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Dear Rebecca

Subject: Retirement Income Covenant Position Paper

Thank you for the opportunity to participate in the consultation process.

We agree that the retirement phase of the superannuation system is currently under-developed, and we strongly support the Government's efforts to develop a retirement income framework that is better aligned with the overall objective of the superannuation system of providing income in retirement to substitute or supplement the Age Pension.

We support the progress that has already been made to remove barriers to the introduction of pooled lifetime income products and to clarify their treatment for the Age Pension means tests. We also support the Government's plans to prioritise progress on the development of a retirement income covenant.

This letter provides our feedback and comments on the covenant principles and future considerations contained in the position paper, to assist the Government to achieve its objectives. We have deliberately kept our comments at the principles level, acknowledging that there will be several challenges we will need to resolve in the detail, which we anticipate will be the subject of future consultation.

We would be delighted to discuss our feedback and comments contained in this submission.

Yours sincerely

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Covenant Principles

Principle 1. Retirement income strategy

Trustees should assist members to meet their retirement income objectives throughout retirement by developing a retirement income strategy for members.

The Institute strongly supports the principle that all superannuation funds should develop a retirement income strategy for its members, including the list of eight factors that trustees should consider. In relation to stability of income, we note that research shows that real spending often reduces as retirement progresses. Having said that, income needs and spending patterns in retirement can and do vary significantly and there is no one-size-fits-all solution.

We also strongly support the notion that trustees should consider eligibility for the Age Pension when considering a member's income in retirement. We are also very pleased to see specific mention of whether and how cognitive decline may affect outcomes.

Principle 2. Engagement

Trustees should assist members to meet their retirement income objectives by providing guidance to help members understand and make choices about the retirement income products offered by the fund.

While we agree with this principle, that trustees should help members to understand and make choices about retirement income products, we also believe that it would not be appropriate for trustees to guide all members to buy a CIPR. As we said above, income needs and spending patterns in retirement can and do vary significantly and there is no one-size-fits-all solution. In addition, a person's circumstances can change during retirement such as their state of health and (part time) work status. These factors may influence the appropriate time for a person to purchase a longevity risk management product.

Principle 3. Definition of a Comprehensive Income Product for Retirement (CIPR)

A CIPR is a retirement income product which is designed to provide:

- **efficient, broadly constant income, in expectation;**
- **longevity risk management (income for life); and**
- **some access to capital.**

A 100 per cent allocation to an ABP (account-based pension) alone would not meet the definition of a CIPR.

We agree that it is not sufficient for a CIPR to merely provide income to life expectancy, or even for a short, fixed period after that. Retirees need to be encouraged to plan for their income and spending needs, including beyond life expectancy even if this is at a lower level than earlier in retirement. Having said that, for some retirees, the Age Pension alone may provide an adequate level of income beyond life expectancy or some other advanced age. Those who hope to continue to live at a higher level throughout should be encouraged to use a product giving longevity protection.

A range of +/- 2.5% is much too narrow for volatility and would severely constrain investment freedom. An investment linked annuity invested entirely in shares (which could well be appropriate for wealthier individuals and is used by many account based pensions) would have a standard deviation of 15% or more. Rather than impose a broadly constant standard, we would suggest that members be given adequate disclosure of the likely volatility of the income stream.

We do not believe that CIPRs that produce a level of income that is fixed in nominal terms for a long period will always be appropriate, for example for a member who is already receiving a full Age Pension. Research shows that many people suffer from "money illusion"[1] and underestimate risk of inflation, including its potential size and volatility. For example, there have been three periods over the last century where inflation has risen to double figures.

We look forward to further consultation on the certification requirements for CIPRs.

Principle 4. Offering a flagship CIPR

All trustees should offer a flagship CIPR to members at retirement, subject to limited exceptions (see principles 7 and 8).

