the ability to meet all of retirees needs.

Suggested attitude: "Comprehensive" (in the CIPR context) would suggest that the CIPR/s, will be designed to meet the totality of member's retirement income needs in terms of income security, inflation protection and access to capital. Meeting all of these needs suggests not one but a composite product. This requirement could be relaxed at least in the early years of development of CIPRs or at least in relation to the default option.

Given that individuals (or couples) require each of these (trilemma) needs in varying combinations and have widely diverging circumstances, the question is what degree of tailoring will CIPRs provide?

The more customised are the design of products to meet the needs of members, the more complex the products will be. We know from behavioural economics that complexity and too much choice is the enemy of decision making. This raises the trade-off between simplicity in the offer and allowing flexibility and tailoring to member needs.

To what extent will regulation determine the degree of tailoring required for the membership and to what extent will it be left to trustee discretion? Trustee will need enough discretion to determine the degree of tailoring required to meet the needs of the majority of their members.The number of defaults offered by trustees will come down to practical considerations of member needs relative to what is achievable given the degree of information obtainable from members and costs. These issues are taken up in the development of the choice architecture as discussed in the following section.

Regular and stable income stream

"*Regular and stable income stream*" is an important CIPR design feature. How will the proportion, or dollar amount, of a superannuation balance devoted to secure income be determined? Options include:

- Relative to external benchmark of basic spending needs in retirement such as the ASFA Retirement Standards.
- As a percentage of assets.
- As a proportion of current income levels of members.
- As a simple fixed or increasing amount, or varied depending on life stage needs.

If a target level based on some measure of adequacy is used, it will need to take account of other income streams such as the public pension and other stable income streams eg DB pensions.

Suggested Attitude: "*Regular and stable income stream*" would ideally be determined as a proportion of superannuation balance. The information gathering for the triage process would determine whether the member has other superannuation balances, public pension entitlements and other stable income streams eg DB pensions. A related issue is what type of products qualify as secure income. Suggest that market linked income return would qualify as "stable" income stream.

Flexible

Flexibility would imply the ability to meet the diversity of member/retiree needs over all the phases of retirement. The degree of flexibility required of CIPRs is related to the range of costs that superannuation is expected to cover, particularly whether it is intended to cover future aged care. CSRI's analysis indicates that compulsory superannuation contributions for the majority of people will be insufficent to provide adequate retirement income and meet future aged care costs. Further, CSRI subscribes to the view that, where possible, homeownership should be earmarked for future age care costs. On this view, CIPR's would not need to be flexible enough to meet the contingent costs of aged care.

Flexibility has to be managed against the potential for adverse selection. If the product can be surrendered or cashed out by product holders encountering serious health issues, this would undermine the pooling of longevity risk.

Providing a cooling off period can also be expensive in respect of longevity management products. It has been estimated that a 12 month cooling off period would cost 6 per cent of the principal for a lifetime annuity.[7] Allowing a "cooling off" period in excess of say two weeks would give new retirees the opportunity to benefit at the expense of existing retirees in the pool from changes in market conditions.

Therefore while a cooling off period is needed in any default process, this does not mean the ability to commute some, or all, of the longevity risk protection given the tension between seeking to pool longevity risk and offering flexibility to commute the pension at any time. Identifying and screening out members who have characteristics that are unsuited to CIPRs (such as poor health, high debt, complex financial arrangements) would help mitigate the risks of poor assignment.

Finally, the requirement that the member be assigned a CIPR on an opt in (rather than a more passive opt out basis) also protects against members being allocated a CIPR that is unsuitable for their needs.

It is important to manage the risks of locking in the solution at a time when market conditions may be adverse. However, this is to be addressed through the process for allocating members to a CIPR rather than as a minimum design requirement of the product.

Suggested Attitude: The need for flexiblity to meet the members needs over the course or retirement is to be addressed as part of the process for guiding members' choice of CIPRs rather than as a minimum design feature of the product.

Take into account cognitive impairment at older ages

According to Alzheimer's Australia there are more than 342,800 Australians living with dementia. Without a medical breakthrough, the number of people with dementia is expected to be almost 900,000 by 2050.

