Green Paper

A retirement licensing regime

Creating a better super system for retirees

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David Bell
Executive Director
The Conexus Institute

Jeremy Cooper
Chair of Advisory Board
The Conexus Institute

Geoff Warren
Research Fellow
The Conexus Institute
Honorary Associate Professor
Australian National University

Introduction

The superannuation (super) system sits alongside Services Australia at the frontline in delivering income in retirement. Super provides guidance services, products and payments to the majority of Australia's retirees. However, the super system is struggling to reach its full potential in the retirement phase.

A central issue is the uneven and too-often modest progress being made by super funds despite the introduction of the Retirement Income Covenant (RIC) around two years ago. Significant dispersion in the capabilities and offerings of individual super funds is of particular concern. While the RIC requires trustees of all super funds to develop a retirement income strategy (RIS), it is highly principles-based. No guidance is provided on what is required to deliver a satisfactory RIS, and no obligation is placed on trustees to ensure that the fund's RIS caters for the widely differing needs of members in retirement in an effective manner. Something more is needed.

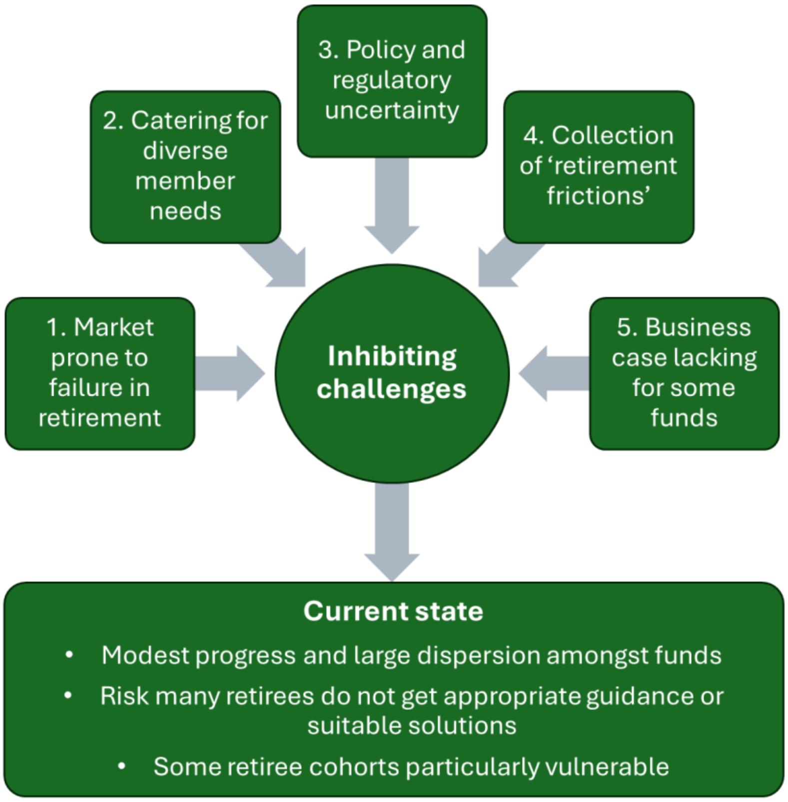
A retirement licensing regime would be a powerful mechanism to make the super system 'match fit' for meeting the retirement needs of Australians. It would ensure that only funds choosing to apply for a licence and meeting the licensing conditions would sit at the super system's retirement frontline. It would address some significant challenges that are inhibiting super funds and hence the overall super system in retirement. A licensing regime would require super funds to decide whether to commit to retirement, and if so, get moving in delivering a RIS to required standards.

In this high-level paper, we outline the challenges faced by the super industry in serving retirees and discuss how a retirement licensing regime could address many of the challenges. We are releasing this paper in a 'green paper' format to encourage engagement, with a view towards firming up the details in a future 'white paper'. We welcome suggestions on retirement licensing and how it might work to best effect.

