



6 August 2021

Director
Retirement, Advice, and Investment Division
The Treasury
Langton Cres
PARKES ACT 2600

Email: superannuation@treasury.gov.au

Dear Sir/Madam

Consultation: Retirement Income Covenant Position Paper

The Actuaries Institute welcomes the opportunity to comment on Treasury's Retirement Income Covenant (Covenant) Position Paper dated 19 July 2021. The Institute is the sole professional body for actuaries in Australia. Our members have had significant involvement in the development and management of superannuation within Australia, not only on defined benefit matters where there are prescribed actuarial roles, but also on regulation, financial reporting, insurance in superannuation, benefit projections and risk management.

1 Strong support for Covenant

We strongly support the Government's intention to introduce the Covenant into the Superannuation Industry (Supervision) Act 1993 outlining an obligation for trustees to formulate, review and give effect to a retirement income strategy. Our strong support reflects the Covenant changing the focus of the superannuation industry from fund members building up a superannuation "nest egg" to providing income for retirees.

We also support grounding retirement income strategy on assisting members achieve and balance the potentially conflicting aims of maximising retirement income, managing risks and income stability, and having some flexible access to savings.

2 Timing of Covenant

We support the Government's intention to legislate for the Covenant to commence from 1 July 2022. However, given the nature of the Covenant, and its intersection with advice for retirement matters that will be considered by Treasury's Quality of Advice Review in 2022, we believe that trustees should be allowed appropriate time to implement their retirement income strategy for a period of two to three years after it is legislated and trustees have access to regulator guidance. This will also give the regulators sufficient time to issue and consult on guidance to trustees to facilitate trustees meeting the Covenant, allowing them to build a framework for its implementation.

Institute of Actuaries of Australia

ABN 69 000 423 656

Level 2, 50 Carrington Street, Sydney NSW 2000, Australia

t +61 (0) 2 9239 6100 f +61 (0) 2 9239 6170

actuaries@actuaries.asn.au | www.actuaries.asn.au



3 Principles-based approach

The Position Paper differs from the predecessor position paper issued by Treasury in May 2018 in that it is now more principles based. Given the financial needs of individual retirees differ significantly, we support this lack of prescription. However, we believe that the Covenant or supporting guidance should explicitly require trustees to make a variety of retirement income solutions available to their retiring members, designed to be appropriate to their circumstances.

4 Guidance to support the principles-based Covenant

We believe the Covenant or supporting guidance should be more directive in the areas of product development and advice, for example suggesting trustees:

- Develop retirement income product “building blocks” or solutions for common retiree scenarios. These would be expected to include investment options with varying risk profiles and access to longevity retirement income products (inside or outside the trustee’s superannuation fund); and
- Provide some form of guidance to all their members approaching retirement.

5 Cohort construction

Superannuation is one pillar of Australia’s retirement income system, and individuals also need to consider the means tested Age Pension and their voluntary savings outside superannuation when making the complex choices as to how much to save and consume in retirement, and how to invest. This makes it difficult for trustees to build meaningful membership cohorts for the purpose of structuring an appropriate retirement income strategy without access to substantially more information about the member’s own situation.

Key factors for cohort construction identified in the Position Paper include couple status (and the partner’s financial situation), home ownership and mortgage status, the age a member intends to retire and the amount to be drawn down from their superannuation. These are all factors not readily known to trustees, all of which can change from time-to-time. Unless a trustee knows all these factors for an individual, the retirement income strategy presented to a member may not be optimal. We expect that few, if any, trustees have yet been able to include these factors when constructing cohorts of members under APRA Prudential Standard SPS 515 so acknowledge this will be a complex process.

It follows that most trustees would not be able to construct cohorts at the granular levels suggested in the Position Paper. We therefore suggest that the Covenant or supporting guidance requires trustees to:

- Consider membership cohorts by superannuation account balances. This ensures that trustees at least consider the likely implications of the Age Pension for the ‘average’ member with different account balances;
- Develop a plan to address the data gaps which act as the main hurdles for constructing better segmented cohorts of members; and
- Develop more detailed cohorts as they build more data about their membership (e.g. where members have provided their partner status).



Use of this broad cohort approach (at least initially) is also more likely to prevent cohort construction being a tick-the-box exercise based on averages.

