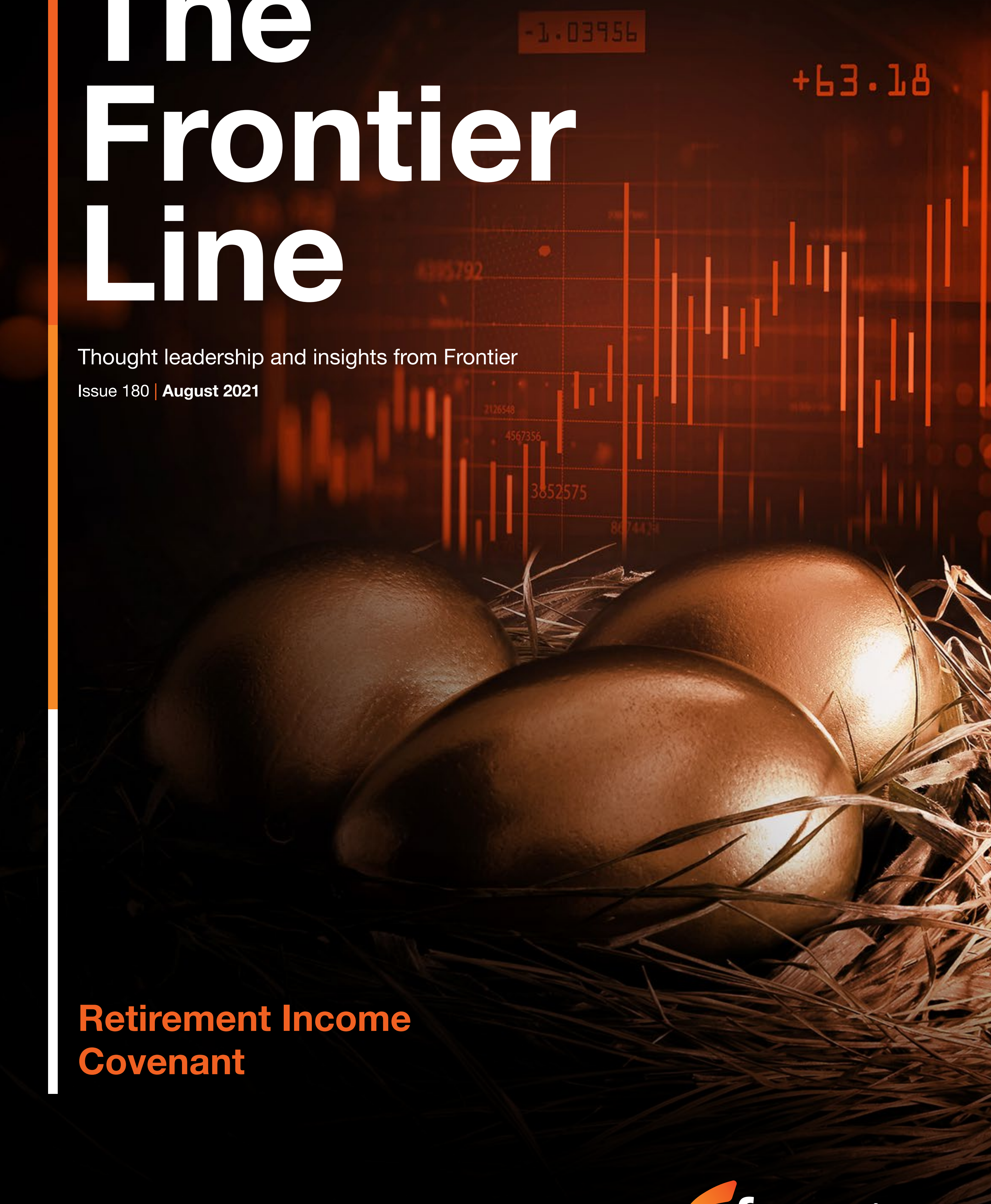
The Frontier Line

Thought leadership and insights from Frontier

Issue 180 | **August 2021**



Retirement Income Covenant

frontieradvisors.com.au

frontier

About us

Frontier has been at the forefront of institutional investment advice in Australia for over 25 years and provides advice over more than $470 billion of assets across the superannuation, charity, public sector, insurance and university sectors.

