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15 June 2018

Mr Darren Kennedy
Manager, CIPRs
Retirement Income Policy Division
The Treasury
Langton Crescent
PARKES ACT 2600

Dear Darren

Re: Retirement Income Covenant Position Paper - Consultation

Thank you for the opportunity to comment on the Government's position paper for the retirement income covenant. Challenger welcomes the proposed changes to the policy settings for retirement income as we believe they will improve the lives of Australian retirees and the sustainability of the age pension system.

Challenger is a top-100 ASX listed company and the leading provider of annuities in Australia, delivering on our vision to provide our customers with financial security for retirement. We provide more than 60,000 Australians with a secure and reliable income in their retirement. Our unique position in the market combined with our dedicated retirement income research unit gives us unparalleled insight into the retirement experiences of Australians. In this submission we share these insights with the objective of informing the development of this critical policy initiative.

Improvements to the post-retirement phase of super have been considered by numerous reviews tracing back almost 10 years; each concluded that more needs to be done. The super system has now reached critical mass with over $760 billion in retirement and more than 700 Australians retiring each day, yet there remains significant under-development in the post-retirement market.

We strongly support the introduction of a covenant in the superannuation laws to ensure the governance arrangements for the retirement phase of super keep pace with the size and importance of the system. Currently there is no retirement-specific governance framework for the decisions super trustees make in relation to their members. This is an issue which requires urgent rectification.

We also support the development of comprehensive income products for retirement (CIPRs). According to National Senior Australia research, regular, constant income that meets essential spending needs is the number one retirement finance concern of retirees. After years of accumulating savings, many retirees are not well-equipped to efficiently match their spending to their lifespan.

Our experience in providing retirement income products has demonstrated the benefits of combining pooled longevity products with an account-based pension (ABP). The result is the ability to deliver higher income, longevity protection and capital flexibility. The inclusion of an annuity in a combined portfolio delivers superior outcomes for three key reasons:

- provides longevity insurance for retirees who live past their life expectancy, through the pooling of mortality credits;

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- enables a higher proportion of remaining ABP to be invested in growth assets (across the life of the product);
- an annuity can generally create better returns than defensive fixed income investments, such as low risk bond funds.

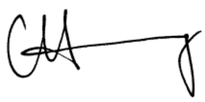
The result is a retirement portfolio which generates a higher level of income, that lasts for longer, than that delivered by an ABP alone.

The CIPR concept is achievable. Currently a small number of retirees benefit from combining products in this way. A result of having sought specialist retirement advice. The inclusion of a longevity component through the CIPR has the potential to assist many retirees to better manage consumption of their retirement nest egg, without the need for advice. Yet the framework has been developed with enough flexibility so that those who want highly personalised assistance can still seek it.

A detailed submission is attached which provides surrounding data and case studies supporting the reforms, outlines some observations and suggests possible enhancements for consideration.

If you have any questions or would like further information in relation to this submission, please do not hesitate to contact me on (02) 9994 7288.

Yours sincerely



Carla Hoorweg
National Manager, Government & Industry Relations

Retirement income framework

Response to May 2018 Treasury position paper on the retirement income covenant

15 June 2018

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1. Executive summary

Challenger welcomes the opportunity to comment on the May 2018 Treasury position paper outlining the proposed principles for the retirement income covenant, being stage one of the retirement income framework.

The history of this reform proposal goes back nearly 10 years. We have set-out in **appendix 6** the various reform proposals both the Coalition and Labor have worked on to enhance the retirement phase of super over that period. There has been a large amount of work so far, culminating in the retirement income framework.

Challenger supports both the direction of the position paper and the detail of the proposals. The retirement income framework opens the way for a new phase of the super system: safely, simply and efficiently giving retired members their money back to spend over increasingly longer retirements.

Challenger supports the reorienting of the project so that it starts with governance, rather than product design, as the way to enhance the retirement phase. The retirement income covenant takes nothing away from what we have today and is an achievable next step for the super system. We view the framework and CIPRs as evolutionary, rather than revolutionary; enhancing what we already have, rather than disrupting it.

We also believe that now is the right time to drive this reform forward and we support the phased approach as outlined in the position paper.

2. Retirement income framework is much needed

In our view, the retirement income framework is a top priority reform for the following reasons:

1. 700 Australians are retiring every day, more than 85% of whom have had super and need reliable income for life, but less than half of them are entitled to the full age pension;[1]
2. the industry standard is that accumulation-style products are presented to retirees as retirement income streams;
3. diversification is the only risk mitigant applied to most retirement income streams, with all other risks currently borne by retirees who are consequently self-insuring, living too frugally and leaving 'unintended bequests'[2] to the next generation;
4. over $760bn is already in the retirement phase, but the industry is substantially under-prepared for this;
5. there is very limited governance currently dedicated to retirees and retirement income; and
6. risk pooling and insurance are widely used in the accumulation phase, but are not routinely used in the retirement phase to reduce the risk of running out of money in retirement.

[1] ABS Cat No 3101 number of people about to turn 65; ATO taxation statistics 2015-16 and DSS 2017 annual report.
[2] See paragraph 9 of this submission.

3. About this submission

The purpose of this submission is to provide surrounding data and case studies supporting the reforms. We have broken the submission into four parts:

- Support for the proposals;
- Observations;
- Possible enhancements; and
- Appendices 1-6 (relevant supporting information).

Support for the proposals

4. The need for a retirement income framework

Australia's retirees are living longer, saving more and becoming increasingly self-reliant. The super system was conceived for 55-75-year-olds, but today's retirees are typically living into their late 80s. **Appendix 3** explains current life expectancies for today's 65-year-olds, being: 87.1 years for males and 89.3 years for females; and they are only averages, roughly half of each cohort will live longer.

By 2030, more than $1.3 trillion of super savings will move into the retirement phase as increasing numbers of Australians retire. Super is moving from supplementing the age pension to substituting it for an increasing proportion of retirees, with only 42% of over-65s currently on a full pension. This is forecast to decrease as super increasingly reduces the need for government assistance. Our super system is more mature than most people realise. It's doing the first part of its job, allowing people to accumulate assets through their working lives, with typical household super wealth at retirement in the $350,000-$500,000 range and increasing. This wealth was accumulated to provide income in retirement, but the system is not yet set up to do this next phase successfully. Pooling mechanisms to reduce the risk of running out of money in retirement are largely absent in our current system. Financial risks and challenges in retirement are substantially different from the accumulation phase of super. We have attached as **appendix 5** our April 2018 paper: *Retirement really is different*, which makes the case for reform of the governance of the retirement phase; more specialised products and targeted financial advice, all aimed at retirees getting better outcomes.[3] The paper raises a large number of issues that would be addressed by the retirement income framework.

5. The time is right

It is often said that because the super system is not fully mature, retirement balances are still low and therefore we are not ready for reforms like the retirement income framework. These assertions are wrong. As we illustrate in **appendix 2**, super account balances across the system are now more than adequate for the rollout of the retirement income framework. June 2017 APRA data on the scale of retirement phase balances show that now is the time to be making these changes. At that time, retirement phase assets were $413bn for large APRA funds and an estimated $350bn+ for self-managed funds (SMSFs), totalling over $760bn.

[3] https://www.challenger.com.au/group/Retirement_really_is_different_position_paper.pdf

Today, nearly one in every three dollars in super would be directly supporting a retirement income stream.

6. **All super funds must offer a CIPR to members at retirement (p 7 of the position paper)**

   We think an obligation, rather than an option, to offer a CIPR is the preferable policy position because providing appropriate income streams to retirees is fundamental to the purpose of super. It might also overcome inertia and ensure quick progress in delivering better outcomes for retirees. It will also ensure that all retirees, regardless of their fund, are provided the same opportunity.

   The requirement that all large APRA-regulated funds (other than eligible retirement funds (ERFs) and defined benefit (DB) lifetime pension funds) must offer CIPRs is the right policy setting.

   Importantly, of course, there is no compulsion on the part of the member. The decision (and even consent) of the member is a key part of the proposal.

7. **Not a default**

   It follows from our previous point that a CIPR will not be a default. Retirees will have a clear and simple choice. We support this policy setting. Recent comments from the Productivity Commission, in its draft report on Stage 3 of its review into the competitiveness and efficiency of the super system entitled: Superannuation: Assessing Efficiency and Competitiveness, also support this approach. On page 20 of the draft report, released on 29 May 2018, it said:

   > "A default retirement product ('MyRetirement') is not warranted. The goal of policy should be to remove unjustified obstacles to all products, rather than favouring the take-up of specific products. Policy changes in mid-2017 to Comprehensive Income Products for Retirement were a good step in this direction."

8. **Engagement covenant principle (p 5 of the position paper)**

   We support the notion that trustees should have a duty, via the proposed covenant, to assist members with their retirement income objectives through guidance about their choices. Regardless of the account balance threshold below which a CIPR need not be offered to a member, all members should benefit from the engagement aspects of the covenant.

   Leading funds are already engaging in various ways with members about retirement income, but the covenant will ensure that it becomes a core activity of all funds.

9. **Meeting member needs: what do the members want?**

   It is important to understand how Australian retirees are living their retirement; what they would like to do better; and how their super could help them better attain their goals. Studies show that Australian retirees are frugal with their retirement savings and spend less than what they could afford, missing out on a better lifestyle in retirement.[4] The result is that many of the estates left on death could be classified as 'unintended'. Those retirees just didn't get around to spending their money. What this means is that they did not enjoy the standard of living that their retirement savings could have provided them.

The notion of the unintended bequest is consistent with a 2017 survey of NSA members.[5] This noted that only 3% of senior Australians intended to preserve all their savings for an inheritance. Forty-one per cent thought they would spend most of their savings and maybe leave something behind, which is a common outcome. When asked about the importance of leaving something for their adult children, only half said it was important, and only 23% of respondents thought it was very important. The top two financial goals were: regular, constant income that covers essential needs (84% very important) and ensuring that money lasts for life (77%). The combination of these two goals is what a CIPR can provide to members in retirement. Retirees are clearly expressing a desire for the features a CIPR will provide. The objection that retirees are not asking for CIPRs is a bit like arguing that motorists did not ask for seatbelts, nor the many other extraordinary improvements in car safety over the last 40-50 years. Sometimes, product-makers can pre-empt consumer requirements.

Focus groups of Challenger clients confirm these desires. Consumer satisfaction from the peace of mind delivered by a regular stream of income, guaranteed for life, highlights the benefit of the approach.

NSA 2017 survey highlights:

10. Retirement income framework - evolution not a revolution

a. The covenant

The position paper outlines two principles to be included in a retirement income covenant (SIS covenant) in the *Superannuation Industry (Supervision) Act 1993* (SIS Act) that will require trustees to:

1. assist members to meet their retirement income objectives throughout retirement by developing a retirement income strategy for members;

This will plug a significant gap in the SIS Act. Retiring members currently do not have the benefit of such a provision and neither do fund trustees; and

4 For example see: http://au.milliman.com/insight/2018/Surprising-new-research-reveals-the-majority-of-Australian-retirees-spend-less-than-the-Government-Age-Pension/ or *Superannuation Drawdown Behaviour: An analysis of longitudinal data* CSIRO-Monash working paper 2016-04, March 2016.

5 *Seniors more savvy about retirement income*: a report by National Seniors Australia and Challenger October 2017.

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

Members over 50 are more engaged with their super[6] and stand to benefit from this initiative.

The retirement income covenant is designed to fit into the SIS Act next to covenants that are similar in style and intent and has the potential to send a strong normative signal about what is expected of trustees in the retirement phase.

b. Support for a phased approach

We support the approach of developing the SIS covenant ahead of the other regulatory measures needed to implement the retirement income framework. Setting appropriate governance standards that place emphasis on the needs of members in retirement is a critical first step in this process.

Where possible, APRA should be given the responsibility of implementing and developing the reform package via its power to make prudential standards under s 34C(4)(a)(ii) of the SIS Act, which empowers it to make standards relating to:

> the conduct by an RSE licensee of a registrable superannuation entity of the affairs of the registrable superannuation entity [ ] in such a way as to:
>
> ...
>
> (ii) meet the reasonable expectations of the beneficiaries of the registrable superannuation entity;

We expect that the SIS covenant will create 'reasonable expectations' on the part of retiring members in a range of respects. APRA will thereby have the power to make standards in respect of those expectations.

c. CIPRs will not affect a large part of the system

CIPRs will:

- not impact members in accumulation;
- not apply to SMSFs; and
- only apply to retiring members who choose one. Even then, many CIPRs will still comprise around 75-80% ABPs.