We further suggest that for each cohort, the Covenant or supporting guidance requires a trustee to:

- Consider the suitability of a longevity-based retirement product for that cohort, and where the strategy for a cohort does not include a longevity product, provide an explanation why in the trustee's view this was not required; and
- When presenting the retirement income strategy to members, include a list of factors that may be material to the strategy not suiting an individual member of a cohort. Examples might include where their balance is small but their partner has a large balance, or where a member may be in ill-health and so a longevity-based retirement product is unlikely to be suitable unless the product provides enhanced lifetime income streams to allow for their lower life expectancy. These will assist the member make an informed choice about whether the suggested retirement income solution for the 'average' member in their cohort is right for them.

6 Guidance and advice

We welcome the Position Paper recognising the importance of guidance and advice as pre-retirees and retirees navigate the complexities and trade-offs when considering their own retirement income. However, the concerns regarding the current laws and regulations governing guidance and advice are real, and until these are resolved, it will be problematic for trustees to provide affordable guidance and advice to pre-retirees and retirees.

The Position Paper requests feedback on barriers to the provision of appropriate guidance. Our experience is that fear of falling foul of the regulations governing financial advice is a major obstacle. We suggest a "Safe Harbour" structure could be used (as proposed in the 2018 Position Paper) to protect trustees who are looking to guide their member with making an informed choice of retirement solution. Under this safe harbour structure, trustees should be permitted to more easily offer a menu of carefully designed support services, including:

- Education relevant to the member's situation;
- Information about how the trustee's retirement income solutions work;
- Guidance on which features of a product tend to suit different retiree objectives including 'red flags' where certain product types are unlikely to suit certain situations; and
- Providing personalised, holistic retirement income projections using certified modelling tools which meet very high standards (see section 9 below).

7 Data

Trustees do not have ready access to sufficient information about a pre-retiree member's situation (refer section 5 above) in order to assist them with the design of a retirement income solution that is optimal for that member, as opposed to the 'average' member in their cohort. We are aware that some trustees are investigating the possibility of obtaining banking data using the Consumer Data Right. Data could also be obtained through the ATO, Centrelink and MyGov. We recommend that these options be considered and pursued as possible means of



potentially improving cohort construction, providing better advice to members at a reasonable price.

One suggestion to improve members' retirement outcomes would be a requirement for trustees to request additional information from a member considering retirement. Even if the information is not forthcoming, the request is at least educational in helping the member to identify issues that will impact their retirement outcome. This is broadly similar to a requirement for South African retirement funds, which must provide members with "counselling" in the three months before retirement that involves members providing information to their funds and the funds then providing members with an "investment overview" that gives them relevant details about the fund's particular products.¹

Further, there are areas where additional data is required to help trustees better understand members' likely spending patterns in retirement. Some areas where government and regulators might encourage the collection of additional data include:

- Further analysis of drawdown behaviour: The UNSW Business School has looked to initiate a survey of the drawdown behaviour of those with account-based pensions², but more is required;
- Mortality and morbidity investigations: The Institute has had difficulty in continuing its historical role of supervising mortality and morbidity investigations, where insurers and superannuation trustees pool data and develop appropriate tables for the pricing of lifetime income streams; and
- Spending on medical out-of-pocket and age care costs in retirement: Developing greater knowledge on this spending would greatly assist in determining member needs for liquidity in retirement. Research in this case could be undertaken by the Department of Health, given this knowledge also has important consequences for the design of Medicare and Private Health Insurance benefits.

8 Risk and uncertainty

Actuaries specialise in helping quantify and communicate risks and uncertainty. The Position Paper covers longevity risk and investment risk but is silent on inflation risk. We believe this is an important oversight which should be rectified.

Retirees are uncertain of their future spending needs. In relation to the Position Paper's statement that "*A significant body of evidence shows that the real spending needs of most retirees decline over the course of retirement*", we make the following comments:

- Whilst it is important for retirees to account for different income needs through different stages of retirement, it would be concerning if trustees only offered nominal income products without considering inflation risk;

¹ S39 Annuity Strategy of the South African Pensions Fund Act (1956)

² <https://www.apra.gov.au/sites/default/files/Balnozan-Modelling-heterogeneous-drawdown-behaviours-in-phased-withdrawal-retirement-income-products.pdf>



- “Most retirees” does not mean “all retirees” - some retirees’ spending needs will not decline over the course of their retirement, in particular the less well-off;
- Even where the real spending needs of retirees do decline over time, retirees can still suffer from unexpected inflation impacts;
- Some retirees will be concerned that they are falling behind community living standards; and
- The objective ‘maximising retirement income’ could be defined in real terms.

