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| Ms Rebecca McCallum ManagerRetirement Income Policy DivisionAustralian Treasurysuperannuation@treasury.gov.au |

21 June 2018

Dear Rebecca

**Retirement Income Covenant Position Paper**

Mercer is delighted to be able to make a submission in response to Treasury’s paper entitled *Retirement Income Covenant Position Paper* released in May 2018.

Our submission contains the following sections:

* Attachment A: some general comments
* Attachment B: our responses to the proposed Covenant Principles outlined in the Position Paper
* Attachment C: a reflection on our previously submitted Ten Principles for the development of CIPRs in light of the Position Paper

**Who is Mercer?**

Mercer is one of the world’s leading firms for superannuation, investments, health and human resources consulting and products. Across the Pacific, leading organisations look to Mercer for global insights, thought leadership and product innovation to help transform and grow their businesses. Supported by our global team of 22,000, we help our clients challenge conventional thinking to create solutions that drive business results and make a difference in the lives of millions of people every day.

Mercer Australia provides customised administration, technology and total benefits outsourcing solutions to a large number of employer clients and superannuation funds (including industry funds, master trusts and employer sponsored superannuation funds). We have over $150 billion in funds under administration locally and provide services to over 2.4 million superannuation members and 15,000 private clients. Our own master trust in Australia, the Mercer Super Trust, has around 230 participating employers, 239,000 members and more than $22 billion in assets under management.

In addition, Mercer has a national team of 55 financial advisers, servicing 13,000 clients with over $3 billion of funds under advice. Mercer is also the only current provider of a group self annuitisation (GSA) product within Australia with our Mercer LifetimePlus product.

We would be delighted to meet with you and your team to discuss our submission and related matters about this submission or provide additional insights into the development of retirement income products. Please contact me on 03 9623 5464 or by email if you would like to arrange a discussion.

Yours sincerely,

**Dr David Knox**

**Senior Partner**

Attachment A – Some general comments

## Introduction

### As noted in our earlier submission of 6 July 2017 we endorsed Recommendation 11 of the Financial System Inquiry which was to:

“Require superannuation trustees to pre-select a comprehensive income product for members’ retirement. The product would commence on the member’s instruction, or the member may choose to take their benefits in another way. Impediments to product development should be removed.”

We continue to support the development of Comprehensive Income Products for Retirement (CIPRs) and believe that a strong and innovative post-retirement market, including a requirement for trustees to provide such products together with the widespread use of longevity pooling, will generate more efficient retirement outcomes whilst continuing to provide individual retirees with flexibility and choice.

We have also reviewed the ten principles for CIPRs which we set out in our previous submission against the Position Paper. Our comments in respect of each principle are set out in Attachment C. However, as will be noted, the Paper has picked up many of these principles and therefore we believe that the Position Paper represents a very important and positive step forward in the evolution of Australia’s retirement income system.

We agree that retirement phase of the superannuation system is under-developed and that the system needs a much stronger focus on incomes. We also support the two intentions of the framework outlined on page 2 of the Position Paper, namely:

1. to increase living standards in retirement through a broader range of products; and
2. to facilitate easier transition to retirement with the offering of well-rounded products that meet certain objectives.

We also applaud the recent announcement of the means test treatment of pooled lifetime income products which should encourage greater acceptance of longevity products amongst retirees and therefore an increased willingness to include a CIPR within their overall retirement solution.

We also believe that this overall development of retirement income products is consistent with similar thinking in other parts of the world. For example, the American Academy of Actuaries has recently released the following Position Statement in respect of retirement income options:

“The American Academy of Actuaries supports policy and educational initiatives that increase the availability of retirement income options within employer-sponsored defined contribution plans. Such options, based upon actuarial principles such as longevity pooling and other risk mitigation strategies, can help retirees manage their financial security over their remaining lifetime.”

They go on to say that “retirement income policy should encourage and enable the development of ***lifetime income*** solutions, tools, and education”. (their emphasis)

## The Proposed Covenant

We support the introduction of a retirement income covenant into the *SIS Act* as long as it remains at a principles-based level and does not prescribe detailed requirements. We believe the detailed requirementsshould be in *SIS Regulations* and possibly a future APRA prudential standard.