We support the timeframe for legislation to be in place by 1 July 2019 to provide certainty to the industry and allowing the development of longevity protection products and CIPRs to commence. We also support the principle of requiring funds to offer a CIPR to members at retirement, however we are not confident that 1 July 2020 will provide adequate time to allow all of the industry to prepare, particularly given that the new means testing rules will not take effect until 1 July 2019 and the full range of longevity protection products may not be available by 2020 and most likely not with enough time for their features to be properly considered by trustees.

We therefore suggest that funds be able to offer CIPRs on a voluntary basis from 1 July 2020, with the requirement on all funds to offer a CIPR commencing at a later date (but no later than 1 July 2022). The compulsory start date can be determined based on an evaluation by APRA of the industry's readiness during the 3-year period from 1 July 2019 to 1 July 2022.

We do not know whether it is the intention (or not) to use the term "flagship CIPR", but to avoid doubt, we believe that the use of the term "flagship CIPR" could be confusing to consumers, especially in circumstances where a fund offers multiple CIPRs.

We do however support the concept that funds should be expected to inform all retirees about longevity risks and that there are longevity products available to manage it.

[1] *Shafir, E.; Diamond, P. A.; Tversky, A. (1997), "On Money Illusion", Quarterly Journal of Economics, **112** (2): 341–374*

Principle 5. Third party products

Trustees can fulfil their obligation in part or in full by using a third party.

Reflecting on principle 4, allowing trustees the opportunity to offer "a CIPR that has been developed and/or offered in part or in full by a third party" is an elegant way to potentially increase the scale of the longevity risk management products offered to members. Properly designed, it also negates the immediate necessity for each superannuation fund to compulsorily offer a CIPR.

To repeat our earlier comment, the Institute strongly supports the principle that all superannuation funds should develop a retirement income strategy for its members that includes communication of the risks to retirees. We believe that, initially, this should be sufficient to develop enough options for members entering the retirement income phase. If this is proven not to be the case, then compulsion is something that could be properly considered in due course.

Principle 6. Consent

Consent should be required for a CIPR to commence.

The Institute agrees with the principle that consent should be required for a CIPR to commence.

However, we believe that the success of the CIPRs initiative could be enhanced (and members provided with greater protection) by two supporting changes.

1. Adviser Best Interests Duties.

One potential barrier to the success of the uptake of CIPRs is the risk that members (explicitly or implicitly) receive poor financial advice that fails to adequately inform members, and effectively recommends members not to proceed with a CIPR.

This risk of poor advice arises due to several factors, including:

- Most financial advisers lack the appropriate framework to properly communicate the risks and benefits of alternative retirement strategies products – particularly incorporating pooled longevity products into a retiree's portfolio.
- Our research[2] suggests that most financial advice is based on longevity expectations which may be understated due to realistic expectations of potential future mortality improvements not being incorporated – and largely ignores the risk of living longer.
- We believe that a substantial portion of financial advisers do not have appropriate expertise with pooled longevity products. In many cases they only have had access to life annuities for a short time, and in some cases these products are not on their approved lists. Moreover, they face a loss of income should they recommend life annuities.

[2] https://www.actuaries.asn.au/Library/Events/FSF/2018/AdviceToPreRetireesPaper.pdf

- There may be conflicts of interests for some financial advisers in ‘twisting’ business away from a trustee endorsed CIPR, and instead recommending another financial product, and vice versa. The view has also been expressed that many trustees will be reluctant to suggest longevity products that compete with their own account-based pensions. Given that the longevity products will probably be offered by life insurers rather than superannuation funds, this may become an issue.

As a result, there is a risk that the advice members receive is not in their best interest.

While ASIC guidance RG175 requires that Statements of Advice should consider the client’s tolerance for the risk of capital loss and that following the advice does not produce the expected benefits (which may include longevity risk), it is our view this is inappropriately framed and could be enhanced, as follows:

- The Safe Harbour for the Best Interest Duty be clarified in RG 175 to explicitly state that to satisfy the “expertise required” and the “reasonable investigation” conditions - any advice that involves recommending any retirement product must include appropriate disclosure of the proposed changes in the retiree’s consumption in the face of investment market volatility and the prospect of exceeding life expectancy.
- ASIC foreshadows that it will be scrutinising and monitoring advice recommendations that involve:
    - An evaluation of a CIPR offer, or
    - A comparison of a CIPR with another product.