The pooled lifetime component would initially only represent a very small proportion of the overall system and even a modest proportion of the retirement phase. We have estimated that if all retired members opted for a CIPR with a 20% allocation to a pooled lifetime product in the first year of the new regime, this would amount to around $40bn allocated to a pooled lifetime income product.[7]

It is not a disruptive or revolutionary change, but a necessary enhancement for a system with around $1.3 trillion heading towards the retirement phase by 2030.

[6] *Seniors more savvy about retirement income*: a report by National Seniors Australia and Challenger October 2017.
[7] At 30 Jun 2017, APRA superannuation bulletin, members over 65 with $200,000 to $1m had a total of $206bn of benefits.

d. Rome can't be built in a day

There should also be an acceptance that the CIPRs of 2030, will be significantly more sophisticated than the ones that first emerge in 2019/2020. Technology and more comprehensive data will play a big part in this. A key to the success of CIPRs will be to allow enhancement over time, rather than try to build a regulatory regime appropriate for the 2030-model CIPR in 2020. The 2020 regime should be less ambitious, allowing the industry to evolve the model over time. Again, APRA standards can play a role here.

Having said that, there are aspects of the retirement income framework that are more appropriate for ASIC to deal with. These include product disclosure; investor behaviour and competition issues under ASIC's new competition mandate.

11. How CIPRs will improve retiree outcomes – case studies in appendix 1

We have developed a series of case studies in **appendix 1**. They are designed to illustrate the advantages of the retirement income framework over the present retirement phase option: the account-based pension (ABP) on its own.

The case studies illustrate that these advantages are available in a range of different wealth segments. They support the logic of CIPRs; a key component of the retirement income framework.

The case studies illustrate that a super fund doesn't need detailed personal information about members in order for the mass-customised product to provide a material benefit to their retirement outcomes. We are also of the view that CIPRs will work without personal advice where that option is not available. We say this because CIPRs are evolutionary, rather than revolutionary. The existing mass-customised product: the ABP, will continue to predominate. Critics of CIPRs say that they sound like a 'one-size-fits-all' solution. But that's what we have now. Even a single CIPR would be better insofar as it is built for retirement, whereas the ABP by itself is not. Having up to three flagship CIPRs would be a material improvement on current industry practice.

12. The mass-customised concept

a. Collective member preferences

We support the idea that a large super fund should offer a flagship CIPR aimed at the typical member on a mass-customised basis. Beyond that, funds will be able to orient two more flagship CIPRs aimed at different member cohorts or offer more tailored retirement income products.

We understand that the primary consideration in developing flagship CIPR cohorts will be the member account balance, which will be used as a proxy for age pension eligibility. To the extent that funds have additional relevant information about cohorts that allows them to tailor flagship CIPRs, this information should be considered. There will be no obligation on funds to seek out this information, so this sets a minimum standard and assures that the regime is doable for funds.

b. What three flagship CIPRs might look like

We agree that three cohorts should be sufficient for funds to tailor a suitable mix of products for different members. Funds will not be required to offer a CIPR to members with very low balances, so there is no need to tailor one for their needs.

Also, it can be assumed that members with very high balances (above the $1.6m transfer balance cap) will seek other solutions.

The key component of a CIPR is the addition of a pooled lifetime income stream to an ABP. This is what provides the longevity risk management within a CIPR and as such, the main difference across the three cohorts of a fund's CIPR should be the degree of need for longevity risk management.

At low balances, a fund member is likely to have an entitlement to the full (or close to full) age pension. This already provides an income stream that is guaranteed for life. The level of the age pension, however, is a safety net falling short of a reasonable measure of retirement income adequacy, for example the ASFA standard for a modest retirement. Longevity risk management for these members can be small, but can still provide the peace of mind that retirees value. At extremely low balances, this benefit is likely to be outweighed by the 'pre-annuitisation' of the age pension and the value of flexible access to capital.

Members with higher balances will have a different need for longevity risk management. By limiting spending, they could sustain a reasonable standard of living for life. Adding some longevity risk management can help them enjoy a higher standard of living, as long as they have protection in case events don't happen as planned. Members with higher balances can generate enough income up front, but still need some longevity protection if they live longer than expected.

In the middle, will be the range of people who need the most longevity risk protection. Typically, their assets will be high enough to reduce their entitlement to the age pension, but they won't have enough money to sustain a worry-free level of spending through retirement. This group should have the largest allocation to the pooled lifetime income stream.

The effect of the reforms will be that all members are better off, principally because they will have the benefit of what is currently available from their ABPs, but will also have the longevity risk protection that they are currently lacking.

c. Financial advice

Much has been said about the need for financial advice about retirement income options. Our interpretation of the retirement income framework is that through the combination of products across the three flagships and the engagement, guidance and disclosure from the fund, much of this need will have been mass-customised at the fund level. This goes to the very heart of the reforms. Super is a compulsory system. Many funds already have tens of thousands of members in the retirement phase. For many of those funds, individual bespoke financial advice is not an option. The retirement income framework addresses this issue. Financial advice will still be available, of course, for those who want it, whether or not they are considering choosing a CIPR.

13. Support for reversionary pension option

Nearly 70% of Australians start retirement in a couple household. The sharing of retirement savings between a couple and providing support should one member of a couple predecease the other are central to a typical retirement.

We therefore support the option of a reversionary pension being central to the retirement income framework. Providing reversionary benefits to dependants is a core purpose under the sole purpose test in s 62 of the SIS Act. In many cases, super death benefits are paid late in life in favour of a surviving spouse. It is a preferable policy setting for such benefits to involve broadly constant lifetime income.

14. Why pooling? Understanding mortality credits

Central to the CIPR concept is the use of pooling to mitigate or insure against longevity risk. It is worth reflecting briefly on the mechanics of pooling. Pooling involves the use of the 'law of large numbers' to diversify away the idiosyncratic risk that we might live a long time. This is effected by joining a large group of people (ie lives) and sharing that risk and part of our retirement savings to produce a yield (mortality credit) from those who die prematurely to pay income to those who end up living longer.

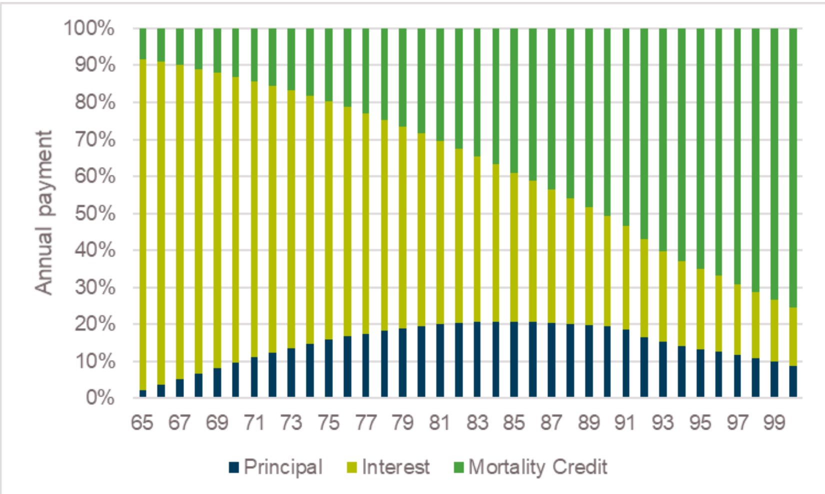
There are three components of a payment from a pooled lifetime income product:

1. interest;
2. a partial return of capital; and
3. mortality credits – distributed ex ante from the first payment.

Our retirement income system needs more access to mortality credits. They are a source of income for longer-living retirees that is not available through 'self-insured' options such as an ABP, are not correlated to other asset classes, nor are they market-linked.

Figure 1 illustrates the changing composition of payments over time from a pooled lifetime income stream with no additional features such as a death benefit.

Figure 1: Indicative composition of pooled lifetime income product payments



[Appendix 4](#) has more information about annuity rates and why they are different from rates of return on other asset classes.

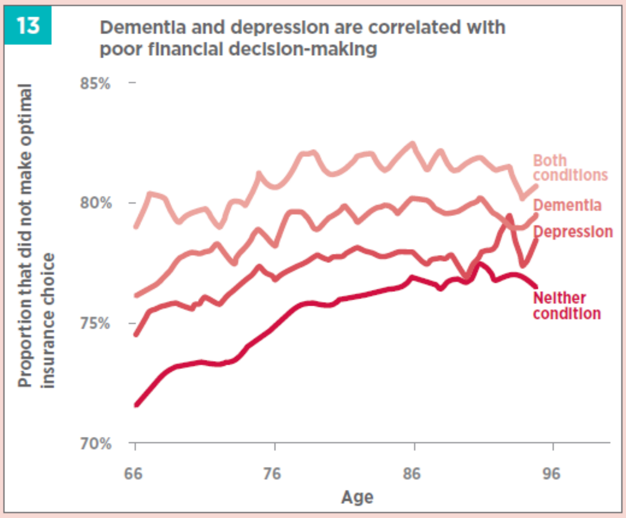
15. The importance of CIPRs in addressing cognitive decline

It was a key component of the Financial System Inquiry (FSI) recommendation for CIPRs that they would assist with the problem of cognitive decline and the complexity of retirement income decision-making under current arrangements. The position paper expressly references this issue in the discussion on covenant principles. We strongly support this aspect of the reforms.

Some researchers estimate that there are over 400,000 Australians currently living with dementia and this is projected to double over the next 20 years.[8] It has also been estimated that 37% of people aged between 70 and 90 have mild cognitive impairment (MCI).[9] Elder abuse, of the financial variety, is also an issue.

Dementia and depression are correlated with poor financial decision-making.[10] **Figure 1** shows the combined effect of age and either or both dementia and depression on the tendency to make a sub-optimal decision on choosing a prescription drug insurance plan.

Figure 2: Correlation between cognitive impairment and poor financial decision-making



Source: Keane, Ketcham, Kuminoff and Neal (2017)

Many consumers made 'confused' decisions, over-weighting the upfront premiums and not the long-term cost, but this gets materially worse with age and impairment.

The retirement income framework should endeavour to require retirees to make fewer financial decisions at older ages.

16. Proposed commencement dates

The proposal is for the framework to be legislated by 1 July 2019 with a commencement date of 1 July 2020. We support this implementation timeframe. We believe there is sufficient information provided in the position paper for trustees to begin initial product development and design discussions. After all, 700 Australians are retiring every day without the benefit of these reforms.

[8] Brodaty, H., M. Heffernan, N. A. Kochan, B. Draper, J. N. Trollor, S. Reppermund, M. Slavin and P. S. Sachdev (2013) 'Mild cognitive impairment in a community sample: the Sydney Memory and Ageing Study' Alzheimer's & Dementia, 9(3), 310-317.
[9] Brown, Hansnata, and La, 2017 'Economic cost of dementia in Australia 2016-2056' Alzheimer's Australia. Institute for Governance and Policy Analysis, University of Canberra.
[10] CEPAR: Cognitive ageing and decline: Insights from recent research 2018.

Observations

17. What is retirement income?

Not surprisingly, retirement income is a central concept in this discussion. The difficulty is that not everyone sees retirement income in the same way. For the retirement income framework to be effective, there needs to be a broader conversation to the effect that retirement savings produced by contributions to super are not so much capital, but deferred wages ready to be spent in retirement. Retirement income involves the safe and regular consumption of those savings. Through that lens, the concept of 'broadly constant' income is readily understandable. It does not necessarily mean broadly constant investment returns, but more like broadly constant spendable cash flows.

Many retirees believe that retirement income only means accretions to their capital by way of investment returns, dividends and the like.

18. Pooled products can have death benefits

It is often thought pooled lifetime products involve a total loss of capital in the event of an early death and are therefore unsuitable for retirees. This is not correct. Most lifetime annuities sold in Australia today have some form of death benefit. Following the *Retirement Income Streams Review* in 2016, the government passed legislation providing for a diminishing death benefit regime for 'innovative superannuation lifetime income streams' that would be outside the minimum drawdown requirements in the SIS Regulations. Under that regime, death benefits of up to 100% of the original purchase price are allowed for half of the life expectancy (ie the relevant number derived from the life tables published by the Australian Government Actuary) of the retiree when acquiring the product. For example, a maximum of 9.5 years (ie 19/2 years) in the case of a 65-year-old male. After that, the maximum death benefit for this 65-year old would be the same as the maximum commutation value, which diminishes in a straight line to age 84 under the 'capital access schedule'.

19. Retirement income projections (p 11 of the position paper)

The position paper notes that future considerations will include details of how trustees will engage with members about retirement, including making retirement income projections.