Suggested Attitude: CIPRs would desirably include some form of deferred secure lifetime income that requires little intervention from the retiree in their senior years. Other approaches that may achieve a similar end should also be encouraged.

[7] Modelling undertaken by Challenger.

Longevity Risk Management

The term “*longevity risk management*” is a key design feature of a CIPR that therefore needs to be defined.

The use of this expression rather than *“longevity risk protection*” by the FSI implies that CIPRs do not necessarily require guaranteed income for life, but do involve a portion of income resulting from some form of pooling arrangement including group self annuitisation and investment indexed annuity. It is important that regulation does not stifle product innovation to better manage longevity risk. The government announced in the 2016 Budget that it would implement the findings of the Treasury review of income stream products to remove the impediments to the development of new income stream products. Even once these changes are legislated, there will contine to be the need to monitor the effect of regulation to ensure such impediments do not re-emerge.

There is a tension between managing the longevity risk of the fund membership versus managing longevity risk on an individual basis. From a membership perspective, pooling of longevity risk requires that those that do not meet their life expectancy forfeit their death benefits to the pool to cover the benefits of those who exceed their life expecancy. Whereas from an individual basis, annuities are most valuable where the member expects to outlive their life expectancy as per the actuarial table giving rise to the problem of adverse selection. In addition to consideration of age and gender, there is the question of whether trustees will need to consider other individual member’s risk factors in greater detail in pre-selecting a particular CIPR.

Providing suitable retirement income solutions requires consideration of the combined life expectancy of couples. Given the very high probability that at least one member of a couple will survive to what is currently considered a great age, the use of joint lifetime annuities or lifetime annuities with a reversionary benefit would be appropriate.

Where the CIPR is needed to fund retirement income for a member and their partner or dependent, reversionary pensions should be provided for. This is particularly important as women on average have lower superannuation benefits than men and many rely on their spouse’s super to help finance their retirement. However reversionary benefits are more costly, and women are more likely to outlive their spouse. Therefore CIPRs intended for an individual who is a “dependent spouse” would be best not to provide reversionary benefits.

Suggested Attitude: *“Longevity risk protection*” implies that CIPRs do not necessarily require guaranteed income for life, but do involve a portion of income resulting from some form of pooling arrangement including group self annuitisation and investment indexed annuity. It is important that regulation does not unduly inhibit future innovation to better manage longevity risk.

- As restrictions on the payment of death benefits are needed for pooling of longevity risk (ie forfeiture of death benefits) trustees should be required to give priority to the needs of the group rather than individuals. However, there may need to be certain exceptions to this rule (eg terminal illness diagnosed before retirement) where the trustee may assume that longevity risk is sufficiently low that longevity risk is inappropriate. There will however be shades of grey in definitions and timing. Ideally, CIPRs should provide both single and joint life longevity risk protection products, so that members may choose the approriate product for their needs.

Gender Equity

In a policy environment that encourages greater take-up of annuities, the existence of gendered annuity pricing may have systematic adverse implications on women who already experience systematic economic disadvantage in retirement savings.

What are the pros and cons of maintaining the exemption from the sex discrimination act for insurance and superannuation products to permit gender-based pricing of annuities. What would be the implications of removing the exemption?

Further Analysis: A paper elaborating on these issues from a market perspective is to be prepared after which the broader public policy perspective will be overlaid.

Low cost

Cost is a factor to be taken into account in the design of CIPRs. The product should be provided at the lowest cost commensurate with the product benefits. It would be important that government and industry work together in developing a framework to enable members to compare products across a range of features, not just cost.

Suggested Attitude: CIPRs should be provided at the lowest cost commensurate with the benefits to the member. Government and industry work to develop a framework that assists members to compare products across a range of features including, but not limited to, cost.

In summary, 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. Meeting all of these needs suggests not one but a combination of products.

Given the complexities of providing a comprehensive product that meets all retiree needs as a default, the alternative viewpoint has also been put that a CIPR should be focussed solely on managing longevity risk, at least in relation to the default option.

The following additional 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.