Frontier's purpose is to empower our clients to advance prosperity for their beneficiaries through knowledge sharing, customisation, technology solutions and an alignment and focus unconstrained by product or manager conflict.

AUTHOR

David Carruthers

Principal Consultant,
Head of Member Solutions

David joined Frontier in 2015 as a Senior Consultant and leads the Members Solutions Group. He provides investment advice to a range of clients and conducts research in the area of retirement strategy and product development for superannuation funds. Prior to Frontier David spent 19 years at Mercer in both the UK and Australia. Prior to joining Mercer, David was at Towers Perrin for around six years, working with a number of clients in a consulting and research capacity. David holds a Bachelor of Economics from Macquarie University and is a Fellow of the Institute of Actuaries of Australia.

Summary

The current Australian retirement product market is underdeveloped, with many superannuation funds offering their members the same products in accumulation and retirement phase. There is a limited range of products designed specifically for retirees wishing to convert their superannuation into an income stream.

Frontier supports an aim of focussing on income in retirement and away from lump sums at retirement. There is much to like about the Treasury's Retirement Income Covenant position paper.

- It encourages a focus on maximising income, recognising that retirees drawing down at the minimum rates are under consuming.
- It recognises members' needs of their superannuation will vary depending on a number of factors, including whether they receive the Age Pension
- It recognises the importance of 'guidance' for those members who find the task of choosing an appropriate retirement product difficult.

Rather than continuing to debate and wait, funds can take some concrete actions to improve their product offering for their most important members:

1. Understand the needs of their retirees and members approaching retirement. Understanding the needs of customers should be a high priority for any business.
2. Determine the sustainable draw down rates so that members can move away from minimum drawdown rates.
3. Redesign the account based pension products with an objective of providing income.
4. Consider longevity solutions for those members who will benefit from greater certainty of lifetime income.

As the position paper mentions, trustees do not have to wait to start developing or offering innovative income products to their members. Leading funds have already started to bring innovative products to market.

Introduction

Treasury released the Retirement Income Covenant position paper on 19 July 2021. It was open for consultation until 6 August 2021. This position paper follows a similar consultation exercise in June 2018. That position paper was preceded by a July 2017 discussion paper on Comprehensive Income Products from Retirement (CIPRs).

The Government committed in the 2018-19 Budget to introducing a Retirement Income Covenant for superannuation trustees, taking effect from 1 July 2022. The covenant aims to codify the requirements and obligations for superannuation trustees to improve retirement outcomes for individuals, while enabling choice and competition in the retirement phase.

Similar covenants exist for investment, risk management and insurance strategies.

The Retirement Income Covenant will oblige trustees to formulate, review regularly and give effect to a retirement income strategy.

The strategy will be a strategic document developed by the trustee, outlining their plan to assist their members to achieve and balance the following objectives:

- maximise their retirement income
- manage risks to the sustainability and stability of their retirement income
- have some flexible access to savings during retirement.

According to Treasury's position paper, requiring trustees to have a retirement income strategy ensures they identify and recognise the retirement income needs of the members of their fund and have a plan to build the fund's capacity and capability to service those needs.

The strategy should reflect a trustee's broad understanding of their membership, either for the members of the fund as a whole or for cohorts of members. The position paper notes the characteristics of these cohorts are at the discretion of trustees but could be determined by factors such as superannuation balance, home ownership status, partnered status, and age of retirement.

The summary of obligations and discretions of trustees is reproduced in the appendix.

Proposed principles

The position paper outlines the proposed requirement for superannuation trustees to develop a retirement income strategy for the members of their fund who are retired or approaching retirement.

Trustees are required to formulate, review regularly, and give effect to a retirement income strategy for the retired members of their fund, and the members of their fund approaching retirement.