We note that the covenant and supporting principles will not apply to DB schemes that offer a DB lifetime pension. We believe this exemption needs to be tightened to ensure that a Retirement Income Strategy is in place for retirees who receive a lump sum benefit. In addition, the exemption should not apply to DC members of such schemes or where there are DC components of the benefits.

We understand the Government proposes to legislate the covenant by 1 July 2019 but to delay application of the covenant (that is, the need to develop a retirement income strategy) until 1 July 2020. We support this delay. However, there is no mention of the date by which funds must offer a CIPR. We suggest it should be 1 July 2021. This delay will provide time for the development of longevity products as well as providing trustees with a clear timetable to develop their CIPR product(s) following the development of their strategy.

We support the concept of developing “simplified, standardised metrics in product disclosure” to help consumers make decisions about the most appropriate product. This is a worthy goal, but we recognise that this will be really challenging in practice as a CIPR will have many components to it, some of which may not be readily understood. The prescribed ASIC dashboards are unlikely to work in their current form. We therefore recommend that prior to any requirement, the proposed disclosure requirement are fully tested across a range of consumers and advisers and that there be extensive consultation with the industry.

## Terminology

We are confused by some of the terminology that is being used. Let us provide two examples.

First, the term “product”. There is general agreement that the retirement phase of the superannuation system is underdeveloped and that it is desirable to have a broader range of products. But, what is a product? Currently, one can suggest that the account-based pension is the most popular product for retirees. But an annuity (term certain or lifetime) is also a product. Now most CIPRs are likely to be a combination of two products, say an account-based pension and a longevity product. But a CIPR is also a product with the P standing for Product. So we have a combined (or comprehensive) product which is actually a combination of two or more products. Therefore we need to recognise that the term “product” can be used in several contexts.

Second, the use of the term “CIPR”. The confusion surrounding this term is perhaps more important than the previous example, particularly as it is a new concept to the industry, advisers and retirees.

To begin and to keep it simple, let us assume that a superannuation fund offers a single CIPR, their “flagship CIPR”, which represents a 75/25 combination of an account-based pension and a longevity product that meets the capital access schedule. This CIPR has also been certified as meeting the stipulated requirements.

Following discussion with their financial adviser, a retiree decides that in their personal circumstances an 80/20 combination is more appropriate. Is this revised product still a CIPR? If so, does this new combination need to be certified? If it is determined to be a CIPR, but not the “flagship CIPR”, what’s the difference? If it is not a CIPR, what are the consequences (if any) for the fund or the individual? Is there any difference if the retiree does not receive any financial advice but makes a personal decision?

This situation may become even more complex if the fund offers three “flagship CIPRs”, one of which may have an 80/20 combination for members with retirement balances that are lower than the balance held by above-mentioned retiree. Therefore this retiree, who has chosen to move from 75/25 to 80/20, would have been in a “flagship CIPR” if the balance was smaller but is not anymore. Does this outcome make sense?

We therefore recommend that the terminology be simplified and clarified regarding:

* The meaning of a CIPR and a flagship CIPR
* The requirements to be a CIPR and a flagship CIPR
* The consequences of investing or not investing in a CIPR or a flagship CIPR.

Attachment B: Our responses to the Covenant Principles

## Principle 1 - Retirement income strategy

Trustees should assist members to meet their retirement income objectives throughout retirement by developing a retirement income strategy for members.

A comment is made in the second paragraph that “Requiring all superannuation trustees to develop a retirement income strategy will help to ensure appropriate high-quality products are developed and offered to retirees.” Whilst the development of a strategy will obviously help, the success will really depend on how the trustees choose to support members to choose the most appropriate retirement strategy for their individual circumstances and then, if appropriate, how the Fund “offers” a CIPR to their members. The fact that a fund must have a CIPR “available” does not guarantee success.

We support the concept that the retirement income covenant in the *SIS Act* will require trustees to consider a number of factors and the trade-offs between them. However some of the factors mentioned need more clarity or less prescription. For example:

* What does “maximising income for life” mean?
* Whilst the investment strategy adopted or product design will affect certain risks, the trustees cannot be expected to manage all risks which affect the stability of income.
* Members’ needs and preferences in retirement inevitably vary greatly. Hence trustees will need to consider these matters for the cohort as a whole rather than on an individual basis.
* Cognitive decline is an individual characteristic and is hard to generalise. Hence the consequence of this factor may be that no decisions are required from members at older ages and/or that the expected income is simple to understand rather than an assessment of a member’s future cognitive ability.