Consideration would also need to be given to the design of the range of products, or more appropriately solutions, to match the needs of the membership base. This would involve:

- Consideration of the varying characteristics, needs and circumstances of their membership.
- Consideration of the principal risks in retirement (longevity, inflation and market risk, including sequencing risk) that have to be managed with the purpose of providing a reliable income stream over the course of retirement.
- Undertaking analysis to determine appropriate sets of retirement solutions to meet the range of needs of their membership base.

Supporting retirees to make the right choices

Consistent with the accumulation phase the post retirement phase needs to accommodate the spectrum of members from those who rely heavily on trustees' guidance through to those who are fully self-reliant in their retirement decisions.

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 option. Similar in concept to MySuper, although it would preferably be on an opt in basis.

Member-directed choice represents the current arrangements and is not discussed further. *Trustee Guided Choice and Defaults* are described and key issues associated with each are discussed in the following sections.

As highlighted in Part 1, members' needs are more diverse in retirement. Not only must they accumulate wealth, they must decide how much they can draw down while managing their pension means test and making sure that they don't outlive their savings. The complexity of retirement decision making is such that many members would benefit from financial advice. Given the significant constraints in providing comprehensive advice to all retirees, particularly costs and limited availability of planners relative to the number of retirees, more cost effective processes for delivering improved outcomes need to be devised. If the member chooses not to seek full financial advice, the regulatory framework should allow trustees to preselect a product for the member in a way that doesn't constitute financial advice and that achieves better outcomes than no advice. Guidance on a process that would meet with regulatory approval.

The more CIPR options provided, the greater the complexity, the longer the lead period and the greater the cost of change. Matters to be addressed from a trustee perspective are:

- Advice capability – trustees would need the infrastructure to provide retirement advice to members including on-going reviews, risk management and compliance systems.
- Information – administration systems for superannuation funds are generally not set up to capture and use additional personal information that would be required. Requiring trustees to provide guided choices that use personal information would require additional IT spend and delays.
- Technology - complexity of designing algorithms to allocate members to customised post retirement solutions. While robo-advice is expected to be able to assist with such decision making, there appears to be a lead time of several years until robo-advice would be widely available and trustees could be comfortable with the underlying decisioning tools.
- Achieving scale of post-retirement offers may be compromised if there are a multitude of tailored choices and defaults.

At the highest level, CIPRs try to achieve an appropriate balance between security of income (certainty) and access to capital (flexibility). However, preferences and circumstances will differ for each member.

Providing a tailored solution to each member would be impractical, therefore the framework should facilitate a segmentation approach in the development of CIPRs. Such an approach was envisaged by the FSI when it recommended that the trustees should be required to pre-select a CIPR for their members. (See FSI's Stylised example of decision making for superannuation benefits http://fsi.gov.au/publications/final-report/chapter-2/retirement-phase/.)

Preselection of CIPRs will rely on empirical information regarding member utility (for a given gender and age) and additional factual information about the individual member's circumstances.

While there may be multiple variations of CIPRs for different member cohorts based on a market segmentation approach, the aim should be to simplify the member's decision-making process by identifying and offering each member only one CIPR.

Trustees will seek certainty as to their responsibilities if they are to offer CIPRs given the considerable build costs involves. Guidance would be needed as to the process that would provide legal certainty. The aim is to determine a member segmentation process for pre-selecting a CIPR option for each member that would be quarantined from the advice regime and would receive safe harbour protection.

This would involve the provision of decision trees/guidelines to be captured within the boundaries of scaled financial advice (whether this be within general advice or amended intra-fund advice provisions). In effect, this would require the CIPR framework to provide a pathway between a general product offer and full advice. A precedent for this approach already exists in MySuper which allows for life-cycle funds based on age and account balance and other specified factors. A broader range of factors should be allowed including marital status, homeownership status, and general health condition.

Trustee would need guidance on the requirements of a preselection process that would qualify for safe harbour protection. An indication of what such guidance could look like is below.

An illustrative process is outlined below for discussion.

