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Retirement Income Covenant

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Draft Submission for the Retirement Income Covenant

The IPA, in conjunction with Deakin University and the IPA-Deakin SME Research Centre, is pleased to respond to the Federal Government's position paper on the Retirement Income Covenant. The IPA is one of the three professional accounting bodies in Australia, representing more than 35,000 members and students throughout Australia and internationally. The IPA prides itself, in not only representing the interests of accountants, but also small businesses and their advisors.

The Government's position paper provides an opportunity for a thorough national discussion dealing with the obligations of fund trustees and their dealings with monies set aside for individuals on their retirement, which is consistent with the objective outlined in the final report of the Financial System Inquiry (FSI) published in November 2014¹². The objective proposed in the FSI was that superannuation is intended 'to provide income in retirement to substitute or supplement the Age Pension'. It is hoped that this paper can provide a useful foundation from which to start the process of crafting and shaping the potential forms of the retirement income covenant and further clarifying the fiduciary relationship between trustees and the member or members of a retirement fund. A trustee generally oversees all aspects of a fund, including fund investments and distributions on behalf of a member or members. While this might be largely understood, it is important that the significant role of a fund trustee be reinforced following a stream of banking and financial planning controversies that have been exposed in recent years by media reportage or the conduct of official inquiries by parliamentary committees, government regulators and royal commissions.

A framework, which establishes what acceptable conduct is for trustees administering superannuation funds on behalf of fund members, is critical in the light of the quantum of superannuation assets under management. Australia currently has approximately \$2.61 trillion in superannuation assets under management, according to the Australian Prudential Regulation Authority (APRA, 2018)³, which represents a substantial increase from the \$2.44 trillion reported by APRA in the previous 12 month period. The substantial amounts being managed by trustees need to be considered when developing the framework and any related regulations or guidance for trustees. Some trustees will have a highly sophisticated understanding of the financial markets and will use knowledge in exercising their judgment. Other trustees however will be heavily dependent on advice from financial planners, actuaries and other intermediaries with expertise in superannuation. The final version of the framework must factor in different levels of subject matter expertise within the trustee population and provide further guidance in the covenant itself to clarify the obligations of trustees in a specific circumstance such as that of a self-managed superannuation fund (SMSF).

¹ The Treasury (2016) Objective of superannuation: Discussion paper, 9 March 2016, Commonwealth of Australia, Canberra

² Financial Services Inquiry (2014) Financial System Inquiry: Final Report, Commonwealth of Australia, Canberra

³ Australian Prudential Regulation Authority (2018) Statistics: Quarterly Superannuation Performance – March 2018, Commonwealth of Australia, Canberra

The covenant, as proposed in the position paper⁴ provides firm guidance for trustees regarding the objectives of a *Comprehensive Income Product for Retirement* (CIPR), i.e.; to ensure that the CIPR provides a fund member with:

- “Efficient, broadly constant income, in expectation;
- Longevity risk management (income for life); and,
- Some access to capital”.

The position paper states that:

These high level ‘guidance’ principles of a CIPR are strongly supported by the IPA as they articulate a critical objective: the need for a product or mix of products to ensure that individuals have the potential to have sufficient funds for their retirement. The position paper acknowledges, however, that there are circumstances where CIPRs are inappropriate and accordingly the trustee should not recommend a CIPR for certain fund members. We also support this position. We note further that flexibility is critical in circumstances where individuals either have a shorter life expectancy as a result of terminal illness or where the total balance of superannuation assets in a fund is low. While the Federal Government’s position paper refers to these examples, there are other illnesses or disabilities that may result in shorter life expectancy. The possibility of shorter life expectancy resulting from other illnesses such as diabetes or obesity should also be reflected in a final version of the covenant.

Productivity Commission draft report

The current consultation on the retirement income covenant is taking place at the same time the Productivity Commission has requested the community, particularly those involved in the superannuation sector, to evaluate the findings of the Commission’s draft report on the performance of superannuation funds, *Superannuation: Assessing Efficiency and Competitiveness*⁵. The draft report examined the ways in which competition could be increased within the superannuation sector and potentially benefit fund members. The report highlighted two principal problems within the current environment that were resulting in lower superannuation balances in the accounts of fund members. These included:

- The existence of unintended multiple accounts for superannuation that create difficulties for individual employees; and,
- Superannuation funds that routinely underperform.