Challenges inhibiting super funds in meeting retiree needs

The super industry is struggling to surmount multiple challenges in delivering quality retirement outcomes to all retired members. These challenges and the implications for the current state of the super system are summarised in Exhibit 1, before being explored in further detail.

Exhibit 1: Challenges inhibiting super funds and current state of the system in retirement



Challenge #1: The market is prone to failure in retirement

Market forces are commonly relied upon to respond to customer needs, drive efficiency and spur innovation. Two typical foundations of an effective market are informed choice by consumers and the marketplace responding through innovation and competition. These foundations cannot be relied on to give appropriate incentives and signals to super funds in retirement for four reasons:

1. **Cognitive limits** – Many consumers (fund members) are challenged to make well-informed financial decisions due to limited financial literacy, behavioural influences and possibly cognitive decline with age. A large number of members are poorly placed to exercise choice over retirement solutions, products and providers.

2. **Complexity** – The effects of limited capacity for informed choice are compounded by the complexity of retirement itself, particularly the long horizons involved. Comparing providers and understanding solutions, products and strategies is difficult even for those in the industry, let alone for the average Australian.

3. **Market frictions** – It can be difficult to switch providers or products in retirement. Reasons include the cognitive load and time involved in switching between complex and hard-to-compare offerings, exit costs, and transferability barriers notably for lifetime income streams.

4. **Less-than-competitive markets** – A strong incumbency effect exists as familiarity and trust in the existing providers interacts with the complexity of retirement and the difficulty of choosing another fund. There appears to be limited switching between providers (beyond those who seek external financial advice).

The above forces inhibit the operation of the market in retirement income in two ways. First, the *capacity for informed choice is quite limited* for many (not all) members, meaning some require close assistance and that member behaviour can provide unreliable signals. Second, *competitive tension is largely weak at best.*

Challenge #2: Catering for diverse member needs

Retirees differ along *two* main dimensions. First is their personal circumstances and preferences. Second is how they engage with retirement decisions. Super funds should develop the capability to cater for their members along both dimensions through tailored retirement solutions and a range of guidance services. Central to this challenge is collecting and using personal information. Exhibit 2 summarises the breadth of potential engagement and the associated delivery mechanisms that super funds should ideally offer if they are to meet the diverse preferences of all their members.

Exhibit 2: Overview of pathways to a suitable retirement solution

Pathway	**Self-direction**	**Adviser direction**	**Trustee direction**		
	Member choice	Personal financial advice	Trustee recommendation	Trustee assignment	Default
Main features	Member chooses solution, drawing on decision support services	Member is directed to a solution by a financial adviser through: (a) limited advice, or (b) comprehensive advice	Trustee recommends a solution to member, who then opts-in or opts-out	Member requests trustee to assign them to a solution; but can opt-out	Trustee defaults member into a (probably basic) retirement solution
Member type most suited for	Members who want to choose for themselves	Members who desire a personalised recommendation and are willing to pay	Members looking for direction, but: • Do not want to seek a financial adviser • Not well-prepared to choose for themselves		Highly disengaged members who take no action

Challenge #3: Policy and regulatory uncertainty

Super funds face policy and regulatory uncertainty in two key areas when developing their RIS:

- **What will be considered satisfactory** – The policy framework for retirement provides little guidance over what constitutes a suitable RIS or how a RIS will be assessed in the future by the regulators. Funds face considerable uncertainty over what may be deemed an acceptable standard and the consequences for failing to meet any standards as assessment practices evolve.
- **Guidance and advice** – Considerable uncertainty exists around what fund trustees can do in providing guidance under the personal financial advice rules. The policy framework around provision of guidance by super funds is currently being reconsidered as part of the Delivering Better Financial Outcomes (Quality of Advice Review) process and the Treasury Retirement Phase of Superannuation. Where these policy processes will land is uncertain.

Challenge #4: Collection of retirement frictions

Retirees experience multiple frictions, often in the form of administrative barriers, in navigating the super system during their retirement journey. Examples include:

- Establishing an account-based pension requires opening a new account, creating friction at the point of retirement. This is easier through the fund where an accumulation account exists.
- Switching account-based pension providers requires creation of an accumulation account with the existing fund, switching to another fund, and then opening a new account-based pension.
- Contributing to super on re-entering the workforce requires opening an accumulation account.