Guidelines for Pre-selecting a product for the member

Member segmentation

1. Consider the varying characteristics, needs and **circumstances of the membership** that need to be taken into account when developing a range of suitable CIPR retirement solutions.
2. Undertake analysis to determine an appropriate **set of retirement solutions** to meet the needs of the majority of members using a segmentation approach, which also meet the minimum product requirements.

Member Engagement

3. In the **pre-retirement stage** (10-15 years before age pension age), successive communication with the member as follows:
    a. The choices at retirement to manage the <u>key retirement risks</u> they will face and the factors to consider in making their choices (information and education).
    b. Provide <u>projected balance</u> at retirement and peer group comparisons including disclosure of underlying assumptions and appropriate caveats.
    c. Provide <u>retirement income</u> projection based on indicative CIPR option and available key member information and/or assumptions, including disclosure of underlying assumptions and appropriate caveats eg health status; liabilities, and other assets.
    d. Identify <u>actions</u> they should consider to improve their retirement income including additional contributions and consolidation of accounts.
    e. <u>Next steps</u> –
        - Inform them that the fund will be communicating with them before retirement about a CIPR offer.
        - Note that this will not be a tailored solution and will be based on limited information. If member is seeking a tailored solution, they are referred to financial planner
        - Refer them to useful sources of impartial information that can assist the member.
4. **Near retirement** (age 55-65),
    a. Same as points 3a to 3c above.
    b. Invite member to retirement seminar
    c. Inform the member that if they are interested in being offered a CIPR product from the Fund they should confirm, correct and/or complete the required information - (See indicative decision tree attached).

Product Offer - At retirement

5. **Members for whom CIPRs are not appropriate** – screen out those with unusual circumstances or attributes (eg poor health; low net assets given high debt levels). Offer these members financial advice.
6. **Remaining members** – Communicate:
    a. Offer the CIPR option designed for the member's known characteristics – marital status, homeownership status; super balance, other assets and general health.
    b. Same as points 3b and 3c above.
    f. Note that the CIPR is not a tailored solution and will be based on limited information.
    g. Refer them to useful sources of impartial information that can assist the member.
    h. If the member is seeking a tailored solution, refer them to a financial planner.
    c. Inform them of steps for accepting the offer. Member is required to opt in for the CIPR option or they will remain in their existing accumulation option until such time that they make a choice.

The way the CIPR product offer is communicated to the member would be dependent on how much certainty can be attached to the member's details. In cases where the fund has no member-specific information (apart from age, gender and account balance) or the member has not confirmed their details, the CIPR offer would be made based on a set of assumptions (potentially based on HILDA data). The member would then be informed that the offer is appropriate to the extent that the member's circumstances match those assumptions.

Such an approach would be seeking to improve the situation for the majority of people who are expected to be in a passive default compared with leaving them to cope on their own rather than achieving an optimal solution. The process for preselecting a CIPR for each member would need to manage the risk of people being placed into an inappropriate default. A triage process would be required to screen out individuals for whom the default would be unsuitable. Filtering criteria might include high debt levels, significant health issues, and multiple dependents. Similarly, those with chronic illnesses and uncertain health and age care needs would best go through a detailed process with a financial planner.

While the choice pathway is more difficult to implement, if properly implemented it offers the prospect of better meeting the needs of members. However, the practical difficulties faced by trustees in guiding members (namely lack of member financial literacy, compliance costs and technological challenges should not be underestimated.

Practical considerations in pre-selecting a CIPR include the need to provide scaled advice, update administration systems, design a process of allocating members to different offerings. It may be expected that there may be limited customisation of CIPRs initially. However, as the ability to efficiently provide additional guidance improves as digital advice evolves, the provision of more customised offerings would be expected to grow. The current member choice arrangements would remain where retirees can choose how to invest (and drawdown) their superannuation monies, with or without the assistance of a financial planner.

Obligations of trustees

Trustees may be concerned that the CIPR regime could potentially leave them exposed to retirees (or their dependents) claiming a loss from the fund using an ex-post evaluation of the CIPR strategy. While a default regime has operated in the pre-retirement phase for many years without such claims arising, the higher degree of customisation and complexity involved in CIPR products and the potential for more quantifiable losses means this risk cannot be dismissed outright in the decumulation phase. This could serve to discourage trustees from offering CIPRs.