⁴ The Treasury (2018) Retirement Income Covenant Position Paper: Stage one of the Retirement Income Framework – May 2018, Commonwealth of Australia, Canberra

⁵ Productivity Commission (2018) Superannuation: Assessing efficiency and competitiveness – Productivity Commission Draft Report, Government of Australia, Canberra

The draft report, (which is not the first issued by the Productivity Commission in relation to superannuation policy⁶),⁷⁸ discussed matters related to fund member engagement with their superannuation funds. Factors that have made this engagement challenging for members, include product complexity, a constantly changing tax regime and consequent impacts on superannuation, an absence of plain English information on the relevant funds and their benefits, and the difficulties in finding appropriate financial advice. It also stated that a low level of direct member engagement is to be expected in a compulsory system in part, because trustees have the responsibility to act on behalf of fund members and act in their best interests. A retirement incomes covenant such as the one proposed in this first position paper reinforces the trustee's duty to act in the best interests of the fund member in relation to superannuation products that are suitable for the retirement income goals of the individual fund member.

The obligation of trustees of superannuation funds will be fulfilled differently depending on the kind of entity or fund that is managing superannuation assets. PwC (2014)⁹ noted in a submission to the FSI that the governance structures of public offer superannuation funds have a board of trustee directors with knowledge across a range of disciplines such as law, finance, treasury, business operations and regulation. It is expected that the boards of public offer superannuation funds will have access to the necessary corporate expertise – and external expertise where relevant – to make decisions that relate to the development of investment strategies that align with the objectives of the CIPR. This is a sharp contrast to what happens at the other end of the superannuation fund spectrum with self-managed superannuation funds. PwC (2014) stated that the appropriateness of investment strategies determined by some SMSF trustees were concerning. Strategies characterised as being poor by PwC include allocating a high proportion of superannuation assets into cash and Australian equities rather than spreading the superannuation funds across a range of asset classes. Other concerns include the investment of 100% of a fund's assets into one property or into investments that are excessively geared. The capacity of SMSF trustees to make strategic investment decisions as they grow older declines (Earl et al 2015, Mather 2015)^{10 11} due to a range of factors. Earl et al (2015) explored the variances in retirement self-efficacy resulting from the interaction of age, cognitive ability, financial literacy and the self-rated dementia symptoms. The study found that people reporting symptoms of dementia appeared more vulnerable to making poor strategic investment decisions for the self-managed superannuation fund. These findings suggest there may be merit in the government further

⁶ Productivity Commission (2015) Superannuation Policy for Post-Retirement: Productivity Commission Research Paper, Volume 1: Chapters, Government of Australia, Canberra

⁷ Productivity Commission (2015) Superannuation Policy for Post-Retirement: Productivity Commission Research Paper, Volume 2: Supplementary Papers, Government of Australia, Canberra

⁸ Productivity Commission (2016) Superannuation: Alternative Default Models – Productivity Commission Issues Paper September 2016, Australian Government, Canberra

⁹ PwC (2014) Submission to the Financial System Inquiry, March.

¹⁰ Earl, Joanne K ; Gerrans, Paul ; Asher, Anthony ; Woodside, Julia (2015) Financial literacy, financial judgement, and retirement self-efficacy of older trustees of self-managed superannuation funds, Australian Journal of Management, Vol.40(3), pp.435-458

¹¹ Mather, J. (2015, Jul 18). Mental agility test may aid SMSF plans. The Australian Financial Review Retrieved from <https://search-proquest-com.ezproxy.csu.edu.au/docview/1747257724?accountid=10344>

exploring the role SMSFs play in the superannuation system and whether there is any statutory or administrative intervention that should take place when the capacity of a trustee's decision making on financial matters is noticeably impaired by mental illness.