Regarding longevity risk, we recommend that:

- Simple use of average life expectancies (e.g. maximising retirement income to age 85) is inappropriate when looking to assist members maximise retirement income or manage the risks to the sustainability and stability of their income, as at least half of fund members are expected to live longer than this given future mortality improvements. The Covenant should include greater consideration of uncertainty – as a minimum we suggest it should require some form of stochastic analysis in trustee calculations or retirement income calculators be made available to members;
- The risk of future mortality improvements are properly considered by trustees when assisting their members managing their longevity risk. Underestimating the potential for mortality improvements will risk the effectiveness of the longevity protection, whereas overestimating longevity will result in lower incomes. Actuarial judgements are required to strike an appropriate balance;
- Health status and demographics of the member (and their spouse) are important considerations. Retirement strategies developed by trustees should flag to members the impact to them if they have different longevity expectations through the work they carried out, their health or personal circumstances.

In addition, we believe that the nature of longevity risk and trade-off between bequests and lifetime incomes continues to be misunderstood, pointing out that the Position Paper itself seems to fall short. In Box 4 of the Position Paper, it is not true that *“For those who die earlier, members may have lower retirement incomes with the group-self annuity as they will have sacrificed some capital without benefitting from income payments.”* Group self-annuities provide higher retirement incomes because members do not fully benefit from capital after death as some or all is transferred to support surviving members.

On the other hand, there is perhaps inadequate consideration given to the need for residual incomes to the surviving member of a couple. The suggestion on page 11 of the Position Paper that it is enough to allow trustees to maximise a member’s income as individuals underplays the need to provide for the surviving spouse (normally the widow).

There are also risks around uncertain government policies regarding the retirement income system, and it is rational for retirees to allow for this uncertainty when designing their own retirement income strategy. Examples are the way the means test works and the way age care is funded. We recommend that the Government seeks to legislate the objective of the retirement income system as a minimum, including the ongoing role of the Age Pension, alongside the Covenant to help mitigate some of this uncertainty, allowing more efficient



drawdown of retirement income in account-based pensions, and better use of lifetime income streams (and less unintended bequests by retirees).

9 Income projections and calculators

The Position Paper lists income projections as an avenue to assist members balance their retirement income objectives. We strongly support provision of income projections by trustees to assist pre-retirees, and recommend they become a requirement, at least in respect of members within say twenty years of eligibility for the Age Pension and/or for members with a lump sum balance in excess of a certain amount.

The models used for income projections must be fit for purpose. Many existing calculators do not meet emerging best practice in this area – particularly in the areas of risk and allowing for all material items that impact retirement outcomes.

We believe the projection tools and calculators used to guide members to make informed retirement decisions should have a minimum requirement of communicating the implication of key risks including investment, longevity and inflation risks to members' retirement outcomes. At present, most calculators (including MoneySmart) only provide deterministic projections of the expected outcomes without considering the potential range of those outcomes that a member may experience. Without accounting for the "risk to the sustainability and stability of their retirement income", these tools are not sufficient to help members understand the trade-off they are facing to guide them to the appropriate retirement solution.

We also suggest that calculators be updated to include the illustration of lifetime retirement income streams alongside account-based pensions to ensure they can appropriately reflect a range of retirement strategies.

Standards for good retirement income projection tools should be updated by the regulator in line with the Covenant. We would be delighted to support ASIC develop suitable requirements for calculator construction.

10 Disclosure and communication to members

We welcome the Position Paper recognising the importance of communicating retirement income strategies to members. Appropriate disclosure of key information will assist members make informed decisions about their retirement income trade-offs and help them monitor and adjust their retirement strategy over time.

This disclosure should include illustrations of projected retirement income, with appropriate disclosure of the key assumptions as well as the likelihood or the potential range of outcomes members might experience due to investment and longevity risks.

11 Defined benefit schemes, SMSFs and SAFs

The Position Paper proposes that trustees of defined benefit schemes that offer a defined benefit lifetime pension are not required to develop a retirement income strategy for those members. We suggest that this exclusion be limited to those members offered a defined benefit lifetime pension where there is no ability for them to commute this pension for an alternative lump sum payment.

Further, we support the Position Paper's proposal that trustees of Self-Managed Superannuation Funds (SMSFs) and Small APRA Funds (SAFs) with retired members should have



a retirement income strategy, but do not need to develop a strategy for cohorts of members. This complements existing requirements under Superannuation Industry (Supervision) Regulations 1994 Section 4.09 to formulate, regularly review and give effect to an investment strategy, but for funds with retired members ensures consideration of a strategy that will also achieve the objectives of the Covenant.

12 Further information

We would be pleased to discuss this submission or to provide further information. Please contact our CEO, Elayne Grace elayne.grace@actuaries.asn.au if you wish to clarify any aspects of this submission.

Yours sincerely

Jefferson Gibbs
President