The strategy can be formulated for:

- all members in generality, or
- cohorts of members in generality, as identified by the trustee.

The strategy should outline how the trustee intends to assist their members to achieve the following objectives:

- maximise their retirement income (taking into account the Age Pension and any other relevant income support payments identified by the trustee paid under the Social Security Act 1991 or the Veterans Entitlements Act 1986)
- manage risks to the sustainability and stability of their income
- have some flexible access to savings during retirement.

Where these objectives compete, the strategy should identify how trustees intend to assist their members to balance these objectives and whether the trustee's intended assistance is likely to increase or decrease the retirement incomes of their members.

Source: Treasury Retirement Income Covenant position paper, 2021

A retirement income strategy will need to outline how the trustee intends to assist their members to achieve and balance key retirement income objectives. In effect, the strategy is a strategic document developed by the trustee that:

- identifies and recognises the retirement income needs of the members of the fund
- presents a plan to build the fund's capacity and capability to service those needs.

The position paper notes the formulation of a retirement income strategy is not considered to be financial advice, a requirement for a soft default, nor the mandating of a 'one-size-fits-all' approach.

Members

The position paper recognises the retirement income needs of members, and the plan to service those needs, may be different from fund to fund, or from groups of members within a fund. There is significant flexibility for trustees to identify the particular needs of their members and develop a retirement income strategy that is suited to those needs.

The covenant will aim to ensure trustees have appropriately considered the needs of their members and that they are sufficiently equipped to address them. It is at the discretion of the trustee as to whether they construct their retirement income strategy for all members of the fund in generality, or for cohorts of the fund's members in generality.

The factors used to identify cohorts of their members are at the discretion of the trustee, but the position paper recommends that it could include consideration of:

- the size of a member's superannuation balance
- whether a member is expected to receive a full, part- or nil-rate Age Pension at retirement
- whether a member is partnered or single
- whether a member owns their own home outright, owns their home with a mortgage, or is renting at retirement
- the age a member retires and/or starts to draw down from their superannuation.

Trustees will be free to also consider other factors they deem relevant when designing their retirement income strategy in addition to the considerations required by the retirement income covenant.

Product

The position paper outlines the core obligation for trustees is to assist members to balance three key retirement income objectives:

1. maximise retirement income
2. manage risks to stability and sustainability of income
3. have some flexible access to savings in retirement.

When balancing the three objectives, trustees should identify how their proposed approach to assisting their members manage the risks to the sustainability and stability of their retirement income, and provide them with some flexible access to savings, would increase or decrease the retirement income of their members in generality.

Treasury anticipates the requirement to develop a retirement income strategy will result in many trustees evaluating the products they offer and investigating whether their product offerings can be improved to better meet the needs of their members.

1 Maximising retirement income

A retirement income strategy will need to consider how the trustee intends to support their members to maximise their retirement income. Maximising retirement income for members means providing the highest expected net income possible for members over their retirement. This should take into account both the income from superannuation and the Age Pension and any other relevant income support payments.

The objective to maximise retirement income should be balanced with the other objectives considered in the strategy.

2 Managing risks to the stability and sustainability of retirement income

Trustees need to consider how to assist their members to manage risks to the stability and sustainability of their retirement income. A sustainable retirement income means it is reliable and durable over a member's retirement. A stable retirement income means it is broadly constant over that time, that is, from a member's point of view it is broadly predictable.

When developing their retirement income strategy, trustees should consider the following risks to the stability and sustainability of their members' retirement income:

- **Longevity risk** – this should not include consideration of bequest motives to non-dependents
- **Investment risks** – including both market risk (including risk of variable or negative investment returns) and sequencing risk (the risk of converting assets to income at a disadvantageous time).

3 Providing flexible access to savings during retirement

In formulating their retirement income strategy, trustees should consider how they will assist their members to have some flexible access to their savings during retirement. Trustees should balance their approach to assisting retirees to have some flexible access to savings during retirement with the other objectives in the strategy.

