Retirement Income Covenant Position Paper

Submission

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About David Bell
Dr David Bell is Executive Director of The Conexus Institute. Bell's career has been dedicated to the investment and retirement sector. He has worked with both commercial and profit-for-member firms, and ran his own consulting firm. Bell worked with APRA in the development of the APRA Heatmap. Academically, Bell taught for 12 years at Macquarie University and in 2020 completed his PhD at UNSW which focused on retirement investment problems. Full bio here.

***** The author is willing and able to participate in further consultation. *****

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1. Summary

We support the creation of a Retirement Income Covenant (RIC) that is framed around a principles-based approach, thus allowing funds to develop a retirement strategy they consider to be in the best interests of their members. We are confident that the RIC will contribute to better outcomes for retirees over time. We expect the RIC will lead to improved communications, provision of information and interactive tools, development of products and solutions, and funds gaining a better knowledge of their membership.

Our main concerns are in two areas. First is that the benefits may be inconsistently delivered across the system by super funds. In some cases, this will be for rational reasons, such as fund members having different demographic profiles and funds facing a range of business considerations. In other situations, inconsistent outcomes may emerge because the principles-based approach provides funds with a fair amount of latitude. Our second concern is that various mechanics (e.g. APRA assessment, research house ratings) create an element of prescription that inhibits progress and ability to innovate.

Overall, our submission is focused on the following:

- Ensuring the RIC and associated supporting resources are as clearly defined as possible.
- Identifying some areas that should be considered for inclusion in the RIC.
- Offering some broader comments on retirement income policy, with a view to informing future policy development.

Specific issues raised that directly relate to the RIC:

- Policy sequencing may be more effective if the RIC was created after objectives for the retirement income system and for superannuation were enshrined.
- Whether outcomes are framed in real or nominal terms should be either defined in the RIC or specified by the trustee in developing their retirement income strategy.
- RIC should simply state that trustees need to take into consideration the income needs of their retired members, without attempting to place any restraints around how these needs are defined.
- Further clarity is required on how trustees might take additional objectives into consideration, such as bequests.
- We note that the current legal and regulatory framework for advice and guidance provides no clear mechanism for effective delivery of cohort-based strategies; and that defaults would provide such a mechanism.
- We encourage consideration of an additional component of the RIC requiring trustees to develop a retirement engagement strategy for all members approaching retirement.

Broader retirement income policy reflections:

- We discuss the difficulty of delivering effective competition amongst retirement solutions providers under the current framework.
- We summarise aspects of our work (co-written with Associate Professor Geoff Warren from ANU) on choice mechanisms, and advocate for the concept of fund-guided choice.
- We explore the positive benefits that defaults may provide.
- We outline the concept of a retirement choice support model that Professor Pamela Hanrahan from UNSW has recently introduced.

2. Issues specific to the Retirement Income Covenant Position Paper

2.1. Introducing the RIC prior to establishing system objectives

The RIC represents an important step in the development of the retirement income policy framework. Codifying the requirements and obligations for superannuation trustees in generating retirement outcomes for their members is important.

We encourage the development and introduction of objectives for the retirement income system and for superannuation. This will contribute to policy cohesion and remove a potential source of hesitancy for funds to progress on developing retirement solutions.

2.2. Possible conflicts exist between the RIC and a retirement income system objective

Given the RIC is being formulated in the absence of stated objectives for the retirement income system and for superannuation, an important question is whether there are any scenarios whereby the requirements and obligations that are outlined in the RIC run contrary to objectives that may be established for the retirement income system.

At first glance, the stance taken in the RIC Position Paper appears consistent with the goal suggested by the Retirement Income Review (RIR) *"to deliver adequate standards of living in retirement in an equitable, sustainable and cohesive way"*. On further consideration there are areas of possible conflict:

- Sustainability: The RIR opines that sustainability *"… will depend on whether people have confidence in the system and its integrity and believe it to be cost-effective in delivering adequate and equitable outcomes."* A principles-based RIC creates the risk of inconsistent product quality, inability to compare products across providers, and risks laggard funds. All have the potential to impair confidence and reduce sustainability.

- Cohesion: The view of the RIR is that *"A coherent system should avoid as much complexity as possible, but to address complexity, it should have the mechanisms, support and incentives that help people to optimise their standard of living in retirement. This includes helping people navigate the retirement income environment through retirement defaults, guidance and facilitating access to affordable advice."* We note two concerns:

    - The decision to not include a clear pathway for provision of defaults by funds, especially while the legal and regulatory frameworks for the provision of guidance and advice are so challenged, poses a risk to the achievement of cohesion. The potential benefits of defaults are referred to throughout this submission and discussed in detail in (4.3).

