Retirement Income Covenant Exposure Draft

Submission

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About The Conexus Institute
The Conexus Institute is an independent, not-for-profit research institution focused on improving retirement outcomes for Australian consumers. Philanthropically funded, The Institute is supported by the insights of a high-quality advisory board, whereby each member's involvement is on a pro-bono basis. The Institute adopts a research-for-impact model and frequently collaborates with researchers from academia, associations, and industry. Research is generally made open source to create transparency and accountability. The Conexus Institute exists with no commercial relationships. Further information here.

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 modelling. Full bio here.

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

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1. Introduction

We support the introduction of the Retirement Income Covenant (RIC) as an important next step in retirement incomes policy. Retirement incomes has been a long policy journey, with more to go, but the societal benefits are worth the effort. We support an RIC that adopts a principles-based approach, allowing trustees to develop a retirement income 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, greater provision of information and interactive tools, development of products and solutions, and believe that funds will gain a better knowledge of their membership.

Credit to the team at Treasury for the quality of work leading to the RIC Exposure Draft.

Important detail will reside in the accompanying APRA guidance and/or standards. We believe it is important that this work is open to consultation.

We advocate for a single small improvement to be made to the RIC, namely clarity around the income framing (nominal or real terms). If the intention of policymakers is to leave this to trustee discretion, then this should be clearly stated. If not, the basis of income should be clearly stated. Here, we would advocate for income to be framed in real terms.

We further reflect on the emerging retirement incomes policy setting. What stands out most is the huge transition in choice architecture as consumers move from accumulation (where defaults provide a foundation) to decumulation (purely choice). This is significant, but when combined with the difficult situation faced by super funds regarding provision of guidance and advice, we have a combination that may not serve consumers well.

We explore aspects of this problem and consider some solutions that may be useful as next-step considerations for policymakers.

2. Comments on the RIC Exposure Draft

2.1. Income – real, nominal, or other?

Neither the Exposure Draft or the Explanatory Materials clarify the basis of retirement income (nominal or real terms).

From the Retirement Income Review (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 believe a real frame is appropriate, and this 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. If the RIC provides trustees with discretion on the income basis this will make it more difficult to compare products (with comparability a foundation of effective competition).

In the Explanatory Materials inflation risk is identified as a risk to the stability of real incomes, and that trustees should be cognisant of this risk. This suggests a real income focus.

2.2. Flexible access to funds and the role of home equity release

In the Explanatory Materials section (1.48) it is stated:

"The concept of having flexible access to available expected funds is intended to have a broad meaning, which includes private savings, liquid assets and consideration as to the extent to which non-liquid assets can be drawn upon to meet beneficiary needs. Trustees should make informed assumptions about investment arrangements and use this information to assist beneficiaries to have flexible access to funds in retirement."

We believe that home equity release can provide sizable access to funds for some households. We suggest that the following alternative wording may better reflect the role of home equity release in retirement financing:

"The concept of having flexible access to available expected funds is intended to have a broad meaning, which includes private savings, liquid assets and consideration as to the extent to which non-liquid assets, including the home, can be drawn upon to meet beneficiary needs. Trustees should make informed assumptions about investment and home ownership arrangements and use this information to assist beneficiaries to have flexible access to funds in retirement."

3. Reflections on broader retirement income policy

3.1. Significant shift in choice architecture

The RIC and the direction presented by government represents a significant change in choice architecture as people move from accumulation to decumulation. Defaults form the foundation stone of accumulation, where nearly 60% of accumulation assets in APRA-regulated funds are invested in MySuper options. In comparison, government policy envisages no defaults in decumulation. All consumers will be required to make an active decision.

It is difficult to predict all the impacts of this shift in choice architecture. Unanticipated consequences will likely be experienced. The change in architecture will have varied and sizable impacts on consumers, funds, other service providers, and regulators.

In the next sections we briefly explore five aspects which relate to the RIC, the retirement choice architecture, and the current challenges impacting the provision of financial advice and guidance. The first two focus on challenges (delivery mechanism for cohort-based solutions, and the risk of ineffective competition), while we explore three possible part-solutions (choice mechanisms and fund-guided choice, the role of defaults, and a government sponsored retirement choice support model).

3.2. Absent delivery mechanism for cohort-based solutions

We are concerned that the delivery mechanism for cohort-based solutions is impaired under the present legal and regulatory environment for financial advice and guidance. It is unclear how members will find their way to the cohort-based solutions that is most appropriate 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, especially given industry's reaction to High Court's decision in *Westpac Securities Administration Ltd v ASIC* (2021) 387 ALR 1.
- 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."*
- It may be that funds are hesitant to make any reference to a member's personal situation, in which case we may have:
    - *"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. It is up to you to make a choice, or you could consider seeking financial advice."*

Funds would benefit from having a clear pathway for how cohort-based retirement solutions can be directed to their retirees.

3.3. 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 desired by Government. 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:

- Stapling will generate a high likelihood of consumers having 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 information and tools that will support easy comparisons across different solutions offered by a range of funds.

- 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 to account for 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 advice industry is not well-placed to generate significant competition. Many financial advice practices have struggled to integrate the necessary practices that would allow them to integrate new products and solutions into financial plans. Many financial advisers appear to use an income bucketing approach.

Mechanisms to ensure effective competition are difficult to identify. We believe it is an area that policymakers need to review before the retirement sector takes shape.

3.4. Choice mechanisms and fund-guided choice

A recent thought 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. To implement, this would 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, 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.

3.5. Defaults are useful

Defaults have the potential to serve many valuable 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 matches their needs to the best degree possible given available information.

- Defaults may be used as a vehicle under which safe harbour is provided to facilitate the delivery of cohort-based solutions by super funds.

- 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.

3.6. Retirement choice support model

We briefly introduce the concept of a retirement choice support model. This idea is only at a formative stage and was first proposed by Professor Pamela Hanrahan of UNSW (Exploring Big Ideas webinar – video embedded within article here). A paper will soon be released, exploring the concept in detail.

The retirement choice support model proposal would utilise a government sponsored tool to provide low-cost retirement choice support services to retirees (and pre-retirees). The tool would be accessible to approved providers (initially, APRA-regulated entities and licensed financial advisers) and sit outside the existing regulatory arrangements for 'personal financial product advice'.

The proposed tool is intended to be safe by design, rather than safe by regulation, reducing the cost and risk to approved providers in providing it.

This is intended to reduce the cost and risk to approved providers, encouraging them to make it widely available to people approaching, entering, or in retirement. It is directed at people who do not want (or cannot afford) personal financial product advice. It is not proposed as a replacement for the current model of regulated financial product advice, for which we think demand will remain steady or increase if the tool improves awareness, engagement, and financial literacy among unadvised people. It provides a cost-effective and scalable alternative to that model.

In exploring this idea we adopt a "90-for-90" philosophy: develop a process that can provide quality support (90% of the quality of good comprehensive financial advice) which addresses the retirement situation faced by 90% of the relevant population.

4. Summary

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