The covenant does not, however, remove the obligation of fund members to seek information themselves to better understand what is happening to their superannuation assets. Regulators such as the Australian Securities and Investments Commission (ASIC) already provide information on the main ASIC web site¹² as well as the Money Smart website¹³.

Financial Services Royal Commission

Concerns have been heightened by the conduct of trustees and superannuation advisers as a result of recent evidence presented to the Financial Services Royal Commission¹⁴ being presided over by former High Court Justice Kenneth Hayne QC. Case studies related to the provision of advice on self-managed superannuation funds have exposed inappropriate advice provided to clients^{15,16} as well as the failure of financial institutions to deal promptly and satisfactorily with client concerns. While Federal Treasury's consultation on the development of a retirement incomes covenant predates the announcement and work of the commission, the evidence regarding inappropriate advice given to consumers on superannuation matters should inform the development of the final framework.

Covenant principles

The IPA-Deakin SME Research Centre strongly supports the retirement income covenant core principles;

1. The development and existence of a retirement income strategy
2. Facilitating the engagement of fund members with decision making on matters concerning their own retirement.

Retirement income strategy

Requiring the trustee acting on behalf of fund members to develop a retirement income strategy that focuses on the collective need of fund members is supported. The trustee will develop and implement a strategy by giving consideration to a range of factors that include:

¹² <https://www.moneysmart.gov.au/life-events-and-you/over-55s/supporting-older-australians> [accessed 12th June 2018]

¹³ <https://www.moneysmart.gov.au/superannuation-and-retirement> [accessed 12th June 2018]

¹⁴ The Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry web site can be found at <https://financialservices.royalcommission.gov.au/Pages/default.aspx>

¹⁵ Australian Associated Press (2018) Westpac advice cost couple dream retirement, banking royal commission hears, The Guardian Online accessed at <https://www.theguardian.com/australia-news/2018/apr/19/westpac-advice-cost-couple-dream-retirement-banking-royal-commission-hears> [accessed 11th June 2018]

¹⁶ Michael McGowan (2018) Banking Royal Commission: AMP says adviser with conflict a 'grave concern', the The Guardian Online, 23 April 2018 at <https://www.theguardian.com/australia-news/2018/apr/23/banking-royal-commission-anz-amp-nab-evidence-live> [accessed 11th June 2018]

- Maximising income for life for members;
- The potential life spans of members and the costs and benefits of managing longevity risk for members as a whole; managing risks that affect the stability of income, including inflation;
- Providing members with access to capital;
- Member needs and preferences for the factors above; the costs and benefits to members of developing a CIPR in-house compared with offering a CIPR developed and managed by a third party or a combination of both in-house and a third party;
- Expected member eligibility for the age pension; and,
- Whether and how cognitive decline may affect outcomes.

It is noted that the factors that appear above, are the subject of a trustee's professional judgement and legal protection or 'safe harbour' will be important to protect trustees that have taken all reasonable steps to ensure that they have fulfilled the requirements under the covenant.

A significant shortcoming of this core principle is that it is defined as the only principle relevant to SMSF trustees when in fact considerations in other parts of the document are of equal, if not greater, importance to SMSF trustees. The circumstances in which a fund member's illness may suggest that a different assumption needs to be made for life expectancy is not solely a consideration for larger funds. It could be assumed that the guidance on the issue of considering terminal illness or low account balances is sufficient for larger funds with greater financial resources to access relevant financial planning and actuarial advice. SMSF trustees may require further detail in a set of principles such as this to ensure they have considered all issues that might be relevant in the case of their fund.

The text of the first of these two core principles should be amended in the first instance to ensure that SMSF trustees are aware that all of the principles apart from core principle two, which is outlined below, may apply to their SMSF depending on the nature of their fund. Such an amendment to the text of the first principle will provide the SMSF trustee with a prompt to consider all of the contents of the principles that might be relevant to the circumstances of their fund.