    - A principles-based approach runs the risk of creating significant complexity in terms of the range of solutions being offered across funds. We expect both the regulators and the industry itself will find it difficult to compare products, let along consumers. Cohesion is unlikely to be maximised under a principles-based RIR.

2.3. Maximising retirement income

2.3.1. Income – real, nominal, or other?

The Position Paper makes no reference to whether retirement income should be defined in nominal or real terms.

From the RIR: *"The rate of growth of spending in retirement will influence whether a retiree's income is adequate for all their retirement years. The evidence points to retirees' needs growing in line with prices. In projections undertaken for the review, the deflator for incomes in retirement is the CPI."*

We think a real frame is appropriate, and hence should be specified within the RIC. In the absence of doing so, the RIC should state that the treatment of inflation is at the trustee's discretion. Either way, the ambiguity should be removed.

2.3.2. Income – profile

The Position Paper states: *"Maximising retirement income requires consideration of when in retirement their members are likely to need income to meet expenses and maintain living standards. A significant body of evidence shows that the real spending needs of most retirees decline over the course of retirement."*

While we acknowledge that it is appropriate for trustees to consider the profile of income requirements over the course of retirement, we wonder whether a constant income objective may offer system benefits. For instance:

- It would provide a solid basis from which consumers may then engage and have input into the desired income profile that informs a tailored solution.
- It may increase confidence that the targeted income is available for life. In contrast, being presented with declining future retirement income trajectory (implying that you will have less to spend) may encourage precautionary savings.
- Variable projected income streams could reduce product comparability.
- Some members may not have specific income needs but may merely be aiming to maximise or manage the deployment of their savings. For instance, a low balance member might be merely aiming to generate some income out of the savings they have.

As such, we think it should be considered not unreasonable if a trustee was to target a constant income through life. We hence suggest that the RIC simply state that trustees need to take into consideration the income needs of their retired members, without attempting to place any restraints around how these needs are defined.

2.4. Clarity around bequests

The Position Paper takes a binary position on bequests: "*While bequests may be a consequence of the strategy for some members, it should not be an aim of the strategy for members in generality.*"

But product design is a trade-off. Consider a scenario where two solutions provide identical performance with regard to retirement income, risk management and access to capital. However, one provides superior bequest properties. Would trustees have a fiduciary duty to implement the solution which provides superior bequest properties? We suggest so.

Let's extend the scenario to a situation where one solution provides marginally better performance along the three criteria with regards to retirement income, risk management and access to capital, but has *significantly* worse bequest properties. It appears the RIC Position Paper directs one to the product with marginally better performance across the three retirement income criteria.

Greater clarity would assist industry, including perhaps more detailed case studies like those above.

2.5. Additional retirement income objectives

The above discussion around bequests (2.3) is a representative example of any other retirement preference that members may hold. Assuming that the three primary objectives of retirement income, risk management and access to capital are intended to rank above all others, we suggest the following clarification:

- *"Trustees should focus on determining the optimal balance of the three primary objectives maximising retirement income, managing the risks to retirement income, and ensuring appropriate access to capital.*

- *Trustees may consider additional objectives and preferences that they consider of relevance to their fund's membership as secondary objectives."*

Followed by one of the following:

- *"The incorporation of these additional objectives and preferences cannot be to the detriment of maximising the three retirement income objectives."*

  Or

- *"The incorporation of these additional objectives and preferences cannot be to the significant detriment of maximising the three primary objectives. It is up to trustees to determine what is "significant detriment"."*

2.6. Delivery mechanism for cohort-based solutions

The Position Paper emphasises the opportunity to develop cohort-based solutions. We are concerned that the delivery mechanism for cohort-based solutions is uncertain under the present legal and regulatory environment with respect to financial advice and guidance. It is entirely unclear how members will find their way to the cohort-based solutions that is most suitable for their needs. For instance:

- There is no default mechanism to 'place' a member into a cohort-based solution.
- Funds will be hesitant to 'recommend' a cohort-based solution to a member under existing laws and regulations around advice and guidance.
- It may be possible that funds present 'representative member' examples:

    - *"Here are three case studies that may reflect your personal situation, along with modelled solutions."*
- However, we are not that is possible either if it references someone's personal situation.
    - *"This is the range of solutions we offer. You can look (here) for a description of their features, expected outcomes, and the type of member they are designed for; and (here) for an interactive calculator. We invite you to make a choice."*

We understand that the aim of the RIC is to codify principles-based requirements and obligations for trustees. Nevertheless, the Position Paper emphasises the consideration of cohort-based research without clarity of how this is delivered. Providing further clarity on how cohort-based retirement solutions can be directed by funds to their retirees would be beneficial.