Such frictions not only increase the level of difficulty retirees face in engaging and effectively navigating retirement, but also hamper the super industry in assisting retired members.

Challenge #5: Business case is lacking for some super funds

The RIC places an obligation on *all* super fund trustees to develop a RIS. However, a clear and rational business case for committing effort and resources to RIS development is lacking for some funds, resulting in limited incentive to prioritise retirement. Potential reasons include:

- Many funds have few assets in retirement accounts, with the range stretching from 2% to 69% (median of 11.5%) at June 2023[1].
- The financial case can be tenuous. Developing the ability to tailor to individual members through a range of retirement solutions and guidance services (see challenge #2) entails high costs that are incurred up-front, while benefits accrue over a long timeframe. The opportunity for member acquisition appears limited as outlined in challenge #1, although the retention opportunity appears stronger.
- The financial case is further undermined by significant uncertainty over the policy and regulatory environment as per challenge #3, making a wait-and-see approach rational.
- Many funds have concerns around cross-subsidisation between younger and older members, especially profit-for-member funds. Meanwhile, for-profit funds face cost-benefit hurdles.
- Some funds might consider other business priorities more pressing than RIS development, such as mergers, meeting other regulatory requirements or pursuing operational improvements, e.g. governance, cyber security, etc. Resources and management time are not limitless.

Current state: A super industry struggling to deliver outcomes for retirees

The challenges outlined above intersect and interact in ways that may result in some concerning outcomes that align with our observations, and likely those of the regulators. Of note:

- Limited overall progress has been made in developing retirement offerings within the super industry. Dispersion between funds is large, with some funds making good progress (albeit with more work required) while many have not progressed much. We expect this dispersion to increase given that only some funds have momentum and their 'plumbing and wiring' in order.
- Trustee guidance models are targeting members that engage, typically through decision support services such as calculators or providing access to paid personal financial advice. This is likely to adequately serve only a subset of retirees, such as those willing to engage and with relatively straightforward financial situations, or willing to pay for personal financial advice. We are concerned that the disengaged and those 'disinclined to engage' are left highly vulnerable to poor outcomes.
- The industry is focused on improving pre-retirement and point-of-retirement services, while ongoing guidance processes and backdating for existing retirees who may not have received any guidance does not seem a priority.

Retirement licensing would address many issues

A retirement licensing regime would require funds to have the capability to deliver a RIS to a reasonable standard before being allowed to offer retirement solutions to their members. It would address many of the challenges faced by the super industry in the retirement phase. A licensing regime would get the super funds moving towards meeting the diverse needs of all their members,

[1] See page 25-26 of our *State of super 2024* booklet.

establish what is expected from fund trustees, and help protect members against poor outcomes in the following ways:

- Establishing baseline standards would increase the likelihood of all retirees finding themselves in a suitable retirement solution, thus helping to guard against poor member outcomes.
- Licensing conditions could be framed to require that super funds cater for member differences by incorporating key member characteristics into retirement solution design and allowing for the various ways in which members engage in configuring their guidance services.
- Regulatory expectations can be established through licensing conditions thus reducing a large area of regulatory uncertainty for super funds. This could include tying ongoing RIS assessment back to the capability requirements set out in the licensing conditions.
- Knowledge of licensing conditions and the associated regulatory certainty will clarify the business case for super funds and create a decision point around being a retirement provider. Funds would need to commit to meeting the licensing conditions within a specified time frame.

How a retirement licensing regime might operate

This green paper focuses on the concept rather than the detail of a retirement licensing regime. Nevertheless, we provide a high-level overview of how retirement licensing might operate to make the idea more tangible. Exhibit 3 outlines a framing of the initial licensing framework. We envisage that super funds would be required to apply for a retirement licence some period of time after establishment of the licensing conditions, thus affording the industry time to prepare.