  This could be similar to the way ASIC have been specifically monitoring insurance advice for “churn” business between insurers.

2. Apply “nudges” (using behavioural insights) in requiring an “informed decline”.

While we agree that consent should be required for a CIPR to commence, one way to potentially improve their take-up is to nudge members into a deeper consideration of the issues when rolling money out to a non-CIPR product at retirement.

One suggested approach is an “informed decline”. This borrows from other public policy concepts where there is no compulsion, but there is public policy imperative that consent is preferred. Examples include informed refusal of medical treatment in hospital and the exemption from vaccination.

Such an approach can be combined with the emerging field of Behavioural Insights to improve the take up of CIPRs. Some of the methods that can be used for influencing behaviour are contained in the following table.

Cognitive Bias	Application for CIPRs
Anchoring	CIPR being presented as the primary choice option
Framing	Making it clear that the objective is not an investment, but a plan for consumption in retirement. Requiring any alternative to a CIPR be justified by reasons (e.g. evidence of financial or medical advice).
Status Quo Effect	Presenting CIPRs as the status quo option, i.e. that it is the option that was intended and anything else is a deviation from the status quo.
Social Norms	Utilising language to indicate a CIPR was intended for "people like you"
Spousal Concordance	Involvement / Agreement of spouse has a significant impact on outcomes. In the USA, introducing a reversionary annuity as a default increased the proportion of reversionary annuities from 48.1% to 63.9%, and mandating reversionary annuities without written spouse consent increased to over 70%.[3]

Principle 7. Offering an alternative retirement income product through advice

Trustees may offer an alternate CIPR or another retirement income product to a particular person or cohort of people through any form of personal financial advice, including scaled personal advice, intra-fund advice, or full financial planning.

No feedback or comments.

Principle 8. Exception for individuals for whom CIPRs are unsuitable

Trustees may choose not to offer a CIPR *at all* to a particular person if the trustee has reliable information that a CIPR would not suit that person.

We support the concept that the Trustees do not need to offer a CIPR to an individual if certain information is known. However, we believe that the $50,000 limit may be too low, as most retirees below and above this threshold by a reasonable margin will be receiving a full Age Pension, which is indexed and guaranteed by the Government. At this level, they are likely to have longevity protection for at least 80 per cent of their income.

In addition, from a product provider perspective, investing 10% or even 20% of $50,000 in a longevity protection product is likely to be inefficient.

[3] Aura, S. (2005). Does the balance of power within a family matter? The case of the Retirement Equity Act. *Journal of Public Economics*, *89*(9), 1699-1717 – p1701.

We would therefore like to discuss this threshold with you further, to understand how this figure was arrived at and to consider whether a higher threshold could be more appropriate and how it should be indexed in future.

Of course, we do acknowledge that whatever the chosen threshold, this does not preclude funds from choosing their own lower threshold, or members themselves voluntarily choosing to take up a CIPR (or other longevity protection) below this threshold.

Future considerations

Lifetime engagement

Trustees should engage with members about retirement early (from the point of joining the fund onwards) and continue to engage on an ongoing basis.

We strongly support the rationale behind the provision of generic retirement income information (including retirement income projections) on an ongoing basis.

Legacy products

An approach for managing legacy retirement income products and issues related to these legacy products should form part of the framework.

We agree – no further feedback or comments.

Safe harbour

Trustees could qualify for a safe harbour, in limited circumstances, provided they act diligently and comply with all relevant legal obligations in designing and offering a CIPR.

While the comments in the position paper make sense, the mere necessity to include this section identifies the risks involved in what is being proposed and the need for caution in the approach adopted.