We support the proposal for ongoing projections of retirement income as part of a program of lifetime engagement. Unlike the current voluntary regime, income projections should be mandatory so that all members benefit from them.

ASIC class order CO11/1227[11] provides a solid base for a retirement income projection regime. The class order prescribes that a fund making a projection of a future retirement income stream from a lump sum must use an assumption of $5,660 per year to age 92 for each $100,000 invested. Like with any pooled product, this assumes the progressive consumption of capital to fund retirement.

A subsequent ASIC class order: CO 14/870,[12] dealt with projections that included estimates of age pension entitlement. It would be desirable that CIPR projections included assumed age pension entitlements.

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[11] https://www.legislation.gov.au/Details/F2014C01259
[12] https://www.legislationgov.au/Details/F2014L01509

20. Disclosure proposal

A key part of the retirement income framework is an enhanced disclosure regime for CIPRs. We support this proposal, but have two important suggestions:

a. The covenant

The covenant could refer to life engagement and guidance, but should not be overly prescriptive or detailed when it comes to the disclosure regime. The SIS Act is not the right place for substantive disclosure requirements, nor is APRA the appropriate regulator to administer and enforce the requirements.

b. Chapter 7 of the ASIC Act

The requirements of the new disclosure regime for CIPRs should be enacted as an amendment to Part 7.9 of the Corporations Act, where other similar provisions are located.

Possible enhancements

21. MySuper – whole of life

Currently, there are thousands of members in MySuper options heading into retirement. Section 29TC(1)(i) of the SIS Act prohibits a MySuper option from paying a pension, meaning that members currently must leave MySuper to take up a retirement income stream. The question arises whether the retirement income framework should see adjustments made to this rule so that members in MySuper products could be offered the choice of taking a CIPR option with minimal change to their underlying interest in the fund.

22. Raising the threshold for an offer

It is possible that a consolidated pre-retirement superannuation balance of $50,000 is too low a threshold for the obligation to offer a CIPR. At low super balances, the clear majority of retirement income is provided by the age pension. Assuming that it is desirable to have some of a person's retirement income in flexible/liquid form, a reasonable level for the threshold could be as high as $100,000 to $150,000 on a consolidated basis.

It would also be important, as part of the engagement process carried out by the funds, to ensure that retiring members with debts understood that it is important to pay them off before investing in a CIPR.

23. Obligation to consolidate balances

Part of the preparation for the retirement income framework should be an obligation on the part of funds to identify and consolidate a retiring member's multiple accounts within the fund so that an accurate assessment of their consolidated account balance can be made.

24. Offering an alternative retirement income product through personal advice

Where a fund offers a retired member a non-CIPR retirement income product based on personal advice, there should be an express component of the best interests test that requires the adviser to be able to demonstrate that the longevity risk solution is superior to the CIPR. Without this anti-avoidance provision, the concern is that some funds might use the personal advice exemption to justify a return to the 100% ABP option for members who would be better off in a CIPR.

25. Clarification of application to small APRA funds

The position paper says that the retirement income covenant and principles would apply to all funds other than eligible rollover funds and defined benefit (DB) schemes that offer a DB lifetime pension. On page 4 of the position paper, it says that the retirement income strategy would be the only principle what would apply to self-managed funds. Small APRA funds should probably also be included in this exception.

Retirement income framework

Appendices to response to the May 2018 Treasury position paper on the retirement income covenant

15 June 2018

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Appendix 1

Retirement income case studies

Explanatory notes on cameo modelling

A CIPR offered by a super fund is likely to include a pooled lifetime income stream to manage longevity risks alongside the traditional ABP which provides flexibility for the retiree. This hybrid approach has been used in recent years by thousands of Australians who have been increasing their use of lifetime annuities as part of their retirement income solutions.

There is scope for super funds to combine different products, including new innovative products, in order to meet member needs in retirement. This appendix provides an example of three case studies that have slightly different CIPRs offered to their members, but all improve their outcomes, relative to the option of just using an ABP at minimum drawdowns. Some of these will be similar to what our clients are currently doing with their guaranteed lifetime annuities.

Case Study 1: Barry and Penny

Background

Barry, 66, worked for a local council for most of his career and is a member of the TopSuper fund. His wife Penny, also 66, was a part-time nurse, but she is a member of a different super fund. TopSuper contacted Barry after his latest birthday. He confirmed that, as he is now eligible for the age pension, he and his wife are looking to retire. Based on his balance, TopSuper offer Barry a CIPR that uses a lifetime annuity and an ABP.

Barry has $250,000 in super, with limited additional savings. The couple are looking forward to some travelling around Australia in retirement and helping to look after their grandchildren. They still have $50,000 on their mortgage to pay off and Barry will use a lump sum from his super to do that, investing the remaining $200,000 in TopSuper's CIPR.

TopSuper CIPR

The TopSuper CIPR offered to Barry has been designed for someone who is likely to receive a full age pension for most of their retirement. As such, it has a relatively low (15%) allocation to the lifetime annuity as they expect the age pension to provide Barry with some longevity risk management. Inside the CIPR, the ABP component has a growth allocation of 60%. This is higher than the allocation of 50% used in the ABP-only product. This allocation means that the total growth exposure for Barry is around 50% so that the exposure to growth assets in the CIPR is consistent with the existing retired members without a CIPR.

Knowing that Penny doesn't have as much of her own super, Barry wants to ensure that she will have enough income in the likely event that she outlives him. Barry takes the reversionary pension offer with his CIPR so that she too will have additional guaranteed income for life.

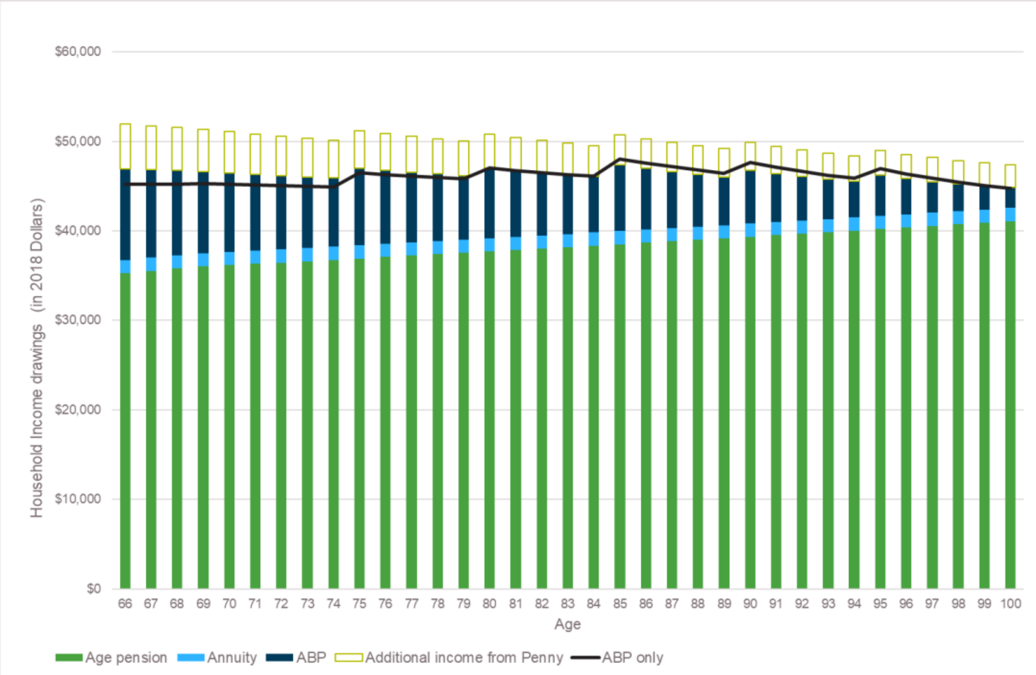
The drawdown from the ABP component will start at 6% pa for Barry. This is above the minimum drawdown and will provide Barry and Penny with an expected income level of around $52,000 through their retirement from the CIPR, including their age pension entitlement and around $5,000 a year from Penny's super. Barry and Penny are happy with the offer of the CIPR and don't seek any further advice.

Higher income with a guaranteed base

In total, Barry and Penny enjoy almost $2,000 a year more in the early years of retirement, compared to an ABP with a minimum drawdown. While TopSuper does not have any details of Penny's super, TopSuper's CIPR provides a stream of broadly stable income for Barry and Penny through their retirement. The lifetime annuity will provide a small lift in income at all ages so that if they need to draw their savings down for an unplanned event (or market returns are low) they will always have a little more income than the age pension.

Figure A.1 shows the contribution to household income for Barry and Penny, from age 66 to age 100, (if they were to live that long) assuming constant, average market returns. The majority of their income will come from the age pension. The black line shows the level of income they would receive under the age pension and ABP-only option if Barry used that. Penny's income would be in addition to this.

Figure A.1: Barry and Penny's retirement income sources



Case study 2: Olga

Background

Olga, 66, is a single mother who, after raising her two daughters, has been working full-time as a nurse to rebuild her retirement savings. With a balance of $250,000, she hopes that she has enough to retire. She loves her grandchildren and will be looking after them for some time to enable her daughters to work full-time. She is a member of the TripleA Super fund, which has a different approach from TopSuper.

TripleA Super CIPR

The TripleA Super approach is to use a deferred lifetime annuity (**DLA**) to provide the longevity protection for its members. TripleA allocates 20% of Olga's balance to a DLA, which is set to make payments from age 85, adjusted for inflation. The other 80% is invested in a balanced fund with just over 60% allocated to growth assets, to give a 50/50 split between growth and defensive assets in total. The drawdowns start at 7% pa of the ABP balance. They are managed to provide smooth income for Olga, well above the minimum drawdown rates.

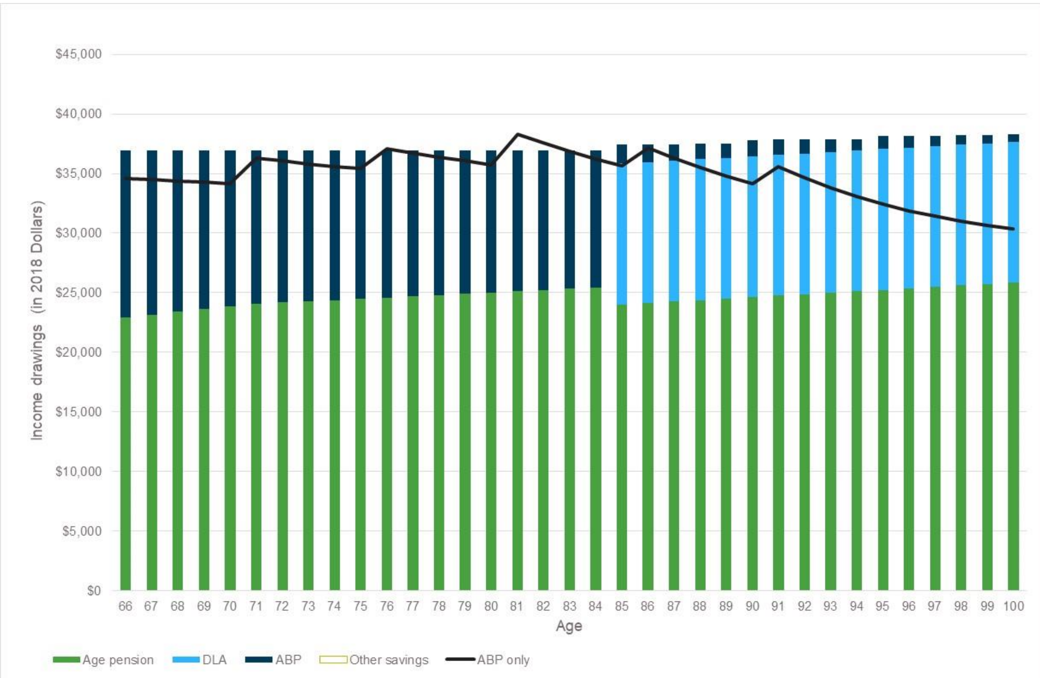
The security to enjoy retirement now

Olga can expect to receive around $37,000 a year for the rest of her life (measured in today's dollars). Knowing that she will have the additional income from her DLA to meet her needs later in life gives her the security to spend her capital down now to improve her retirement lifestyle.

By using the CIPR, Olga will have around $2,000 a year more income in the early stages of her retirement, compared to an ABP with the minimum drawdown rates. In addition, her total income will be much higher after the DLA payments begin and will continue for as long as she lives.