While there is the need to clarify trustee duties and provide them protection against so-called hindsight risk, trustees will likely need more inducement if the system is to develop beyond the status quo. There may also be the need for regulatory arrangements to place a duty on superannuation fund trustees to provide retirement solutions to their members that are fit for purpose and provide a specific framework for CIPRs which will assist them to achieve this.

The wording of the FSI final report recommended that trustees be “required” to pre-select a CIPR for member’s retirement. The government’s response stated that it would consult on legislation to “facilitate” trustees providing pre-selected CIPRs.

The FSI recommendation meant that all public offer funds would be required to pre-select CIPRs for their retirees, and therefore, every fund retiree would have a CIPR offered to him or her at retirement (through the “opt in“ process outlined above).

However the government’s response seems to imply that it will be a matter of choice whether a trustee develops a CIPR. Trustees who, for whatever reason, do not wish to provide CIPRs within their fund could continue not to do so. For example, a trustee of a small or mid-size fund may feel that the cost and complexity of developing a CIPR and any potential risk exposure for trustees may not warrant the fund developing a CIPR. While members seeking longevity protection would be able to transfer to a fund offering a CIPR or seek an alternate solution, many members are ill-equipped to make these decisions on their own.

If that is indeed the government’s intention, then the danger is that those less engaged retirees for whom the CIPR concept is designed are precisely those retirees who are least likely to transfer to a fund offering a CIPR. If offering CIPRs is voluntary and a significant number of funds elect not to provide CIPRs we could end up with a system which for a significant proportion of retirees, is similar to the current one – that is, with many retirees not being offered longevity and other retirement risk protections. For pooling to work it needs to overcome adverse selection and exploit economies of scale and diversification benefits of having a large pool. Simply offering annuities is not enough to make them attractive if adverse selection makes them too expensive for most people.

Trustees of superannuation funds should have a specific duty in relation to the investment strategy of CIPRs which deals with all the principal retirement risks. This duty could be provided by replacing MySuper post-retirement products with CIPRs:

> *"Trustees must devise a separate investment strategy for post-retirement members in MySuper products which has regard to factors set out in section 52(6) of the SIS Act as well as inflation, sequencing and longevity risk."*

Regulation of the Provision of Advice

Preselecting a CIPR for each member would be carried out more cost effectively if it were carved out of the advice regime. If this process were to constitute financial advice, the question would be raised as to whether the current financial advice regulatory regime would accommodate the allocation of CIPRs or would further regulatory changes, or guidance, be required?

The regulations to support the provision of advice that is limited in scope for CIPRs already exists in the form of scaled advice. ASIC (Regulatory Guide 244) provides guidance on complying with 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 (safe harbor) that advice providers may rely on to prove they have complied with the requirements.

The cost of advice may however serve as an impediment to the provision of scaled advice. '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 advising CIPRs for members.

- It can only relate to a beneficial interest in the fund or related assets. It therefore cannot take into account other income and assets of retirees such as the family home and the age pension as would be necessary.
- It cannot relate to ongoing personal advice. On that basis it precludes periodic reviews, and monitoring of the implementation of the advice.

The current rules for intra-fund advice should be broadened to determine if they need to be modified to accommodate trustees pre-selection of CIPRs for members.

How far should members be directed?

Care is needed to ensure that members are pre-selected an appropriate CIPR for their needs. The key mitigant is to give members the ability to override the trustees' selection. This raises the question of whether this overiding ability should be given on an opt-out or a more stringent opt-in basis.

The MySuper system operates on an opt-out basis - if a member does not notify the trustee of a different investment choice, their contributions are allocated to the relevant MySuper arrangement.

This has influenced the design of MySuper arrangements, including insurance benefit design. MySuper members can opt-out at any time.