## Principle 2 - Engagement

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

We support the idea that trustees should provide simple and clear guidance to their members, including through the use of tools and a range of technology. However the level and sophistication of guidance that is expected to be provided by trustees needs more clarity. Otherwise many trustees will be cautious and not provide the required assistance in case their assistance is considered to be personal financial advice. On the other hand, there should not be a prescribed format of guidance as funds should be able to mould their guidance to suit their members and their overarching approach to engagement.

## Principle 3 - Definition of a Comprehensive Income Product for Retirement (CIPR)

A CIPR is a retirement income product which is designed to provide:

- efficient, broadly constant income, in expectation;

- longevity risk management (income for life); and

- some access to capital.

A 100 per cent allocation to an ABP (account based pension) alone would not meet the definition of a CIPR.

We support this general definition of a CIPR and that a 100% allocation to an ABP does not meet the requirement. Indeed, we suggest a minimum allocation to the longevity component may be required, although we recognise this may not be needed when the efficiency requirements are known. We also recognise that the minimum may depend on the type of a longevity product; for example, the difference between immediate and deferred annuities.

It is unclear as to the level of capital access that may be required in a CIPR. For example, would it be open to a trustee to determine that adequate access to capital would be provided by a 100% allocation to an immediate annuity which meets the Capital Access Schedule? We note that this would provide fairly limited capital access, including zero access after life expectancy. On the other hand, a CIPR comprising an ABP and a deferred lifetime annuity may also be designed to have no capital access available after life expectancy. In our view these scenarios should be permitted for CIPRs and we suggest subsequent material make it clear that a minimum level of capital access will not be prescribed, rather it will be up to the trustee to determine whether their CIPR provides adequate access to capital. Of course, we note that at least half the population is expected to live beyond the current life expectancy figures. Therefore, whilst access to some capital is an important component of any CIPR design, we recommend that no requirements or regulations be made in this respect of this topic.

We are also a little confused by the comment in the fifth paragraph on page 7 that some access to capital could be provided through some commutable value from the pooled lifetime income product. We would expect that most longevity products within CIPRs would meet the capital access schedule such that there is no commutable value or death benefit after life expectancy.

We also support the greater flexibility relating to the meaning of broadly constant expected income. That is, it may be expressed in terms of nominal or real income (or in between) and may incorporate the expected age pension payments. However in the second paragraph on page 7, a comment is made that “the trustee would need to ensure that the CIPR is designed in such a way that even if the member lives to 105, they will continue to receive broadly the same level of income from the product.” This comment runs directly counter to the comment in the previous paragraph where trustees may choose to incorporate the age pension when determining ‘broadly constant income’. We suggest adding ‘or from the product and the age pension combined.’

In view of the above-mentioned flexibility in the definition of expected income, the requirement for the expected income to be within a band of +/- 2.5 per cent is unreasonable. For example, the incorporation of allowance for the age pension (with the expected effects of both the assets test and income test) means that this narrow band is unlikely to be possible throughout life, unless the drawdowns from the ABP are made very complex.

Although a constant income may be desirable, it must be recognised that many retirees have a level of discretionary expenditure (eg travel) and this is often adjusted in periods of lower income or volatile wealth balances. Hence, we recommend that the band be expanded to at least +/- 5 per cent, if not +/- 10 per cent, from the income in the first year.

It is also important to recognise that this requirement is the expected income based on the adopted investment strategy and longevity product within the CIPR and not the actual income achieved. It is almost certain that with many investment portfolios, the actual income will vary significantly from the expected income due to market movements. This difference between actual and expected incomes needs to be clearly explained to retirees although it should be noted that this already happens with most ABPs and does not cause major concerns.

We continue to support the need for an actuarial certification for CIPRs so that the market knows that every CIPR meets certain requirements. However as discussed in Attachment A, the consequences of being (or not being) a CIPR needs to be clear.

We understand that this actuarial certification will require the expected income to “be efficient”. We presume this will be defined in the certification requirements which will be determined at a later date. However we recommend that:

* the efficiency requirement be kept simple so that it can be readily calculated and understood by providers and advisers
* these certification requirements be announced as soon as possible so that appropriate longevity products and CIPR designs can be developed.