Olga's retirement income sources are illustrated in Figure A.2. While she will still receive a large portion of her income from the age pension, a significant proportion will be delivered from her super savings. The DLA provides protection against living past 85 so Olga will be able to retain her dignity late in retirement. A 66-year-old Australian woman living in 2018 actually has an 82% chance of living beyond age 85.[1] The chart also assumes that Olga does not spend any of the 10% residual of the ABP left over when the DLA payments start. On this assumption, the ABP provides a little extra income after the DLA payments start.

Figure A.2: Olga's retirement income sources



[1] Australian Life Tables 2010-12, with 25-year mortality factor improvements.

Case Study 3: Satish

Background

Satish, 66, had a career as an electrical engineer, but spent the last 10 years in management in a small construction company. Satish lost his wife to cancer 15 years ago and has been living on his own since. He sees his daughter and her family frequently, but really cherishes the time when he can travel to Queensland to visit his son and his family.

Having built up $500,000 in super, Satish also has an additional $50,000 in bank savings. His super fund SparkSuper is not aware of these additional savings when it offers Satish a CIPR. He is looking for a simple solution to generating his income in retirement.

SparkSuper CIPR

With a $500,000 balance, SparkSuper offers Satish a CIPR that includes a 30% allocation to a lifetime annuity. An allocation of 30% to a pooled lifetime income stream is useful for part age pensioners who want to fully protect their lifestyle against longevity risk. There is a slight difference between what SparkSuper projects for Satish (and his actual position) because of the additional $50,000 savings, but the outcomes presented in Figure A.3 include all his income. Satish likes the availability of the $50,000 to cover any unexpected expenses that might arise and doesn't feel the need to take additional financial advice.

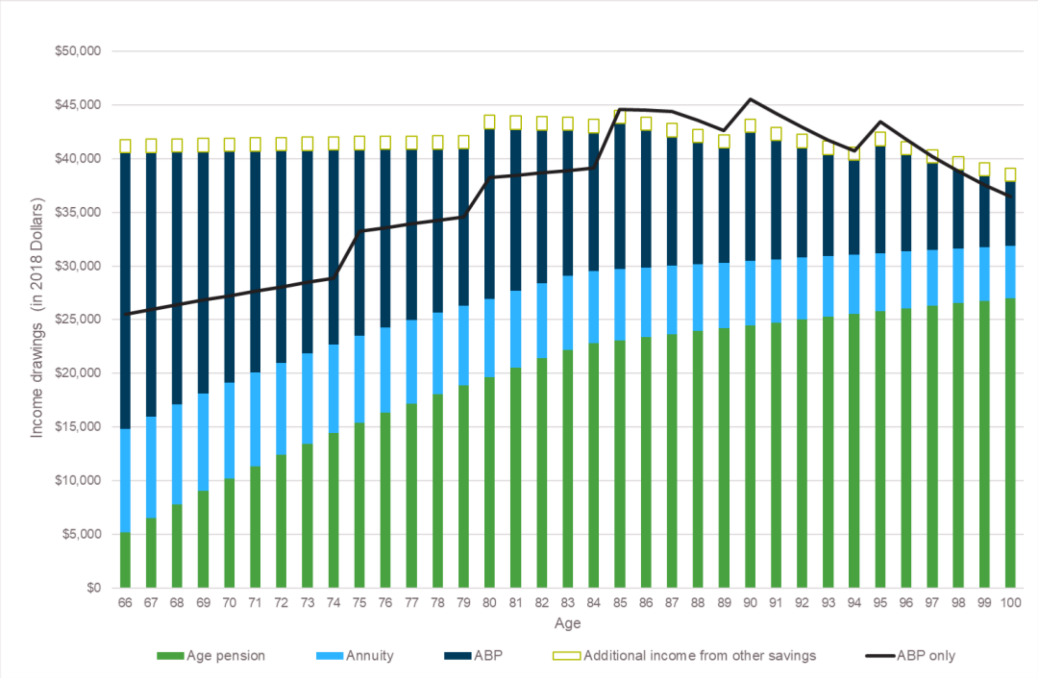
The drawdown from the ABP component will start at 7% pa (2 percentage points above the minimum) for Satish. This will provide him with an expected income level of just over $40,000 pa through his retirement. At older ages, Satish, like all part age pensioners, is likely to get a higher age pension. The drawdowns from the ABP are aligned with minimum drawdowns from age 85, so that the income stream is broadly constant. In addition, the lifetime annuity includes partial CPI indexation in order to increase initial payments. He can use the money outside super for any unexpected expenses, so he is unlikely to draw any lump sums.

Higher broadly constant income with a guaranteed base

With only a part age pension, Satish appreciates the regular income coming from the guaranteed portion of his CIPR. His total income is adequately indexed to inflation to maintain his living standard through retirement. Consuming his capital over time will provide Satish with an increasing entitlement to the age pension and enable him to maintain his $40,000 annual income (in real terms) until his late 90s. These components can be seen in Figure A.3. In the worst case of poor market performance, the CIPR would still provide the equivalent of more than $30,000 a year as guaranteed income between the age pension and the lifetime annuity payments.

Satish will receive $10,000 a year more in retirement income in his first 10 years of retirement compared to what he would receive with an ABP-only retirement drawn at the minimum rate. As the CIPR provides broadly constant income, this gap narrows over time compared to the ABP-only option, which keeps increasing his drawdown in real terms until age 90.

Figure A.3: SparkSuper CIPR: Satish's retirement income sources



Appendix 2

Retirement-phase assets and account balances

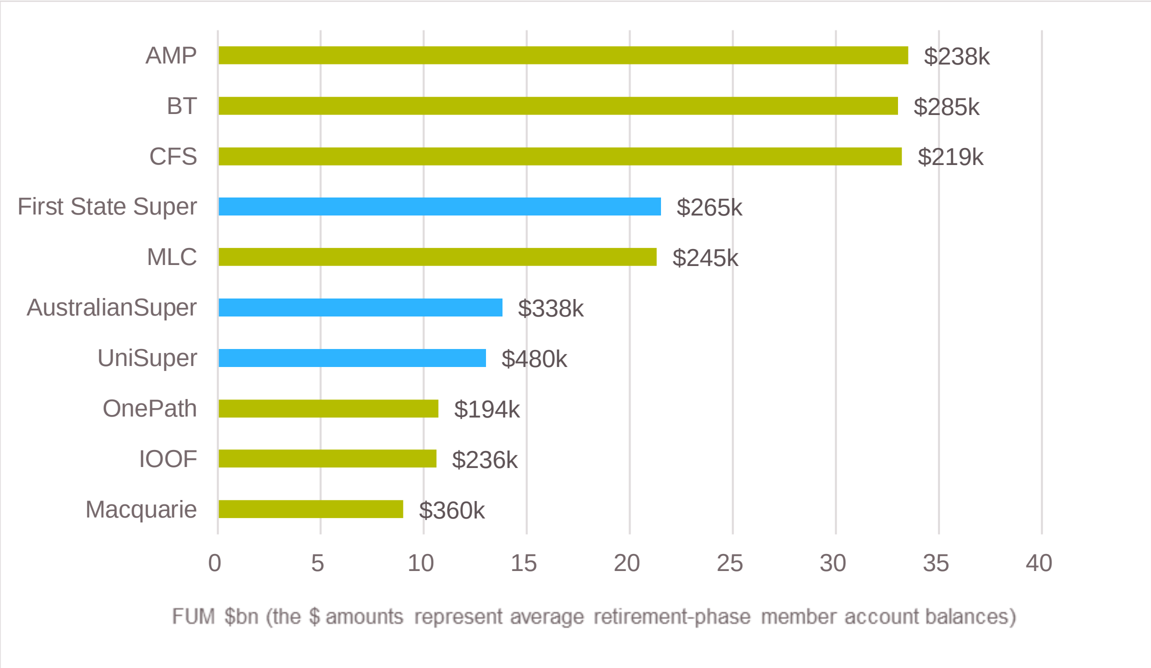
The latest APRA statistics to June 2017 show that super is delivering real scale in the retirement phase.[1]

The retirement phase already speaks for $413bn of the $1,751bn in the large APRA-regulated fund sector along with just under half of self-managed super fund (SMSF) balances (before the $1.6m transfer balance cap). Almost one in every four dollars in super was directly supporting a retirement income stream at June 2017. The weight of money in the retirement phase is such that some large funds could spin-off their retired members into a separate fund which would still be a major super fund.

Across the large APRA-regulated funds, there are now more than 1.6 million retirement-phase member accounts with an average balance of more than $250,000. The average annual pension benefit payment from each account is $20,703, suggesting that super is already making a significant contribution to the lives of many retired Australians.

The recent APRA data enable a comparison of the largest funds, measured by assets in the retirement phase. The chart below highlights the largest 10 of those funds, also highlighting surprisingly large average retirement-phase member account balances.[2,3] These 10 funds together had over $193 billion in retirement-phase assets at June 2017.

Chart 1: 10 Largest super funds (by assets in the retirement phase)



[1] APRA Annual Superannuation Bulletin June 2017 & Annual Fund-level Superannuation Statistics report June 2017, issued 28 March 2018.
[2] The data exclude government DB pension schemes such as CSS/PSS.
[3] First State Super also includes StatePlus balances.

There are some differences in the chart worth noting:

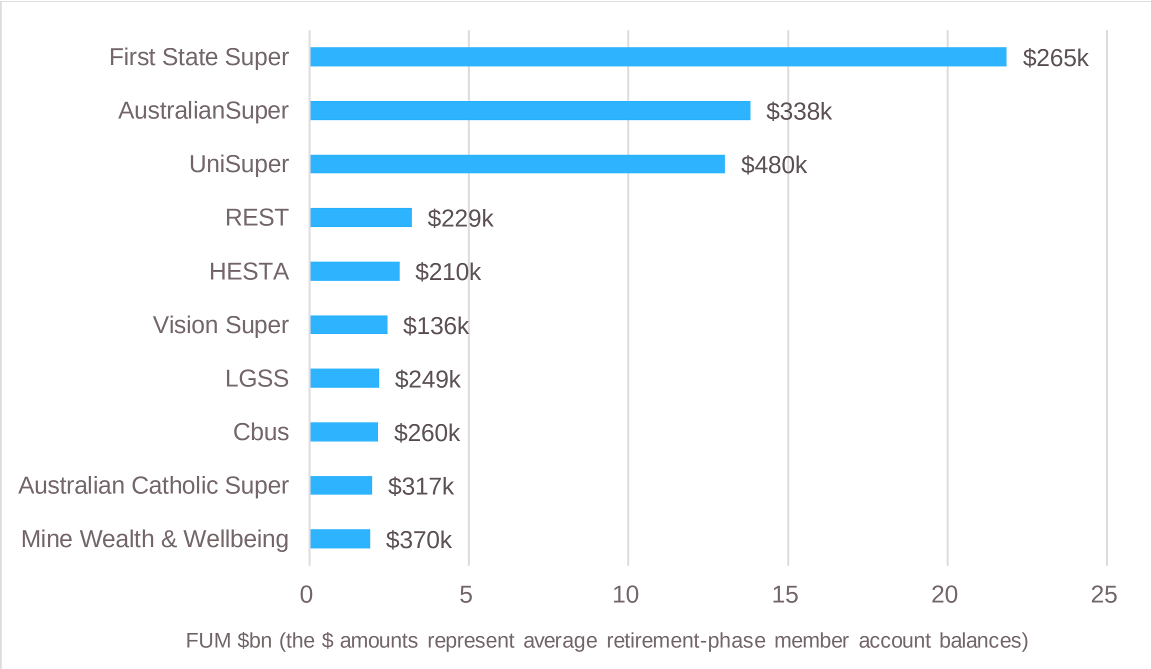
- The retail funds still have more retirement-phase assets, but this is changing. AustralianSuper now has over $13bn in the retirement phase. This means that if the retired members of AustralianSuper were moved into a separate super fund, the new fund would rank in the top 25 super funds based on June 2017 APRA data;
- Balances for retired members are significantly higher than the average balance across funds. The average account balance for a member in the retirement phase is $257,000 across all large APRA-regulated funds. This is the balance that matters to members, and usually has been consolidated into a single account in preparation for retirement;
- The profit-for-member funds have larger balances in retirement. (This might reflect member demographics. That is, the retirement-phase members are likely to be a younger cohort of retirees who have spent less of their retirement savings).

Industry fund sector

Of note is the scale of retirement-phase assets in the industry fund sector.

The chart below highlights the largest 10 industry super funds measured by assets in the retirement phase, also highlighting average retirement-phase member account balances. These 10 funds together had over $65 billion in retirement-phase assets at June 2017. The average balance for a member in the retirement phase in these large funds was $292,000, which is higher than the average retirement-phase member balance across all large APRA-regulated funds of $257,000.