Trustees should consider this objective in the context of the total savings available to their members (including savings outside of superannuation, such as private savings or housing assets) and the likely future needs of their members to flexibly access their savings. When considering their members' expected future needs for flexible savings for health costs (including aged care), trustees should take into account the significant financial and in-kind support provided by the Government.

Trustees should not consider the provision of a bequest as a reason why their members may need some flexible access to savings in formulating their strategy.

Source: Treasury Retirement Income Covenant position paper, 2021

Guidance

A retirement income strategy should outline how the trustee intends to assist their members meet and balance the three retirement income objectives.

Guidance covers a range of information provided to members, from factual information through to personal financial advice. In the context of retirement, Treasury's view is appropriate guidance helps members understand how they can convert their retirement savings into a retirement income in a way that suits their needs and desired financial outcomes.

The Government is aware there are concerns regarding current laws and regulations governing guidance. The Treasury will also conduct a Quality of Advice Review in 2022, as recommended by the Hayne Royal Commission. The review will consider the full breadth of issues impacting on both quality and affordability of all forms of financial advice, including advice for retirement. This will inform future policy development.

The position paper notes guidance in this context does not mean defaulting members into particular products or pushing people towards particular forms of advice.

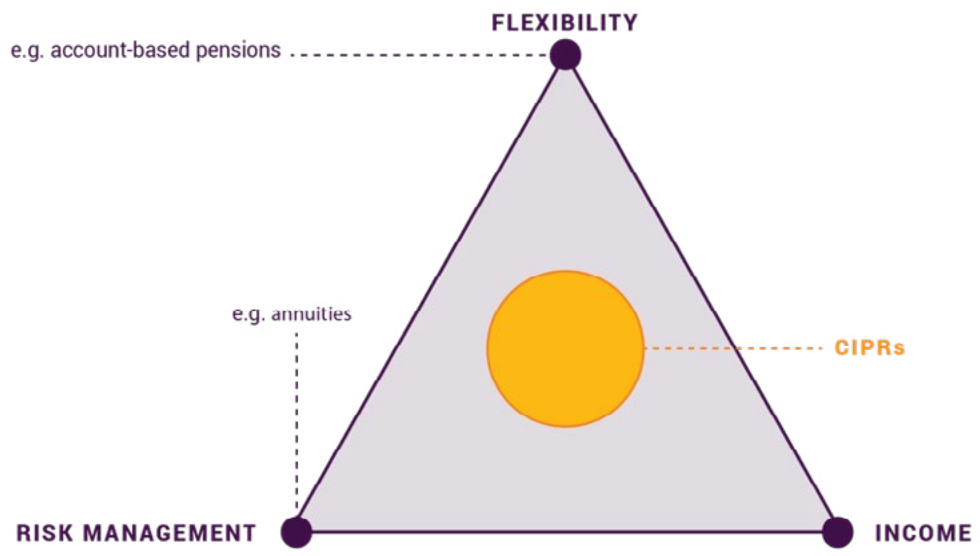
frontier

Comparison with previous position paper

Treasury's 2018 position paper had two main principles:

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

These two principles remain in the current position paper. However, the previous paper had a number of supporting principles regarding the provision of a Comprehensive Income Product for Retirement (CIPR).



Sources: Treasury Development of the framework for Comprehensive Income Products for Retirement discussion paper, 2016

The current position paper makes no mention of CIPRs and is much less product-focussed. However, the objectives of income, risk management and flexibility remain in the current position paper. The significant change is with the prioritisation of income. The other objectives are now subordinate to the objective of maximising income.

In particular, the need for longevity is now downplayed. Previously a 100% allocation to an account based pension alone would not meet the definition of a CIPR. Now "trustees should consider how they will assist their members to manage their longevity risk". Notwithstanding this, funds are likely to need to include products with a longevity component to maximise the total retirement income for part age pensioners. Part pensioners can receive a higher Age Pension if their superannuation product takes advantage of the innovative income stream Age Pension allowance.