2.7. Incorporating a retirement engagement strategy

We encourage policymakers to consider codifying into the RIC the requirement for trustees to develop a retirement engagement strategy with a view to assisting members in finding a suitable retirement solution. This suggestion is partly based on the observation that many members are disengaged and face no safety net in the absence of defaults.

Evidence suggests that there may be a substantial group of members invested in inefficient retirement strategies due to disengagement[1]. In addition, it would be very helpful to ensure that all members are made aware of the decision support tools that are available to them.

An additional obligation for trustees could be worded, in a manner consistent with the principles-based approach, as follows:

"Trustees are required to develop a retirement engagement strategy. The strategy will be a strategic document outlining the plans to assist their members with their retirement income decisions."

3. Broader reflections on retirement income policy

3.1. Effective competition

We find it difficult to identify how the RIC and the broad direction of retirement income policy will create the level of effective competition we suspect that the Government would like to see. We define "effective competition" to be competition based on quality of the products, rather than based on non-product quality issues such as brand and marketing. Our concerns are based on the following:

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[1] There is $175 billion related to 1.2 million member accounts invested in superannuation funds by those of age 65 and over that remains in the accumulation phase. While there are a number of potential explanations, it is likely that a significant number of retirees might not have transferred their superannuation balance to the retirement phase due to lack of knowledge or apathy, and might be missing out on retirement income as well as paying unnecessary tax.

- Stapling will generate a high likelihood of entrenched providers (or default providers). A likely (but not necessarily poor) outcome of engagement with their fund would be many members making an active choice amongst solutions provided by their existing fund, rather than an active choice across providers.

- The range of retirement products and solutions is likely to be very large and highly complex. This will be a difficult setting for consumers to navigate. We cannot see how retirees will be easily equipped with appropriate tools that will support easy comparisons across different solutions providers.

- Furthermore, we struggle to see how research houses will provide an effective institutional competition lens given the additional dimensions of the retirement challenge combined with the need to tailor research opinions towards widely differing personal situations.

- A likely large range of complex products with ill-defined product labels will encourage marketing messages that are aspirational rather than objective. This may create marketing and brand-based competition, which may not improve consumer outcomes.

- In our view, the financial planning community is not well-placed to generate significant competition. Many financial planning practices have struggled to integrate the necessary tools (i.e. stochastic modelling) that would allow them to integrate new products and solutions into financial plans. Many financial planners appear to use an income bucketing approach.

The main reason we raise the issue of effective competition is there may be further policy responses if desired competition levels aren't realised, resulting in further disruption to the system without necessarily leading to better member outcomes. Obvious candidates include:

- *ATO Comparison Tool*: We have concerns based on the YourSuper Comparison Tool around the ability of such a tool to acknowledge and communicate important issues such as risk. It hence runs the risk of creating competition along limited dimensions that may lead to retirees choosing products or solution that are not suitable for their needs.

- *APRA Quantitative Assessment*: Any form of quantitative assessment would require the development of assessment techniques along with a range of test assumptions (for instance, test case characteristics such as retirement balance, household status, home ownership etc.). Any quantitative assessment would feed back into the design of retirement solutions by funds ('what gets measured gets managed'), introducing a sizable degree of prescription into the design of retirement solutions.

3.2. Choice mechanisms and fund-guided choice

A recent opinion piece written with Associate Professor Geoff Warren ("Ensuring all retirees find a suitable retirement solution") explored a range of issues relating to retirement choice architecture and mechanisms to ensure that all consumers find their way to appropriate retirement solutions, regardless of their engagement levels or preparedness to seek comprehensive financial advice.

In this paper, the argument is made that funds should engage with members to ascertain their preferred mode under which a suitable retirement solution is identified. The concept of creating a duty to devise a retirement engagement strategy is explored in (2.7). It could set the foundation for extending engagement over the preference of retired members regarding the mechanism through which an appropriate solution is identified and implemented. This might entail revising the RIC in due course to include trustee obligations to engage with retiring members over their preferred mode for choosing a solution, and then give effect to that choice.