Chart 2: Largest industry funds (by assets in the retirement phase)



Appendix 3

Understanding life expectancies

Life expectancies are often misunderstood. Headline numbers that are used in commentaries about retiree life expectancy are often misdirected for three key reasons:

- Comments are sometimes based on average life expectancy from birth. A retiree has (by definition) survived long enough to retire from the workforce (say age 65), so the average life expectancy of a retiree will be higher than life expectancy from birth;
- 'Period' life expectancies use mortality rates over a period of prior years and assume that those rates will apply for the remainder of a person's life. They are backward-looking. This means that they do not take account of any future changes to mortality rates; and
- Continuing improvements in medicine, health and lifestyles benefit those people still alive. These are known as 'mortality improvements' and add a couple more years to average life expectancies calculated on a 'period' basis. Mortality-improved life expectancies provide a more realistic projection of how long the average person who has survived to age 65 is likely to live. For this reason, it is preferable to use these when thinking about retirement income.

The following table illustrates the different outcomes arising from these different approaches.

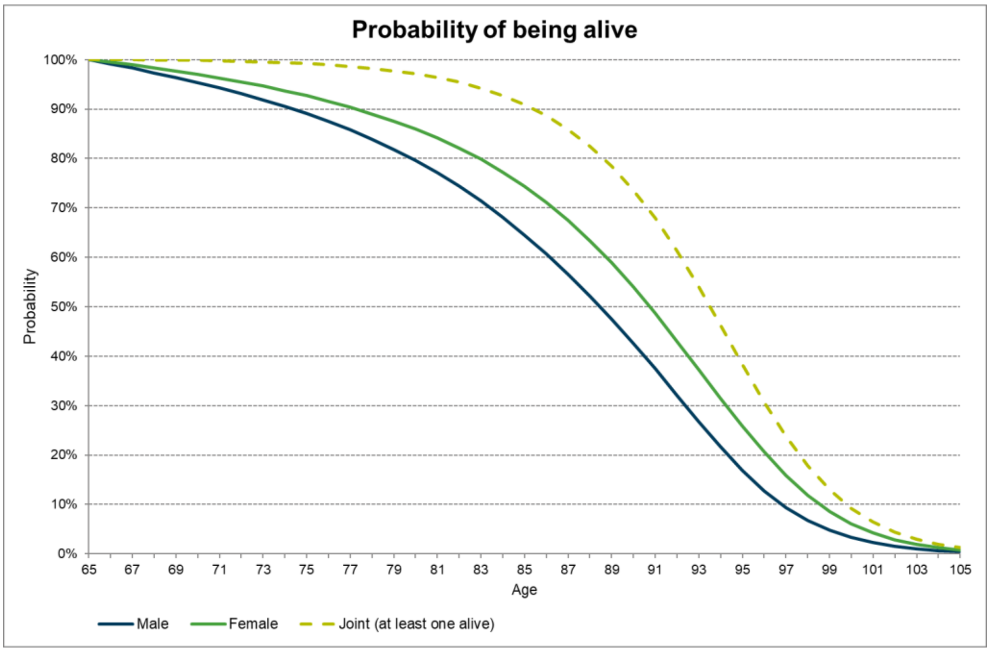
Table 1: Life expectancies

Measure of life expectancy	Males	Females
Life expectancies at birth (used in global comparisons)	80.1	84.3
'Period' life expectancies for 65-year-olds today[1] (ie people born in 1952/1953 who are still alive)	84.2	87.3
Mortality-improved life expectancies for 65-year-olds today[2] (ie people born in 1952/1953 who are still alive)	87.1	89.3

It is also good to remember that these are averages and there is a wide distribution of actual lifespans of Australian retirees. Typically, half the population will not reach life expectancy and half will live longer. The lifespans of around two-thirds of people will end between eight years either side of the average. The range of outcomes is evident in **Figure 1**, which provides the survival probability for a couple, both aged 65 in 2018.

[1] Australian Life Tables 2010-12.
[2] Australian Life Tables 2010-12, with 25-year mortality factor improvements to 2018.

Figure 1: Survival probability for a 65-year-old couple



Source: Australian Life Tables 2010-12 with 25-year mortality improvement factors.

Appendix 4

Understanding annuity rates

Lifetime annuity payment rates are often compared inappropriately to rates of return on other investments. There is confusion at three levels:

1. Each payment includes: interest, a return of capital and mortality credits, rather than just a reward like interest on a bank deposit, which is entirely separate from the capital deposited;
2. There is a temporal component arising out of the longevity protection feature. You do not know in advance how many payments you will get. What this means is that today's rate does not tell the whole story; and
3. Annuities are part of the defensive component of a retirement income portfolio and are not a substitute for growth assets. In a retirement income portfolio, such as a CIPR, an annuity should replace the bonds in the portfolio and so an annuity rate should only be compared to the rate available on other defensive assets (having regard to the differences explained in paragraph 1 above).

Current annuity rate

Consider a live example from an annuity for a 65-year-old male bought from Challenger on 15 June 2018. The annuity option with flexible access to capital and payments fully indexed to the consumer price index (CPI) would begin at $5,297 in the first year for each $100,000 invested. This option also provides for a death benefit of 100% of the original investment if the purchaser dies before age 74.

The rate offered each week changes with market movements (which affect the return earned on the underlying investments). It is also based on an actuarial assessment of the purchaser's probability of survival, given their age and gender.

Let's compare annuities and bonds

For comparative purposes, the example below assumes an initial annuity payment rate of $5,297 per $100,000 invested. This is consistent with an underlying net investment return on the assets backing the annuity of approximately 5.0% pa in nominal terms. The examples below compare the payments from the annuity with the payments from a bond portfolio earning the same (5.0%) net investment return. Payments are assumed to increase at 2.25% pa to match inflation in all cases, in line with current market-based expectations of average inflation for the next 25 years.[1]

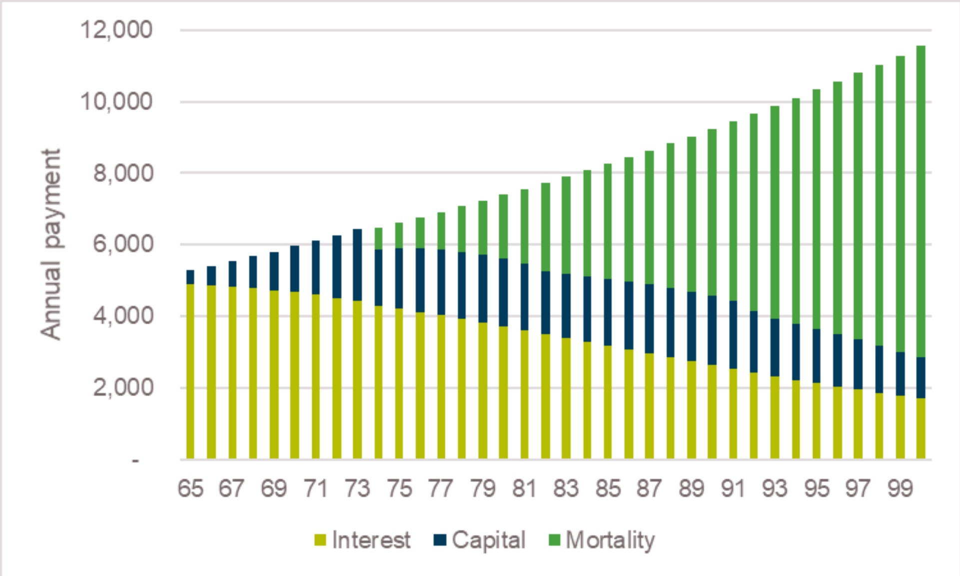
Each annuity payment consists of interest, a return of capital and mortality credits. The relative proportions of these components change over time as the annuitant ages. Consider two people: someone who lives to age 90 and someone who lives to age 95.

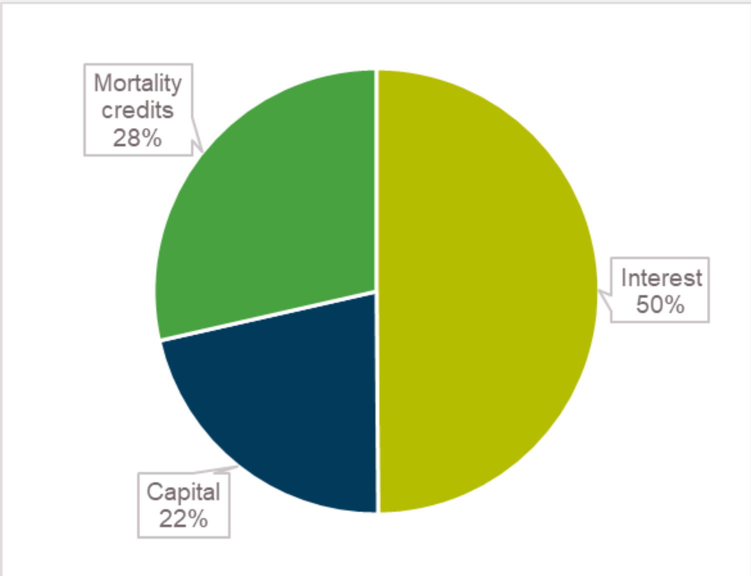
Total annuity payments to age 90 would be (assuming 2.25% pa inflation) $175,189 comprising 57% interest payments; 23% from capital returns; and 21% from mortality credits.[2]

[1] The underlying risk to the investor in this hypothetical example would differ materially between a bond portfolio and an annuity. In the case of the former, the investor would be directly exposed to the credit risk in the portfolio. An annuitant, on the other hand, is protected by the risk-weighted capital held by the life company.
[2] This is equal to $132,425 adjusted for inflation, being 25 annual payments of $5,297 each.

Total annuity payments to age 95 would be (assuming 2.25% pa inflation) $223,508 comprising 50% interest payments, 22% from capital returns and 28% from mortality credits. The longer someone with an annuity lives, the more they receive from mortality credits. This is illustrated in **Figure 1**. The first chart highlights the increasing contribution from mortality credits over time. The second chart shows the composition of payments (from the three sources) from age 65 to 95.

Figure 1: Payments from a lifetime annuity from age 65 to 95



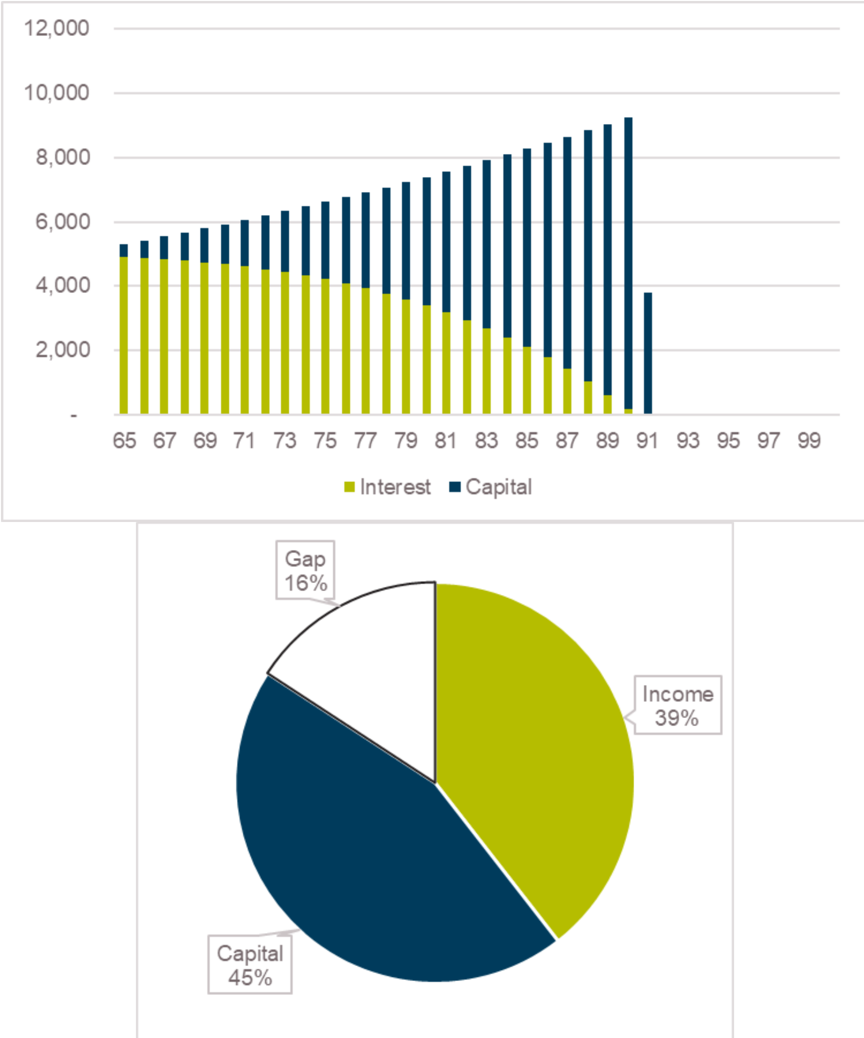


The bond portfolio alternative

The annuity payments can be contrasted to a bond portfolio that was achieving the same 5.0% nominal net investment return. If you wanted the bond payments to last to age 90 exactly, the initial payment could be $5,352 pa (indexed to inflation). To get the payments to last to age 95 exactly, the initial payment would have to be reduced to $4,772 pa to last the distance. This is, of course, an unrealistic example. A retiree does not know in advance exactly how much they can draw from their investment each year, because they don't know how long they are going to live.