Exhibit 3: Development of a retirement licensing framework

Licensing conditions could be framed around capabilities that a fund should have in place to provide members a retirement experience of reasonable quality, possibly covering three areas:

1. **Retirement solution delivery** – Super funds would be required to have the capacity to deliver retirement solutions that meet the diversity of needs of their membership. The licensing conditions might span elements like the capability to design and deliver tailored solutions by combining investment and longevity products with drawdown strategies while accounting for the Age Pension; an ability to tailor via either cohorts or personalisation; and so on.
2. **Guidance services** – Super funds would be required to make available a range of guidance services including personal financial advice (in various forms), decision support tools, information and engagement services to assist all members into a suitable retirement strategy.
3. **Competencies** – Super funds would be required to have the competencies in place for effective delivery and oversight of retirement offerings. Examples include governance of the retirement offering, resourcing, administration and systems, a RIS assessment framework, and so on.

Effectively we envisage retirement licences being awarded on an assessment of the capability to deliver a range of solutions and guidance services to an adequate standard. This contrasts with MySuper, which is largely a product licensing process with well-defined conditions. An implementation timeframe of around two years seems appropriate.

A retirement licensing regime won't solve <u>every</u> challenge

A retirement licensing regime will not solve all the challenges outlined in Exhibit 1. Two in particular require further policy work. First is resolving how super funds can provide guidance and assistance to all of their members, potentially including consideration of three trustee-directed activities (recommendations, assignments, and defaulting). Second is retirement frictions. We note that some funds and industry groups (e.g. AustralianSuper, SMC Australia) are advocating strongly in this area, informed by their experience and specialist insights.

Potential ramifications of a retirement licensing regime

Some of the potential ramifications of a retirement licensing regime include:

- **Impacts on members of unlicensed funds** – Super funds not in possession of a retirement licence might have minimal incentive to engage and assist members with their retirement needs as they approach and enter retirement. Members of such funds could be required to choose another provider upon retirement with minimal assistance from their fund. Policymakers might want to consider measures, such as mandatory pre-retirement engagement and transfer procedures, to ensure these members are not left adrift.
- **Fund sustainability** – Funds without a retirement licence could suffer outflows and declining assets as members retire, which might threaten their sustainability.
- **Effects on competition** – There could be a range of competition effects. A licensing regime might be viewed as a barrier to entry for new participants. Conversely, it could enhance competition by encouraging specialist providers in accumulation and retirement, as well as competition from the latter for members of accumulation-only funds as they retire.
- **Impact on innovation** – There is a risk that super funds anchor on the minimum standards to achieve a licence, thus inhibiting innovation – although arguably the incentives for innovation are also weak under the current state where no requirements are imposed.
- **Super system ideology** – A retirement licensing regime could create funds specialising in the accumulation phase of super. It is worth reflecting on whether it is necessary for every super fund to align with the overall objective of the super system to provide income in retirement.

Conclusion

An effective super system should deliver good retirement outcomes for all Australians. Unfortunately, the system is not currently configured to ensure that this happens as the ability of super funds to deliver is facing into some difficult challenges. These include that market mechanisms (informed choice and competition) cannot be relied upon to provide appropriate incentives and signals to funds in retirement; a need to cater for members who differ significantly in their characteristics and needs; substantial policy and regulatory uncertainty; various frictions; and a range of business challenges. All have contributed to the slow development of RIS with significant dispersion across funds.

A retirement licensing regime would be an impactful policy measure that warrants strong consideration. Licensing regimes, such as RSE licensing and MySuper product licensing, are good examples of how licensing establishes baseline standards that contribute to better outcomes across the broad population of super funds and their members.

A retirement licensing regime would benefit fund members, in particular as market mechanisms are struggling. It could buffer the super system by requiring super funds to focus on the diverse characteristics and needs of retired members, provide clarity around minimum standards of RIS delivery, and prompt fund trustees to address the business case for retirement and decide whether to fully commit to serve the retirement needs of their members by meeting the standards.