Based on the latest position paper, inflation risk is no longer an explicit factor that trustees need to consider. Previously a CIPR needed to provide constant, real (i.e. inflation-adjusted) income. Now the position paper notes the expenditure of most retirees declines in real terms over the course of retirement. This seems to miss the point that retirees are still exposed to inflation risk regardless of whether their spending declines in real terms.

In contrast, the current paper has a much stronger focus on members – ensuring trustees have appropriately considered the needs of their members and that they are sufficiently equipped to address them. Funds are no longer limited to three 'default' products but may have as many (or few) member cohorts as they deem appropriate.

The final word

Feedback on Treasury's paper

The position paper is more principles based than the position paper issued by Treasury in May 2018 and Frontier is supportive of this. However, we think funds should be offering a more extensive range of retirement income solutions to their members than they do currently.

Frontier agrees with an 'income' framing for retirement benefits and that retirees should be encouraged to draw down their superannuation at a higher rate than the minimum. We recommend funds provide members with a statement of the sustainable income that their balance can generate alongside useful insights into the risks involved.

The position paper recognises members' financial needs are more diverse in retirement than in the accumulation phase. Retirement involves difficult trade-offs, and some retirees struggle to develop effective retirement income strategies on their own. Frontier believes funds can play an active role in assisting their members choose a good retirement income strategy for their individual needs. In our opinion, providing factual information which helps retirees choose an appropriate retirement income product is important. Simple and consistent communication is key. Guidance can play an important role and we are strong supporters of introducing default settings which act as 'nudges' to encourage members to draw down faster on their retirement savings.

Retirees have different characteristics. While one-size doesn't fit all, in our view there are a finite number of objectives when designing a retirement solution:

- income that lasts for life
- higher return
- flexibility to access capital
- bequest motive.

While the members' characteristics (e.g. balance, homeownership, etc) can be helpful in creating cohorts, it is member preferences for these objectives which we believe will determine the appropriate solution for a particular member or group of members. Frontier thinks member cohorting based on characteristics rather than preferences can only be part of the solution and should not be overemphasised.

The specific inclusion of any Age Pension entitlements is a departure from previous position papers. It can be difficult and data intensive to determine the Age Pension status for an individual member, especially as it will rely on their entire household financial circumstances. We believe a member's Age Pension status shouldn't be required in determining an appropriate product for them. We recognise for some members their Age Pension status can help determine the optimal product; however, there is a danger the inclusion of Age Pension entitlements over complicates and delays the implementation of the reforms.

Full financial advice forms part of the solution for some members and we look forward to the outcome of the Quality of Advice Review. Financial advice needs to work better for consumers. However, we don't believe funds need to wait for this review. Advice shouldn't be a necessary part of the solution.

Frontier strongly supports the Government's intention to introduce a Retirement Income Covenant outlining an obligation for trustees to formulate, review and give effect to a retirement income strategy. Subject to the above feedback, we support the intention to legislate for a Retirement Income Covenant prior to 1 July 2022 and look forward to the early release of its drafting.

Want to learn more?

Frontier works with a number of superannuation funds to develop product solutions for their members. Please reach out to Frontier to discuss how we can work with you in this space.

frontier

Frontier

Level 17, 130 Lonsdale Street, Melbourne, Victoria 3000

Tel +61 3 8648 4300

Frontier is one of Australia's leading asset consultants. We offer a range of services and solutions to some of the nation's largest institutional investors including superannuation funds, charities, government / sovereign wealth funds and universities. Our services range from asset allocation and portfolio configuration advice, through to fund manager research and rating, investment auditing and assurance, quantitative modelling and analysis and general investment consulting advice. We have been providing investment advice to clients since 1994. Our advice is fully independent of product, manager, or broker conflicts which means our focus is firmly on tailoring optimal solutions and opportunities for our clients.

Frontier Advisors Pty Ltd ABN 21 074 287 406 AFS Licence No. 241266