Another way to compare the bond and the annuity is to consider what happens if exactly the same payments as the annuity were made from a bond portfolio. To age 90, the total payments would all be made, but at a greater capital cost (that is, a greater depletion of the original capital). The payments from a bond portfolio would not last to age 95, but would be exhausted in the 92nd year (ie aged 91), leaving the retiree short a total of $35,285 in payments not received. This is shown as the gap in the charts below in **Figure 2**.

Figure 2: Payments from a bond portfolio from age 65 to 95



Explanation for the difference

We have created two portfolios with an identical underlying rate of return. The reason for the difference in outcome is that the annuity has cash flows boosted by mortality credits, while the bond portfolio does not. The other potential difference is in the amount left to the estate, depending on the age of death. This illustrates the key trade-offs involved.

Appendix 5

Retirement really is different

(first published as a separate paper on 9 April 2018)[1]

…calling for improved fund governance, specialised products and targeted financial advice

1. Making our super system fit-for-purpose in retirement

Former Prime Minister Paul Keating conceded some years ago that the super system was not designed for people who were going to live over the age of 80.

The system he conceived was for the 55-75-year-olds.[2] Today's retirees are now typically living into their late 80s, more than 9 years longer than they did in the 1990s. Sixty-five-year-old women today can expect to live to 90 on average, with one-in-five to live to 98.[3]

By 2030, our super savings mountain will basically double in size from its current $2.6 trillion to around $5 trillion.[4] Over that period, something in the order of $1,300bn of super savings will move into the retirement phase.[5]

Super is doing the first part of its job; it is allowing people to accumulate assets for retirement. However, there is no structure to the drawdown phase in our defined contribution model – flexibility is prioritised at the expense of risk management and income certainty and sustainability.

2. Ability to self-provide in retirement is increasing

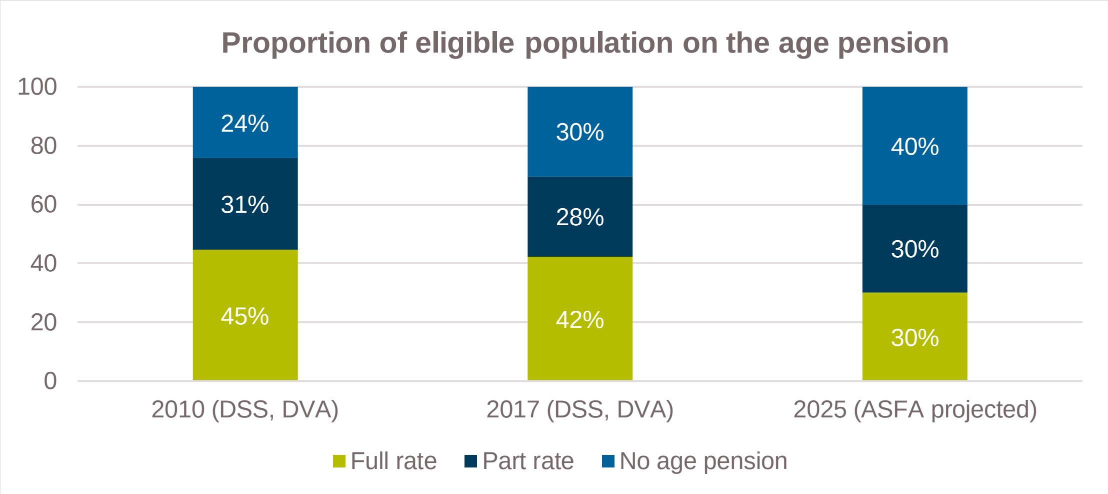
Super is moving from merely supplementing the age pension to substituting it for an increasing proportion of retirees. The evidence is already in. At June 2017, only 42% of the over-65 age cohort were getting a full pension, with a further 28% on a part age pension.[6]

Put another way, more than half of today's retirees (ie 58%) have sufficient means to reduce, or eliminate, their entitlement to government income support and growing super balances will be playing a material part in this story.

The trend towards the need for private provision of stable retirement income is clear, as Figure 1 shows. Apart from anything else, the eligibility age goes up from the current 65.5 by six months every two years until it reaches 67 in 2023. ASFA projections suggest that by 2025, around 20% of people aged 67 will still be working, with a further 40% or so ineligible for the age pension.[7]

[1] https://www.challenger.com.au/group/Retirement__really_is_different_media_release.pdf
https://www.challenger.com.au/group/Retirement_really_is_different_position_paper.pdf
[2] Opening address at the 50th Anniversary ASFA Conference in Sydney on 28 November 2012.
[3] Based on ALT2010-12 with 25-year mortality improvements from the Australian Government Actuary.
[4] Source: Rice Warner Superannuation Market Projections Report 2017.
[5] Rice Warner Superannuation Market Projections Report 2017, sum of flows June 2018 to June 2030 (in 2017 dollars).
[6] Includes age-based veterans' pensions. Age of eligibility for the age pension increased to 65.5 from 1 July 2017.
[7] ASFA Pre-Budget Submission for the 2018-19 Budget, February 2018.

Figure 1: Trend of decreasing reliance on age pension 2010-2025



3. A new retirement income framework

In late 2014, the Financial System Inquiry (FSI) recommended development of comprehensive income products for retirement (CIPRs). The FSI realised that a 'pre-selected' combination of products designed to deliver a regular and stable income stream, longevity risk management and flexibility would simplify decisions at retirement and, most importantly, deliver better outcomes for retirees. The availability of lifetime income streams in retirement is critical to ensuring savings accumulated through super can meet retiree consumption needs.

The government recently proposed that the CIPR concept would benefit from a heightened level of fund governance around retirement income; an improved retirement income framework. To this end, Treasury is currently working with an advisory group to assess a proposal for a new covenant in the SIS Act[8] requiring fund trustees to consider the retirement needs of their members when developing and offering retirement income products. This new governance initiative could form a major plank in the drive to improve the market for high quality retirement income products.

Improving the retirement phase is not just about products. Even with a 'soft default'[9] CIPR, many retirees will need targeted, specialist advice. The importance of the advice industry has been recognised by the government, with the Financial Advice Standards and Ethics Authority (FASEA)[10] established to improve the education, training and ethical standards of advisers. FASEA will have an important responsibility to ensuring that advisers are ready to service the mass market of retirees who will need advice about the safe spending of their retirement savings.

4. Why do we need to act now?

Around 51% of national wealth is owned by the 45-64-year-old cohort[11] and approximately 700 Australians are retiring every day. It is essential that this group gets sound financial advice

[8] *Superannuation Industry (Supervision) Act 1993* (Cth).
[9] Generally taken to mean something that is offered as the preferred option, but falling short of an outcome that becomes the default in the absence of an active choice.
[10] FASEA website https://fasea.gov.au
[11] ABS (13 September 2017) 6523.0 Survey Household Income and Wealth 2015-16.

both before and during retirement and that the financial products available to them meet their needs in retirement.

A recent National Seniors Australia (NSA) report on the behaviour and attitudes of senior Australians regarding their retirement finances shows that six out of ten Australian seniors are turning to financial advisers for advice or information about retirement finances.[12] This proportion is significantly higher than for the superannuation member population overall, where only one in five seek advice.[13]

5. The challenge - retirement is different from accumulation

So far, the super industry has focused on building up the savings pool. This has been an unquestionable success. The issue now is that spending those savings to improve living standards and manage risks in retirement is a very different paradigm.

In retirement:

- **There is usually no income other than an age pension entitlement:** the 'financial dynamics' of accumulation are reversed. There is generally no regular wage or salary (other than an age pension entitlement) and the retiree starts drawing down on their savings to fund consumption. This makes it a fundamentally different proposition from accumulating savings and introduces new risks;[14]

- **Retirees have specific goals:** the goal of most accumulators is simply to build up the maximum amount of retirement savings for a given risk appetite; time horizon and contribution rate (they may or may not be targeting a level of retirement income from those savings). This explains the risk-profiling approach used by most advisers. In retirement, most retirees will have a range of goals that will an income goal for spending; access to capital for emergency spending; growth; peace of mind and leaving a bequest. These goals create a very different dimension from the accumulation phase;[15]

- **Retirees are exposed to longevity risk**: the risk that they outlive their savings because of increasing life expectancies. Longevity risk also has another dimension: the uncertainty of how long people will live. There is a wide distribution of actual lifespans around the mean (ie life expectancies of retirees). A 65-year old female only has a 5% chance of dying in the year of her life expectancy (currently 90). This makes planning around retirement income needs all the more complicated;

- **Sustainability of retirement savings:** becomes a new and important concept. This has two elements: the probability of success of the retirement plan (expressed as a percentage of likelihood of reaching a particular age with savings still intact) and the range of potential outcomes based on market returns that deviate from long term averages;

- **An understanding of life expectancies is critical:** to advise on the sustainability of a retirement portfolio and the rate of safe spending from that portfolio, advisers need a

[12] National Seniors Australia (2017): *Seniors more savvy about retirement income* <https://nationalseniors.com.au/be-informed/research/publications/seniors-more-savvy-about-retirement-income> There were over 5,500 respondents who were over 50; 55% were female and the average age was 68.
[13] MLC Quarterly Wealth Behavioural Survey Q1:2017.
[14] For example, dollar cost averaging works in reverse. See Challenger Retirement top tips: *What works in accumulation works against you in retirement* January 2012. <https://www.challenger.com.au/funds/TechnicalUpdates/CRIR_One_minute_guide_-_what_works_in_accum.pdf>
[15] This is usefully summarised in a 2013 white paper by Lonsec and Milliman entitled: *Boomers, Herding, Denial and Zeitgeist: Who will be First to Grasp the Post-Retirement Advice Opportunity?* <https://www.lonsecretire.com.au/research/white-papers/whitepaper1>

strong understanding of life expectancies, including concepts like mortality rates, mortality improvements and, most importantly, the deviation of actual lifespans from the mean;

- **Market risk takes on a new dimension - sequencing risk**: when drawing on a portfolio, the sequence of returns matters. Negative market movements early in retirement have can have an adverse impact on the sustainability of cash flows.[16] A retiree's ability to recover from poor investment returns (or take advantage of lower market prices) is generally limited because strategies available in the accumulation phase (take more risk; keep working and contribute more) are generally not available;

- **Household expenditure is funded by individual savings**: yet the predominant way people approach the financial challenges of retirement is by sharing them with another person. Around 70% of people start retirement in a couple household. We accumulate retirement savings individually, but generally spend it jointly. As a result, retirement income advice is generally best framed to align with this reality;

- **Inflation becomes a significant risk:** inflation takes on a new dimension because the retiree's capital is disconnected from wage rises and retirees can generally only be confident of maintaining purchasing power via the age pension and explicitly inflation-linked investments. Recent low inflation rates, following an extended period of inflation at 'average' rates, does not make it any less likely that inflation could deviate strongly from the mean during a lengthy retirement;

- **Long-term investing is no longer a panacea**: plans based solely on notions like 'investing for the long term' are generally less relevant in retirement, although growth assets will play a material role in most portfolios. Due to spending needs, approximately half of a typical retiree's savings are consumed in the first 10 years and a smaller proportion of savings can be set aside for 'the long-term'. Later retirement spending is funded from dollars created by compounding returns during retirement;

- **Diversification does not mitigate all risks:** by itself, diversification of asset risks is much less able to deal with retirement income challenges than is widely thought. For example, for most retirees, longevity risk cannot be ameliorated solely by exposure to growth assets. It is not just about having money later, but it is the ability to spend confidently, and not run out;

- **Importance of cash flows**: retirees say that they want a 'retirement pay cheque'[17] and yet most retirement plans are based on investment returns and capital accretion, rather than regular, stable income;

- **Pooling benefits can be realised**: pooled retirement income products produce a distinct form of income known as a 'mortality credit': effectively the yield from capital belonging to those who predecease the projected life expectancy of the pool. This form of retirement income is uncorrelated to market assets like equities or bonds and can be distributed from the start of retirement, based on actuarial assumptions. It is unique to

[16] <https://www.finsia.com/docs/default-source/Retirement-Risk-Zone/the-bca-cab-bac-abc-of-sequencing-risk.pdf?sfvrsn=2>
[17] Ibid 12.

pooled retirement income products and significantly enhances the rate of return to surviving members of the pool;

- **Cognitive decline**: sound retirement income planning and advice involves the recognition that there is a high likelihood that at some point along the way, one or both members of a retired couple will suffer cognitive impairment or dementia. Many strategies involve more complexity and decision-making than is suitable for late stage retirees;
- **Elder financial abuse**: older Australians are exposed to financial abuse, often at the hands of family and carers. An increase in online and card-based services means that older people are even more vulnerable to such exploitation. Those giving retirement income advice need to be attuned to this problem; and
- **Each retiree's needs tend to be distinct**: there are no universal solutions to funding a retirement and the individual circumstances of retirees' (such as their health; intended consumption patterns; financial literacy; marital status and their likely longevity) play a much bigger role in the advice and planning process than in accumulation. This is largely because accumulation does not involve any element of spending.