An automatic transition to a post-retirement arrangements on an opt-out basis would ensure that members do not remain in accumulation arrangements, due to inertia or avoidance. However, there are greater risks of inappropriate allocation of options at retirement given the greater degree of complexity of retiree needs which suggests the need for an 'opt-in' requirement. There are also regulatory reasons why moving to a default post-retirement would need to be on an opt-in basis:

- Trustees will not be aware when a member has met a condition of release (other than reaching age 65).
- A member's interest in a MySuper arrangement can not be transferred without the member's consent.

The operation of default post-retirement arrangements on an opt-in basis would provide the best protection that members are not locked into a solution that is inappropriate for their needs. It also provides an opportunity to the trustee to highlight to retiring members matters such as the advantages of seeking advice for their needs and consolidating multiple superannuation accounts.

Ensuring access to the best products in retirement

Income Stream Products

As outlined in Section 1, the existing regulatory framework for superannuation income streams consitute an impediment to the development of products that could provide better longevity risk management. Restrictive payment structures imposed by the existing regulatory framework are hampering the development of products that could provide better longevity risk management than is provided by existing products. After extensive industry consultation, the government has released the findings of the Treasury's Review of Retirement Income Streams (see findings of the review below). The government has announced that it will implement the finding of this review removing these impediments by mid 2017. (Treasury Income Stream Review Findings May 2016). These recommendations are curently in the process of being implemented.

Aged Care Products

Reducing the fiscal pressures of an ageing society is not just a question of more superannuation to pay for health and aged care. Many part-pensioners and those who are likely to become part-pensioners have significant non-superannuation assets. A range of potential non-superannuation products could provide efficient ways to provide for health and aged care.

If a more efficient approach is available retirees can maintain self-sufficiency either more cheaply or over a greater range of needs. An important element in improving efficiency is to make better use of pooling longevity and other risks. Self-insurance usually means no insurance, as most retirees do not have the financial capacity to reserve enough assets to pay, particularly in the event of unanticipated longevity.

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 face the same regulatory barrier that has faced efficient superannuation longevity products, they are simply not contemplated and therefore not accommodated by current health insurance and aged care legislation. Similarly, they also require clarity on their tax and means test treatment.

Given these regulatory impediments, the Australian market has few financial products specifically designed to meet the costs of health and care for the ageing.

The absence of products to assist retirees with nursing home accommodation bonds is a particular problem raised by advisers. Nursing home costs are escalating faster than CPI and accommodation bonds are escalating faster than the cost of aged care. Many frail aged face a financial barrier to obtaining their choice of care. Some of their heirs may prefer exposure to the family home rather than the nominal value of an accommodation bond.

Rather than liquidating their house and other assets to fund an accommodation bond, or not being able to find a place in suitable care, a proportion of frail aged do seek appropriate financial products, in the form of either conventional loans or reverse mortgages. Life offices could offer a single premium loan product to pay the nursing home accommodation bond at a fraction of the upfront cost of the bond to the resident.

Australia has a product gap in that there is no provision of long term care insurance. By making it easier and providing more flexible solutions for an individual to pay for their aged care and accommodation, efficient private financing solutions would assist government in reforming the aged care system.

Substantive risks include:

- Removal of the government guarantee on return of the bond. The Government has referred this matter to the Aged Care Financing Authority.
- Degree of user pays fees and charges which government requires of the consumer.
- Potential changes to the means test for assessing eligibility for and degree of government subsidy.
- Caps on the amount that government will pay for aged care.

There are a number of regulatory conditions precedent for provision of a single premium lifetime loan product:

- 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 ACAT assessment criteria must be capable of being monitored so that life offices can understand changes in the risks they are underwriting.

Equity Release Products

For many Australians, particularly those who commenced work before superannuation became mainstream, 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 the attention to the need for policy reform options to improve access to home equity to supplement retirement incomes and improve adequacy as discussed in Position Paper 1: *Retirement Income Adequacy.* The focus in this paper is on the potential for better integration between superannuation and housing policies to achieve secure incomes in retirement.