The Government should also consider reinstating the requirement for SMSFs to have an annual audit, which the government removed in the Federal Budget 2018-19 and replaced with a triennial audit. An annual audit of SMSFs represents an opportunity for the trustees to receive assurance that they are complying with the relevant financial reporting and superannuation laws. Annual audits also provide the Government and agencies such as the Australian Taxation Office with assurance that funds are complying with the relevant legislation. An annual audit may also be used as a way of ensuring that SMSF trustees present evidence of an appropriate investment strategy that aligns with the objectives outlined in the covenant. Guidance developed by the Auditing and Assurance Standards Board (AUASB)¹⁷ for

¹⁷ Auditing and Assurance Standards Board (2015) Guidance Statement GS 009 Auditing of Self-Managed Superannuation Funds, Commonwealth of Australia, Melbourne

the audit of SMSFs would need revision in order to ensure an audit of an entity's compliance with the covenant as well as other relevant legal requirements. Paragraph 280 of the guidance statement refers to the obligations of the trustee and the tests the auditor must complete to ensure the trustee compliance with the investment strategy requirements. It should be noted, however, it is not the auditor's role to determine the appropriateness of an investment strategy, which is the responsibility of the trustee. Continuing the process of an annual audit would assist in maintain a regular level of oversight and reporting to the ATO and also ensure that SMSF trustees are focused on ensuring the fund is meeting its objectives.

Engagement with the fund

The second core principle is the facilitation of member engagement with superannuation funds by the provision of information that compares the benefits arising from different financial products administered by the same trustee. Member engagement has largely been automated by the use of online portals that provide comparative information regarding the benefits and associated risks of financial products, which is an effective means of communicating with fund members.

While the notion of fund member engagement is important, the Productivity Commission has also found that member engagement remains low. It is not realistic for all members to be expected to engage with their funds all the time but higher levels of engagement are observed among those fund members that are reaching retirement age or have high fund balances or are owners of self-management superannuation funds. There is also a low level of financial literacy observed amongst a minority of fund members. Greater effort will need to be made by the Government, fund managers and trustees so that fund members are consistently and regularly encouraged to maintain an active interest in their superannuation assets. This should be undertaken through renewed awareness campaigns via mainstream media and online. The Australian Securities and Investments Commission has a web site dedicated to increasing awareness and understanding of the implications of different decisions fund members could make in relation to superannuation. A further option in the longer term objective is to ensure increasing community understanding about matters such as taxation and superannuation forms a part of the school curriculum at primary and secondary level. Greater knowledge of tax and superannuation matters may also assist in growing fund member engagement over time as students entering the workforce encounter taxation and superannuation at a practical level during their working life.

Definition of a Comprehensive Income Product for Retirement (CIPR)

The definition of a CIPR in the position paper is as follows:

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

- *Efficient, broadly constant income, in expectation*
- *Longevity risk management (income for life)*
- *Some access to capital*

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

We support this definition because it emphasises the need for a CIPR to have several elements that contribute to the overall objective to provide income for life for a member of a fund.

A process of certifying a CIPR is mentioned in the position paper and the Government notes that such a certification process should be principles-based so the framework is product neutral and it does not limit any future innovation in product development. It is important that the Federal Government provides an outline for the process of certification as soon as practicable given that the certification process will ultimately govern what products or mix of products is deemed to be compliant with the definition of a CIPR. The certification process will also be an important regulatory measure to ensure trustees and superannuation funds comply with the overall intent of the covenant.

The covenant should also contain specific guidance for SMSF trustees on ways in which they can ensure an SMSF meets the objectives set down in the principles for a CIPR. Such guidance will be required for SMSF trustees because not all of them will have a sophisticated understanding of financial products and actuarial calculations. There is merit in the provision of further guidance for SMSF trustees that serves as a prompt for them to seek further advice on the way in which superannuation assets in their fund are allocated. Such guidance may include a recommendation they seek independent advice on their existing strategy and any changes from individuals with the necessary expertise.

Offering a flagship CIPR

We support the concept of requiring trustees to offer a flagship CIPR to fund members as a default provided the fund concerned has been certified as complying with the overall objectives outlined in the covenant. It is noted that trustees would have the ability under the covenant to offer up to three flagship CIPRs without the offer of the three CIPR offerings constituting financial advice. This would allow trustees to provide three options from which fund members would be able to choose depending on their eligibility status for the aged pension. Each option will need to be clearly explained by the trustees so that fund members are able to understand the purpose each CIPR is intended to fulfil.