6. **Retiree behaviour**

Good retirement income advice involves understanding and pre-empting certain inherent biases that people exhibit. These include lump sum bias (the tendency to overvalue a capital sum as opposed to its actuarially fair income value); hyperbolic discounting (the tendency to undervalue future income) and retirees' aversion to loss which is greatly increased compared to the accumulation phase.[18] The average person does not have the financial literacy to deal with each of these on their own. Financial advisers need to have the appropriate level of professional expertise to guide their clients through these biases.

7. **Wealth segmentation and spending rate**

A way of clearly seeing the cohort most in need of improved retirement income products and advice is to segment retirees according to their wealth at the start of retirement and their spending intentions. A stylised form can be seen in Figure , which highlights that retirees fall into four broad segments: those will continue to grow their savings throughout retirement; those who maintain or preserve their wealth; those who spend all their wealth down over their lifetime; and those who run out of savings and become completely dependent on the age pension.

As the super system matures, the cohort of retirees who spend all their wealth down quickly and rely on the age pension will decrease. Most retirees with less than $1.6m in retirement savings will be in the yellow zone in Figure . These retirees will have a material level of retirement savings, but not so much that they can preserve or grow their wealth, and they will not be able to ignore the risk of running out. To maximise their standard of living, they will need to spend a substantial part of their savings. They will need specialised retirement income products and targeted financial advice to enable them to do this with peace of mind.

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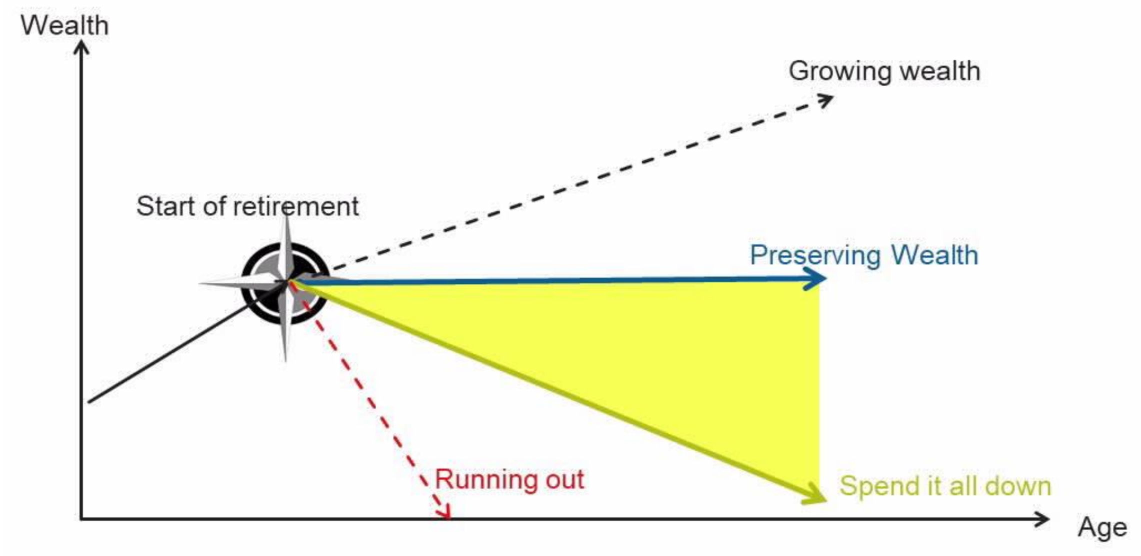
[18] Mitchell, Olivia S. and Utkus, Stephen P., Lessons from Behavioral Finance for Retirement Plan Design (October 2003). PRC Working Paper No. 2003-6 <https://ssrn.com/abstract=464640> provides background to some of the issues. See also Allianz/Shlomo Benartzi: Behavioural Finance and the Post-Retirement Crisis: <http://befi.allianzgi.com/en/Publications/Documents/allianz-dol-rfi-response.pdf>and What Now? How Retirees Manage Money to Make It Last Through Retirement, Report of Findings, AARP and American Council of Life Insurers, Dec 2007 <http://assets.aarp.org/rgcenter/econ/guaranteed_income.pdf>

Figure 2: Retiree spending paths – highlighting the emerging mass-market need



8. **Household view**

In practice, retirement spending happens at a household level. This is another big challenge: we save up super individually because it's employment-based, but most of us spend it jointly in retirement. Sharing a roof is the most basic element of shared consumption of retirees. In the 2016 Census, nearly 70%[19] of people aged 60-64 were married or partnered and less than 20% were living alone.

While it is important not to forget the minority of singles and the extra burden they often face, the majority engage in, and benefit from, pooled household consumption. Where possible, all participants in the retirement income system (ie policy-makers, funds and advisers) need to be more accustomed to distinguishing between the solo retirement and the pooled retirement. They are very different experiences and need different treatment. We are often not making this distinction and much of the debate about the gender gap in superannuation overlooks this fact.

9. **Success or failure of a retirement plan**

One of the biggest challenges in providing appropriate products and advice for the retirement phase is the lack of a clear success measure. In accumulating assets, there is only one goal, accumulate as many assets as possible, with minimal outgoings and an optimal level of volatility to create the largest possible pool of savings. This provides a clear success measure and well-known steps to improve the ultimate outcome, including: asset allocation; saving more; reducing costs; minimising taxes; contributing (working) for longer; right down to the typical competition to get better investment returns. Advisers are well accustomed to working in this paradigm.[20]

In retirement, typically, there are four forms of expenditure to plan for:

[19] The exact figure was 69%.
[20] J. Stock, W. Sharpe and J. Watson, 2009 'The 4% Rule - At What Price?' *Journal of Investment Management* Q3 2009 provides a discussion on the different costs associated with failure and the surplus with success for a retiree following a simple plan.

- Everyday living costs which requires predictable and regular cash flows. These can be further divided between needs (essential expenditure) and wants (discretionary expenditure);
- Emergency or lumpy items (financial assistance for an adult child or renovating a bathroom);
- Expenditure beyond life expectancy (which is itself only an expectation based on averages); and
- Bequests for the estate.

Success will often involve meeting all these objectives; making success much more difficult to measure in retirement.[21] Retirement advice also calls for a focus on the lengthy time horizons involved. Retirees who start spending in year 1 of retirement need to know how that is going to affect the availability of income in year 20 and beyond.

10. Implications for advice standards

The predominant focus of super advice, historically, has been building wealth for investors while they are in the workforce. Retirement advice has often focused on tax strategies that, until recently, were available in transitioning to retirement, and estate planning. Currently, only the leading advisers provide advice on spendable cash flows, the sustainability of retirement savings, mitigating longevity risk, cognitive decline and aged care.

A key challenge for FASEA in designing new standards and education pathways for all advisers is the difference between the government's objective for superannuation and the typical role of the adviser to date. Financial advice was developed as a wealth management tool, focussed on growing and preserving wealth and this is still largely reflected in the training advisers receive today.

On the other hand, the government sees the role of super as providing income through retirement, which includes consuming capital to create a higher standard of living for retirees. The $1.6m transfer balance cap is designed as being enough to provide $100,000 a year across an average retirement, but only if all capital is consumed. The age pension taper rate clearly contemplates a reduction in accumulated savings through retirement. As means reduce via spending, support from the government increases through the age pension.

FASEA will need to contemplate the advice needs of the cohort of retirees who will spend down their capital through retirement, rather than the traditional wealth management cohort who aim to preserve retirement capital. This should be reflected in the content of courses that are approved for existing advisers, as well as the training requirements for new advisers.

11. Call to action

People are living longer than was envisaged when we designed our super system. The system is working well in building up retirement savings. Typical household super wealth at retirement is in the $350,000-500,000 range and increasing.

This wealth was accumulated to provide income in retirement, but the system is not yet set up to do this next phase successfully. It is increasingly clear that many Australians will be

[21] A discussion of some of these objectives in an Australian context can be found in 'Retirement Solutions I: Gaps in the state of the art' Russell Investments, April 2012 <https://russellinvestments.com/au/insights/library/retirement-solutions-i--gaps-in-the-state-of-the-art>

substantially living off their own resources in retirement. Private provision of an age pension-like outcome will be increasingly important part of retirement income plans.

The risk of running out of money in retirement cannot be managed by most retirees on their own. This risk needs to be pooled or outsourced to a stronger balance sheet.

We can contribute to addressing these issues comprehensively as part of the government's CIPR framework reforms, now focused on a potential governance solution. In addition, there are various consultations being run by FASEA on the reform of the training, competence, standards and ethics that should apply to financial advisers. Between these two reforms initiated by the current Coalition government, there is every chance that we can create a world-class retirement income system.

Appendix 6

Retirement income reform initiatives 2008 – 2018

The genesis of the retirement income framework can be traced back to the review of Australia's Future Tax System in 2008 which concluded, in its recommendations on the post-retirement aspects of the superannuation system, that there should be encouragement for the longevity risk management market and innovative retirement income stream products.

Since then, numerous reviews and consultations have been undertaken by both Labor and Coalition governments to explore the need for retirement income products and examine how they could deliver better outcomes for Australian retirees. The following table summarises these initiatives.

Date	Initiative	Links
13 May 2008	*Labor:* Deputy Prime Minister and Treasurer Wayne Swan announced terms of reference for a comprehensive review of Australia's tax system. The panel for *Australia's Future Tax System* was chaired by Dr Ken Henry AC and the review became known as the *Henry Tax Review.* The terms of reference included that the review would reflect the government's policy to preserve tax-free superannuation payments for over 60s.	Media release
10 December 2008	*Labor:* A Retirement Income Consultation Paper was released as part of the *Henry Tax Review* consultation process. Consultation on the retirement income system was brought forward to allow the Government to consider any issues in conjunction with those arising from the Pension Review (due in February 2009). Key considerations of the consultation were whether the retirement income system is broad and adequate, acceptable, robust, simple and approachable, and sustainable.	Consultation paper
29 May 2009	*Labor:* Minister for Superannuation and Corporate Law, Senator Nick Sherry announced the terms of reference and makeup of the *Review into the governance, efficiency, structure and operation of Australia's superannuation system.* The review was chaired by Jeremy Cooper and became known as the *Super System Review*.	Media release