## Principle 4 - Offering a flagship CIPR

All trustees should offer a flagship CIPR to members at retirement, subject to limited exceptions (see principles 7 and 8).

We support the proposal that all trustees must offer a CIPR and that trustees may offer up to three CIPRs, thereby allowing for different cohorts with different characteristics.

However we are concerned that the term “flagship CIPR” will be confusing. In some cases, the relevant CIPR may be the starting point for a discussion with a member who may then tweak their allocation between the ABP and longevity product. However, whilst this adjusted product may be a more suitable product for the member, the member may be concerned that the product is somehow inferior because it is not the ‘flagship’ product.

We are also confused by the opening sentence that “Trustees would be required to offer a CIPR to all members at retirement.” Whilst we support the requirement that all trustees must offer a CIPR, Principle 8 clearly sets out some examples where this will not be required to be offered to all members.

We appreciate the need for trustees to give members the option to include a reversionary benefit. However, there is no mention as to what level of income would be required after the reversion. We suggest this should be left to the Trustees and that it could be at a lower level.

The ‘A+Plus’ example indicates that the member would “have access to a lump sum of up to $15,000 at any time”. We presume this would be from the ABP component although this is not clearly stated. The 15k figure is also subject to market movements and the level of income drawdown. Hence, we suggest it would be dangerous to express such a “promise” in any PDS or promotional material for the CIPR. Any such requirement must also be able to be administered simply. A required “bucket of cash” would add complexity. Further, any requirement to have a minimum capital available at all times may not be possible under certain CIPR combinations; for example, an ABP and a deferred lifetime annuity.

## Principle 5 - Third party products

Trustees can fulfil their obligation in part or in full by using a third party.

We recognise that many products and services within the superannuation industry are outsourced to a third party and therefore fully support this principle.

## Principle 6 - Consent

Consent should be required for a CIPR to commence.

We support this principle of the requirement for member consent to invest in a CIPR. That is, it represents an “opt-in” approach as opposed to an “opt-out” approach which would be required through a default mechanism.

However, the question remains as to the level of consent required. We agree that it should not be onerous for a member to accept the CIPR offer from the trustees. For example, it may be sufficient for the member to sign a statement similar to the following:

“I understand that the trustees of XXX super fund believe this is the best retirement income product for most people with a superannuation retirement balance between $X and $Y. I agree to invest in this product.”

## Principle 7 - Offering an alternative retirement income product through advice

Trustees may offer an alternate CIPR or another retirement income product to a particular person or cohort of people through any form of personal financial advice, including scaled personal advice, intra-fund advice, or full financial planning.

We agree that trustees should be able to offer members other retirement income products. However, we suggest it may be confusing if they are called CIPRs. After all, they may represent a slight tweak to a CIPR but may not have been certified as a CIPR. The requirement to receive such a certificate seems an unnecessary expense if the revised product is more suitable to the individual, following consideration of their personal circumstances. Refer to Attachment A regarding terminology.

It may be appropriate to integrate this principle with Principle 4 so that it is clear when Trustees must offer a CIPR and when it is reasonable for the Trustees to offer an alternate product..

**Principle 8 - Exception for individuals for whom CIPRs are unsuitable**

Trustees may choose not to offer a CIPR at all to a particular person if the trustee has reliable information that a CIPR would not suit that person.

We support the concept that the Trustees do not need to offer a CIPR to an individual if certain information is known. However we believe that the $50,000 limit is too low as most retirees below and slightly above this threshold will be receiving a full age pension, which is indexed and guaranteed by the Government. That is, they are likely to have longevity protection for at least 80 per cent of their income.

The Position Paper provides no explanation of the choice of $50,000 as a lower limit. We suggest that it is necessary to explain the rationale for any limit. For example, the limit needs:

* To recognise when longevity protection is not needed, possibly due to the age pension
* To ensure that any longevity income is meaningful to the retiree
* To be able to be applied to all longevity products
* To ensure that there are not unnecessary expenses from the provider’s perspective due to the small size of the regular payments
* To recognise that only a portion of the total benefit is likely to be invested in a longevity product

We suggest that a more realistic threshold is at least $100,000. Here is one possible rationale:

Most individuals retire as couples and are homeowners. Many people also have some financial assets outside superannuation.

Therefore let us consider a couple with $200,000 in superannuation (ie two super balances of $100,000 each) and other assets of $100,000 (including their car and financial assets of $50,000).