It has been estimated that Australian retirees own over $900bn home equity, yet only $3.5b has been made available by the current equity release market. The current reverse mortgage market in Australia fails to support retirement incomes in several respects. Almost all the loans are for lump sums rather income; the average loan size is too small to have much impact on retirement and they are unaffordable.[8]

Allowing home equity to be converted into superannuation would have the potential to provide retirees with income, liquidity and asset diversification. However, retirees ability to draw on their home equity to make additional voluntary contributions is limited by the combination of the work test, the age limit for super contributions and the annual contributions caps. An integrated policy response would facilitate the transfer of home equity into superannuation to provide liquidity, asset diversification and retirement income.

Restrictions on Use of Super Balances

In relation to application of pension savings at retirement, the World Bank (Rocha and Vitta 2010)[9] has argued for promoting an adequate level of annuitisation but avoiding excessive annuitisation. It also argues for favoring combinations of payout options, covering different products at a particular point in time as well as different payout options over time. Similarly the OECD (2012)[10], whilst arguing for a certain level of annuitisation of balances accumulated in DC plans also recognise the benefits of a combination of products including programmed withdrawals.

Interestingly, there is a difference between the practice promoted by bodies such as the World Bank and OECD, and actual practices adopted around the world in relation to annuitisation of defined contribution (DC) balances at retirement. Actual models adopted internationally are an "all or nothing" approach in terms of annuitzation of lump sums at retirement

- 100% lifetime annuitisation required for Canadian employer sponsored plans, Sweden, Finland, Singapore (up to a certain level) and 100% annuitisation in other forms required in Netherlands or Chile
- No requirements for annuitisation for savings balances in UK or Switzerland, or for Canadian personal plans.

Note that none of the current models where annuitisation is required consider implications of an individual retiring at a time when investment markets are down and/or interest rates are low, but this may be due to these systems not generally being mature for DC plans. The UK has recently removed the requirements for compulsory annuitisation and is examining the introduction of defaults.

The suggestion is sometimes made that, in combination or instead of defaults, there should be restrictions placed on the use of super balances at retirement. Possible rationale would be to further assist members in making choices at retirement while enabling the market demand that would deliver the economies of scale and risk diversification necessary for longevity risk management.

A broad picture of optimal annuitisation at retirement in the Australian context is provided by Iskhakov, Thorp and Bateman (2015) using a stochastic lifecycle model. In the absence of the Age Pension, (and under base case assumptions) the optimal annuitisation level for males (the solid line) is at a constant level of 38% of retirement wealth. When the Age Pension is included the optimal purchases of annuities vary with wealth due to the operation of the means tests). For low wealth retirees, the Age Pension completely crowds out voluntary annuity purchases and annuitisation becomes attractive when retirement wealth reaches nearly $200,000 and climbs to a maximum of 25% of retirement wealth at around $800,000. For both the case with and without the Age Pension, a higher level of

[8] Joshua Funder (2016)

[9] Rocha R and Vitta D (2010) *Designing the Payout Phase of Pension Systems*, Policy Research Working paper 5289, The World Bank.

[10] OECD (2012), *The OECD Roadmap for the Good Design of Defined Contribution Pension Plans.*

annuitisation would be optimal for more risk adverse individuals, for a lower risk premium and for higher volatility (and vice versa). These results indicate that rational decision making would result in a greater take up of annuities than is presently the case. It doesn't necessarily help with answering the question of what should be the desired proportion of annuities if a default were to be part of the policy mix.

Possible mandating structure would be a three tiered framework based on balance size (eg, no annuitization requirement for small balances, some mandatory annuitization up to a medium size balance, with the rest of the balance to be taken flexibly thereafter for larger balances. However, such an approach would raises significant issues:

- How to determine appropriate amount to be mandated is highly complex as outlined above. Can such a system accommodate the varying needs of retirees in later life? While some will need a secure income stream others will need access to capital for aged care.
- It also raises equity implications as it treats people differently depending on their wealth in super. Requiring the inclusion of annuities in defaults, or making them mandatory, penalises disadvantaged socio-economic groups which tend to have lower life expectancy.
- Implementation issues are significant given the majority of members have multiple balances and some may also have a DB pension benefit.
- The annuities market is underdeveloped and the low interest rate environment is not conducive to the sale of annuities. It would be better to pursue more market oriented approaches to achieving economies of scale eg auctioning the provision of annuties.
- Claims of retrospectivity – when members have been building up their superannuation account during their working life, the expectation has been they will be entitled to take the benefit as a lump sum so a requirement to mandate a level of annuitisation would be argued as retrospective.