2 May 2010	*Labor:* Final report of the *Henry Tax Review* released by the government along with an initial response. Recommendation 21 addressed potential changes to the post-retirement system: **Recommendation 21**: The government should support the development of a longevity insurance market within the private sector. (a) The government should issue long-term securities, but only where this is consistent with its fiscal obligations, to help product providers manage the investment risk associated with longevity insurance. (b) The government should make available the data needed to create and maintain a longevity index that would assist product providers to hedge longevity risk. (c) The government should remove the prescriptive rules in the *Superannuation Industry (Supervision) Regulations 1994* relating to income streams that restrict product innovation. This should be done in conjunction with the recommendation to have a uniform tax on earnings on all superannuation assets. In its press release responding to the final report the government specifically rejected **Recommendation 22** which called for the government to consider issuing annuity products itself.	Final Report Media release – initial government response Government response
5 July 2010	Final report of the *Super System Review* released. The report included 177 recommendations covering ten broad areas of reform. Chapter 7 specifically addressed the retirement phase and recognised that the retirement income product market had been under-developed concluding that this largely reflected the relatively small balances that many retiring workers held as a consequence of the super guarantee system being immature (less than 20 years old). The report predicted that super balances would increase substantially in the period ahead and that this, combined with demographic ageing, should help spur product development. Treasury estimated post-retirement assets would more than triple in real terms by 2035 to reach $850 billion. Four recommendations were made on retirement: **Recommendation 7.1** - MySuper products must include one type of income stream product, either through the fund or in conjunction with another provider, so that members can remain in the fund and regard MySuper as a whole of life product. The Government should consult comprehensively	Final Report

	with industry before mandating the post-retirement arrangements to apply to MySuper products. **Recommendation 7.2** Trustees should be required to offer intra-fund advice proactively to MySuper members as they approach normal retirement age. Over time, advice should be available on as broad a range as possible of the financial issues that members will face in retirement, subject to the requirements of the sole purpose test. In the near term, advice should address investment allocation and alternative retirement products offered within the fund. **Recommendation 7.3** Trustees should offer intra-fund advice proactively to MySuper members in the retirement phase at periodic intervals. **Recommendation 7.4** Trustees must devise a separate investment strategy for post-retirement members in MySuper products which has regard to the factors as set out in section 52(2)(f) of the SIS Act as well as inflation and longevity risk.	
16 December 2010	*Labor:* Assistant Treasurer Bill Shorten announced its response to the *Super System Review*, formally accepting the bulk of the review's recommendations through its *Stronger Super* initiative. The Government noted Recommendations 7.1 – 7.3 in relation to retirement and provided support for Recommendation 7.4. Detailed responses: **Recommendation 7.1** The Government will consult with relevant stakeholders on whether post-retirement products should be mandated for MySuper products at some time in the future. **Recommendation 7.2** The Government will consult with relevant stakeholders on whether MySuper products should be required to offer intra-fund advice and the appropriate timing of any change. **Recommendation 7.3** The government will consult with relevant stakeholders on whether MySuper products should be required to offer intra-fund advice and the appropriate timing of any change. **Recommendation 7.4** The Government supports requiring a separate investment strategy for post-retirement members in MySuper and choice products which offer retirement income stream products and will consult with relevant stakeholders on implementation issues.	Media Release Government response Dedicated Stronger Super website

1 February 2011	*Labor:* Minister for Financial Services & Superannuation Bill Shorten announced the establishment of a *Stronger Super* Peak Consultative Group tasked with advising the government on how best to implement the *Stronger Super* package. The group was chaired by Paul Costello.	Media release
21 September 2011	*Labor:* Assistant Treasurer and Minister for Financial Services and Superannuation, Bill Shorten, announced the government's response to the *Stronger Super* consultation, including that: • MySuper products would only cover the pre-retirement phase initially; • More detailed work on post-retirement issues should be undertaken during the transitional period to MySuper; and • Further consideration should be given to a separate investment strategy for a retirement income stream within MySuper.	Media release Information Pack Outcomes of Stronger Super Consultation Process
5 April 2013	*Labor:* Treasurer Wayne Swan and Minister for Financial Services and Superannuation Bill Shorten announced changes to the super system, including providing deferred lifetime annuities with the same concessional tax treatment that superannuation assets supporting income streams receive, to apply from 1 July 2014.	Media release
14 May 2013	*Labor:* The 2013–14 Budget included a restatement of the policies announced in April 2013 along with several other measures, including encouraging the take-up of deferred lifetime annuities.	Budget Measures 2013-14, Budget Paper 2
September 2013	*Coalition Election commitment:* "*Product innovation and increased choice in retirement products can provide significant benefits for Australians looking for options to better manage the financial risks they face in retirement, such as market risk, inflation risk and the risk that they may outlive their retirement savings.* *As a priority, the Coalition will review the regulatory barriers currently restricting the availability of relevant and appropriate income stream products in the Australian market.* *We will work with the financial services sector and regulators to encourage the development of such innovative products whilst*	Coalition policy for superannuation

	ensuring that appropriate safeguards are in place to protect consumers."	
6 November 2013	*Coalition:* Treasurer Joe Hockey and Assistant Treasurer Arthur Sinodinos announced that the government would address all unenacted tax and super measures that had been announced by the previous government and agreed to undertake further consultation on encouraging the take-up of deferred lifetime annuities.	Media release
14 December 2013	*Coalition:* Assistant Treasurer Arthur Sinodinos announced the outcome of consultation on the announced but unenacted measures, including that deferred lifetime annuities would be addressed as part of a broader review of the regulatory arrangements for retirement income streams which would address unnecessary barriers to the development of longevity insurance products.	Media release
20 December 2013	*Coalition:* Treasurer Joe Hockey announced the final terms of reference for the *Financial System Inquiry* 'root and branch' review of the nation's financial system. The Inquiry panel was chaired by David Murray AO.	Media release
21 July 2014	*Coalition:* Minister for Finance and Acting Assistant Treasurer Mathias Cormann issued a discussion paper, *Review of Retirement Income Stream regulation*. The review included consideration of: • regulatory barriers restricting the availability of relevant and appropriate retirement income stream products; • minimum payment requirement for ABPs; and • facilitating deferred lifetime annuities by extending concessional taxation treatment	Media release Discussion paper
7 December 2014	Final Report from the *Financial System Inquiry* released. The report concluded that superannuation assets were not being efficiently converted into retirement incomes due to a lack of risk pooling and over-reliance on individual ABPs. The Inquiry recommended that: • superannuation trustees be required to pre-select a comprehensive income product for members' retirement (CIPR);	Final Report Australian Government Actuary paper

	• the CIPR product would commence on the member's instruction, or the member may choose to take their benefits in another way; and • impediments to product development be removed. The report also included a commissioned a paper from the Australian Government Actuary: *Towards more efficient retirement income products* which examined products available to retiring Australians with an accumulation-style or 'lump sum' superannuation benefit (rather than a defined superannuation pension benefit). The paper concluded that it was possible to design retirement income products that delivered higher income in retirement to retirees than is possible with an ABP, without any increase in the risk of outliving their savings.	
February – August 2015	Treasury consulted with participants in the *Review of Retirement Income Stream* regulation on proposals and conducted further targeted consultations to refine proposals.	
20 October 2015	*Coalition:* Treasurer Scott Morrison and Assistant Treasurer Kelly O'Dwyer announced the government's response to the *Financial System Inquiry*. The government committed to: • task the Productivity Commission with reviewing the efficiency and competitiveness of the superannuation system; • explore additional measures to improve the efficiency and competitiveness of the current system; and • develop legislation to allow trustees of funds to provide pre-selected retirement income products to help guide members at retirement and improve outcomes for retirees, including through increased private retirement incomes, increased consumer choice and better protection against longevity and other risks; and • continue work to remove impediments to product development.	Government response
3 May 2016	Final report on *Retirement Income Streams Review* released by Treasury. The report concluded that: • Current minimum drawdown requirements should be maintained and that the Australian Government Actuary should review the rates every 5 years, or in the	Final Report

	event of a significant economic shock, to ensure they remain appropriate; • an additional set of income stream rules should be developed to allow lifetime products to qualify for the earnings tax exemption provided they meet a declining capital access schedule; • alternative product rules should be designed to accommodate purchase via multiple premiums, but additions to existing income stream products should continue to be prohibited; • SMSFs and small APRA funds should not be eligible to offer products under the new rules; and • a coordinated process should be implemented to streamline administrative dealings with multiple government agencies regarding new products.	
3 May 2016	*Coalition:* Treasurer Scott Morrison and Assistant Treasurer Kelly O'Dwyer announced a package of super tax reforms as part of the 2016-17 Budget. This incorporated the Government's response to the *Retirement Income Streams Review* and included: • enshrining in law that the objective of superannuation was to *provide income in retirement to substitute or supplement the age pension*; • removal of tax barriers to the development of new retirement income products by extending the tax exemption on earnings in the retirement phase to products such as deferred lifetime annuities and group self-annuitisation products, as recommended by the *Retirement Income Streams Review*; and • consult on how the new retirement income products would be treated under the age pension means test.	Media release 2016 Budget Factsheet – Superannuation System
5 May 2016	*Coalition:* Assistant Treasurer Kelly O'Dwyer released the final *Retirement Income Streams Review* report and announced that the Government: • accepted the Review's recommendations; • would remove tax barriers to the development of new retirement income products from 1 July 2017; and • would clarify how new retirement income stream products would be treated under the age pension means test ahead of 1 July 2017.	Media release
15 December 2016	*Coalition:* Minister for Revenue and Financial Services Kelly O'Dwyer released discussion paper *Development of the*	Media release

	framework for Comprehensive Income Products for Retirement (CIPRs). The discussion paper explored key issues in developing the framework for CIPRs, or MyRetirement products and views were sought on: • the structure and minimum requirements of these products; • the framework for regulating these products; and • the offering of these products.	Consultation website
December 2016	The Department of Social Services released a discussion paper *Social security means testing of retirement income streams* for targeted input from key peak bodies and stakeholders to assist with the development of appropriate policy options.	Discussion paper
21 March 2017	*Coalition:* Minister for Revenue and Financial Services Kelly O'Dwyer released draft innovative superannuation income stream regulations and an explanatory statement for public consultation. The regulations were intended as a pre-cursor to CIPRs: • introduce new design rules for lifetime superannuation income stream products that cover a range of innovative income stream products including deferred products, investment-linked pensions and annuities and group self-annuitised products; and • provide a tax exemption for superannuation funds and life insurance companies on income from assets supporting these new income stream products, provided they are currently payable or, in the case of deferred products, held for an individual that has reached retirement.	Media release
29 May 2017	Treasury released a paper outlining a potential actuarial test developed by the Australian Government Actuary. The test related to third-party certification that a product meets the minimum requirements of a Comprehensive Income Product for Retirement (CIPR) The paper was intended to inform public discussion as part of the government's CIPR consultation process.	Proposed test
1 July 2017	*Treasury Laws Amendment (2017 Measures No. 1) Regulations 2017* commenced. Schedule 1 amended a number of superannuation regulations to enable new innovative	

	retirement income stream products to be offered from 1 July 2017. The rules: • introduced a new set of design rules for lifetime superannuation income stream products and innovative income stream products, including deferred products, investment-linked pensions and annuities and group self-annuitised products; and • ensured superannuation funds and life insurance companies will receive a tax exemption on income from assets supporting these new income stream products provided they are currently payable, or in the case of deferred products, held for an individual that has reached retirement.	
16 January 2018	Department of Social Services released *Means Test Rules for Lifetime Retirement Income Streams* which set out proposed new social security means test rules for pooled lifetime retirement income stream products which followed the discussion paper of December 2016.	Position paper (updated 7 February 2018)
19 February 2018	*Coalition:* Minister for Revenue and Financial Services Kelly O'Dwyer announced establishment of a consumer and industry advisory group assist in the development of a framework for CIPRs. The central task of the advisory group was to provide advice to Treasury on possible options and scope of a retirement income covenant in the *Superannuation Industry (Supervision) Act 1993* (SIS Act).	Media release
8 May 2018	*Coalition:* The government announced its Retirement Income Framework as part of the 2018-19 Budget. This included: • clarification of how new innovative income stream products are to be assessed against the age pension means test from 1 July 2019 (in response to the DSS consultations); • requiring superannuation fund trustees to develop a retirement plan for members and offer a wider variety of products; and • requiring superannuation funds to provide more information to help consumers compare and choose products.	Budget 2018-19 Factsheet 3

17 May 2018	*Coalition:* Minister for Revenue and Financial Services Kelly O'Dwyer released a position paper outlining the proposed principles underpinning a retirement income covenant. The covenant would: • require trustees to help their members meet their retirement income objectives and form the cornerstone of the new retirement income framework; • be added to the *Superannuation Industry (Supervision) Act 1993*, which will elevate the consideration of members' retirement income needs to sit alongside the other fundamental obligations of trustees, such as the investment, risk management and insurance needs of their members. The framework will also include supporting regulations that oblige trustees to offer their members a comprehensive income product for retirement (CIPR) and to guide and support members to select the right retirement solution.	Media release Position paper
29 May 2018	Productivity Commission releases a draft report on its *Review into the efficiency and competitiveness of the superannuation system* for consultation. The draft report suggests that a 'MyRetirement' default is not warranted, but supports the CIPR proposals. The Commission is due to make its final report in 2018.	Draft report