The paper suggests that the 'choice modes' should include the concept of 'fund-guided choice'. Under this mechanism a retiree requests their fund to choose a solution for them. Fund-guided choice offers another path – besides defaults (discussed in (3.3)), self-directed choice and financial advice – for matching retirees with suitable retirement solutions. The selected solution could be presented as a recommendation that the member can decide to accept or not. Alternatively, the member could request that their fund assign them to a solution. We suspect that many retirees would welcome the opportunity to ask their fund to make a selection for them, which would be closer to what happens prior to retirement while retaining the ability for members to choose.

We recognise that fund-guided choice may not be easily implementable under existing laws and regulations around guidance and advice. It thus may be more appropriate to include it within the RIC at a later date, after the advice rules have been reviewed and (hopefully) altered.

3.3. Defaults are useful

Defaults could serve many noteworthy purposes in the retirement income system:

- Defaults could provide an implemented solution for disengaged members, to ensure that they are placed into a basic retirement income strategy that may match their needs to the best degree possible given available information.
- Defaults may be used as a vehicle under which safe harbour is offered in the delivery of cohort-based solutions.
- Defaults offer a basis to compare products and solutions for individuals with pre-defined characteristics, if sufficiently standardised. This could prove useful for regulatory assessment and research house ratings.

Defaults do not need to be accompanied by prescriptive guidelines. While the RIC Position Paper doesn't preclude defaults, it is difficult to see how they can perform their function effectively unless a legislative pathway is created to support their creation.

3.4. Choice support model

We provide a brief introduction to the idea of a choice support model for retirees. This idea is only at a formative stage. This idea was proposed and is championed by Professor Pamela Hanrahan of UNSW (Exploring Big Ideas webinar – video embedded within article here). While this idea is clearly separate from the RIC, the two elements of the policy framework would interact.

The position we take is that the legal and regulatory framework for financial advice is broken. Under the current rules, the provision of advice and guidance services by many super funds will largely be dependent on the legal risk appetite of trustees, and quite disparate as a consequence.

A retirement plan is important, yet quite complex to devise. Complexity comes from the functional difficulty of the challenge: making retirement savings last over a long and unknown timeframe during which investment returns are uncertain is no easy problem. Plans need to be determined for individuals with unique characteristics and preferences, while incorporating a range of products. The means-tested Age Pension only exacerbates the challenge.

While most consumers would benefit from financial advice, there are cost and supply constraints. We propose a government-provided solution, which sits outside existing laws and regulations. Choice support is not intended to be as exhaustive as comprehensive financial advice. We are working off the premise it could deliver 90% of the benefits of quality comprehensive retirement advice to 90% of the population if it is done well.

Broadly, it would work as follows:

- A consumer gains access to the choice support system, potentially via their super fund or a financial adviser.
- A short questionnaire (circa 10 questions) would extract key information on their personal and financial circumstances and retirement objectives.
- The service would provide a recommended mix of retirement products (product types, no provider names), along with a drawdown schedule to accompany the account-based pension (ABP).
- The service would provide an accompanying information sheet that would address areas such as:
    - Expected retirement income experience
    - 'Good' and 'bad' scenarios
    - The ability to access capital through time

The question is: would implementing such a retirement choice support model be impeded by the RIC?

Currently the industry faces a poor-outcome scenario that the benefits of the RIC are constrained by the incapacity of funds to provide appropriate advice and guidance to their members. However, an equally poor-outcome scenario would be that the full population benefits of the proposed choice support model are not realised because recommendations cannot be easily implemented by super funds. This would occur if the products recommended by the choice support model were not offered by the respective super funds, noting they are under no obligation under a principles-based RIC to provide such products.

Even though our working view is that the choice support model can provide significant benefits to consumers, potentially larger than the benefits of the RIC in isolation, we acknowledge that the RIC is the next step along the Government's retirement policy roadmap. Fortunately, we envisage some mechanisms which should make it possible for a principles-based RIC to proceed without precluding the subsequent development of a choice support model. Further details will be shared once our initial research is complete.

4. Summary

We are confident that the RIC will contribute to better outcomes for retired members over time – be it improved communications, provision of information and interactive tools, development of products and solutions and funds enhancing the knowledge of their membership. However, we are concerned that these benefits will be inconsistently delivered across the system, which in some cases may occur due to influence of system design.

In our submission we:

- Suggest some areas where specific elements of the RIC and associated supporting resources could be more clearly defined and explained.
- Identify some additional areas that we believe warrant further consideration for inclusion in the RIC.
- Make some broader comments on retirement income policy, which may help inform future policy development.