Let us assume they drawdown 5% of their superannuation assets and the financial assets earn, on average, 4% pa. This provides total income of $12,000.

This couple would also be entitled to a full age pension of $35,573 giving them total income of $47,573.

The part age pension represents 74.8% of their total income and has full longevity protection.

It could be argued that this couple does not need any further longevity protection and a 100% ABP would provide them with additional income and capital access.

We therefore recommend that the exception limit should be raised to $100,000. An indexation mechanism for the limit should also be introduced.

**Future considerations**

Lifetime engagement

**Trustees should engage with members about retirement early (from the point of joining the fund onwards) and continue to engage on an ongoing basis.**

We support this concept and have always been strong supporters of retirement income projections, ideally allowing for the means tested age pension.

Legacy products

**An approach for managing legacy retirement income products and issues related to these legacy products should form part of the framework.**

Agreed

In particular, we need to recognise it is likely that some longevity products will not generate sufficient scale over the longer term. Therefore the legal framework should ensure it will be relatively straightforward for sub-scale products to be closed or rolled into other products, without any penalty for the providers and a reasonable outcome for consumers.

Safe harbour

**Trustees could qualify for a safe harbour, in limited circumstances, provided they act diligently and comply with all relevant legal obligations in designing and offering a CIPR.**

Trustees should be provided with a safe harbour, provided they have met the requirements of the covenant and any subsequent regulations and/or prudential standards.

**Attachment C: Ten Principles for the development of CIPRs**

In our previous submission of 6 July 2017 we suggested ten principles for the development of CIPRs. The following comments reflect on these principles in the light of the Position Paper.

1. A CIPR offered by a superannuation fund will comprise a combination of the provision of regular income for life, access to capital (flexibility), the provision of protection from longevity risk and, in some cases, protection from market risk. Different product designs must be feasible, thereby providing different “best outcomes” for members of different superannuation funds due to their different characteristics.

**Comment:** We believe that the proposed principles are sufficiently broad and that different product designs of CIPRs will be feasible. Trustees will therefore be able to develop CIPRs in the best interests of the majority of their members.

1. The CIPR requirements or framework must be sufficiently flexible to allow for a range of products in respect of income, capital access, longevity protection and guarantees.

**Comment:** As noted above, flexibility is built into the suggested covenant principles.

1. The CIPR requirements must also recognise that the financial needs of retired individuals (and their households) are not constant in real terms, therefore permitting some access to capital during retirement.

**Comment:** We are pleased to see that there is now greater flexibility in the application of constant income in that it may be expressed in real or nominal terms. Furthermore the allowance for trustees to incorporate the expected age pension payments is a welcome step.

1. Trustees should be permitted to offer more than one CIPR to allow for different categories of members and/or members with different characteristics.

**Comment:** We are pleased to note that Trustees may now offer up to 3 CIPRs.

1. It must be recognised that the CIPR offered by a Trustee may not be appropriate for all members.

**Comment:** We are pleased to note that Principle 8 recognises that for some individuals a CIPR will not be appropriate.

1. The regulations and relevant requirements must be product neutral so that no particular product or product-type is favoured.

**Comment:** We are pleased to note that the suggested covenant principles do not favour any particular product; rather the outcomes are important.

1. All superannuation funds that have a MySuper licence and offer a post-retirement product should be required to offer a CIPR by the end of a transition period.

**Comment:** We support the principles that all superannuation funds (with relatively few exceptions) will be required to offer a CIPR.

1. The means test rules for the age pension should not discourage CIPRs. However, if any bias exists, it should favour pooled longevity products such as GSAs and annuities as these products lead to more efficient outcomes.

**Comment:** We believe the new means test rules for longevity products should encourage CIPRs although the extent of any such behaviour is uncertain at this stage.

1. Certification or approval of CIPRs should be required but this should not be conducted by either APRA or the fund itself. A third party approval process by an actuary using professional standards or regulations is recommended.

**Comment:** We recognise that there will be a certification process although the required method or approach has not yet been determined. We continue to suggest that a relatively simple approach with an actuarial sign-off is the best way forward.

1. Income streams should be the focus of our superannuation system. This focus should also lead to the compulsory provision of benefit projections (expressed as income) in each member’s annual statement by the end of the transition period.

**Comment:** We applaud the indication that retirement income projections will be required in the future.