In conclusion, there would be difficulties enough in developing default arrangements to meet the divergent needs of retirees as discussed in previous sections. Mandating that a proportion of savings should be annuitised (even in the broad sense of being placed in a longevity risk management product) would only exacerbate these issues. However, by requiring trustees to focusing on longevity risk management in developing CIPRs, including for default arrangements, greater demand for and understanding of the value of longevity risk management would result, in turn encouraging greater innovation.

References

A Butt, S Donald, D Foster, S Thorp and G Warren. Research Working Paper – “Delegation, trust and defaulting in retirement savings: Perspectives from plan executives and members”, July 2015.

Actuaries Institute. Media Release – Retirement Income Market Report, July 2016.

Agnew J, H Bateman and S Thorp (2013b). Superannuation Knowledge and Plan Behaviour, JASSA, Issue 1: 45-50.

Agnew, Bateman and Thorp (2013a). Financial Literacy and Retirement Planning in Australia, Numeracy, 6, Article 7.

ASIC. ASIC Report 224: Access to Financial advice in Australia, December 2010.

Bateman, Hazel, Behavioural biases and moral hazard arising from the social safety net? The role of defaults and other lessons from behavioural finance. Paper for CSRI Post Retirement Roundtable, April 2016

Bateman H, C Eckert, F Iskhakov, J Louviere, S Satchell and S Thorp (2016a). Individual capability and effort in retirement benefit choice, Journal of Risk and Insurance (forthcoming).

Callil, Nick Willis Towers Watson & David Cox, Challenger. A Comprehensive Income Product for Retirees – Issues for Policymakers and Trustees. Paper for CSRI Post Retirement Roundtable, April 2016

Cox, David, Challenger. Search for Post-Retirement Products - diversity of products needed for a mature retirement income system. Paper for CSRI Post Retirement Roundtable, April 2016

Doyle, Suzanne, StatePlus. Designing retirement plans to suit the diverse needs and circumstances of retirees through the different stages of retirement. Paper for CSRI Post Retirement Roundtable, April 2016

Federal Treasury. Review of Retirement Incomes, May 2016.

Iskhakov F, S Thorp and H Bateman. 'Optimal Annuity Purchases for Australian Retirees', The Economic Record, vol. 91, June 2015.

Investment Trends. Advice and Limited Advice Report, December 2014.

Knox, David, Mercer. What does success look like in a mature retirement income system? Paper for CSRI Post Retirement Roundtable, April 2016.

Lennon, Graham, Dimensional. Retirement: Making Income the Outcome. Paper for CSRI Post Retirement Roundtable, April 2016

Lennon, Graham, Dimensional. Retirement: Unbundling the Risks. Paper for CSRI Post Retirement Roundtable, April 2016

May, Zac, Industry Super Australia. Lifting the welfare of individuals who are relatively disengaged. Paper for CSRI Post Retirement Roundtable, April 2016

National Seniors Australia and Challenger. Retirees’ Needs and Their (In)Tolerance for Risk, March 2013.

OECD. The OECD Roadmap for the Good Design of Defined Contribution Pension Plans, 2012.

Productivity Commission. Housing Decisions of Older Australians, Commission Research Paper, 2015.

Rocha R and D Vitta. Designing the Payout Phase of Pension Systems, Policy Research Working paper 5289, The World Bank, 2010.

Stringer, Ruth, King & Wood Mallesons. Post Retirement regulatory frameworks. Paper for CSRI Post Retirement Roundtable, April 2016

Teppa F, S Thorp and H Bateman (2015). Family, friends and framing: A cross country study of subjective survival expectations, CEPAR Working Paper, 2015.

Tversky and Kahneman 1981

Wu, Thorp and Wang 2014. Age Pensioner Profiles: A Longitudinal Study of Income, Assets and Decumulation, ARC Centre of Excellence in Population Ageing Research, Working Paper 2015/17.