Third party products may be offered

Nothing has come to our attention that would cause it to object to this element of the covenant. Trustees should be able to access third party products they believe meet all of the objectives as set out in the covenant. This is an area where the trustee will need to match the covenant criteria for a CIPR up against third party offering and do the required due diligence before offering third party products to fund members.

Further guidance for SMSF Trustees on the way in which this particular principle impacts on the running and administration of their fund is required so that they are aware of their obligations regarding investment choices they make for the fund. This section of the covenant is of greater relevance to the SMSF sector and it requires tailored guidance so that trustees with

a less sophisticated knowledge of financial products are prompted to seek further financial planning, accounting or actuarial advice to help them with their role.

Consent of fund members to be obtained

The position paper proposes that the fund member must provide explicit consent for a CIPR to commence. This is an integrity measure that ensures that any or all changes to superannuation arrangements are dealt with appropriately by the trustee. It also provides checks and balances for interested fund members; ie the ability to ask further questions of the trustee before signing an agreement for new retirement income arrangements to be effective. There is a need, however, for the Government and the superannuation sector to ensure that members are made aware of the implications of the CIPR in which they are investing superannuation assets. It is important that the Government provides funding for a financial literacy campaign when the covenant is operational so that fund members are fully aware of the consequences of agreeing to participate in a CIPR.

Offering an alternative retirement income product through advice

We support this element of the framework for the retirement income covenant as there may be valid reasons to provide alternative products to individual fund members. A reason for choosing an alternative product, for example, may be the specific needs and wishes of an individual client relating to their specific circumstances.

Exception for individuals for whom CIPRs are unsuitable

We support the proposal that the framework should provide trustees with sufficient flexibility in circumstances where CIPRs are inappropriate because of extenuating circumstances. Use of such an exemption could be required in circumstances where the trustee is aware that a fund member has a terminal illness or has \$50,000 or less in superannuation assets in a fund. Individuals with a terminal illness are unlikely to need a product that has longevity protection associated with it because of their short life expectancy. The position paper acknowledges individuals with low superannuation balances are more likely to receive better longevity protection if they received an aged pension. While longevity protection may be a good overall objective, the trustee of a fund must be able to modify their own approach to managing a fund in circumstances where the standard approach would lead to an anomalous outcome.

SMSF trustees may benefit from additional guidance in the framework that deals with what consideration, if any, should be given to other conditions that may shorten a person's life such as obesity and diabetes. Such guidance in the covenant principles for SMSF trustees will provide a prompt for further consideration of the impact of other illnesses or disabilities on life expectancy.

Covenant principles and regulation

The underlying principles of the retirement income covenant are sound overall but the principles are only as good as the regulatory monitoring and enforcement mechanisms set up to ensure the superannuation assets of fund members are being properly managed. This initial position paper does not deal with the areas of enforcement that may be relevant. It is vital that the Government finalises and issues position papers on how it is proposed that these principles contained within the covenant will be regulated.

Timeline for legislating the retirement income covenant

Additional regulation always poses implementation and compliance challenges for any sector of the Australian economy. The financial services sector is no exception. It is noted that the Federal Government intends to legislate the retirement income covenant by 1 July 2019 with commencement of the relevant provisions of the law being delayed until 1 July 2020. This forward plan for legislating the covenant provides entities in the financial services sector that are affected by its introduction with ample time to assess implications and to put in place strategies to manage the impact of the new covenant.

The published timeline has other advantages for the Federal Government. There are a series of reviews of the financial services sector such as the Productivity Commission's draft report on the superannuation sector and the Hayne Royal Commission. A Senate parliamentary committee on red tape reduction has also proposed an inquiry into the financial services sector that may also produce findings that build on the work of the royal commission and the Productivity Commission's research into the superannuation sector. A 1 July 2020 implementation deadline provides the Federal Government with the ability to factor in recommendations and findings of each of the reviews where relevant in the final design of the retirement investment covenant.

Relationship Issues

There may be merit in the covenant referring to the impact of relationship issues on the retirement income of a fund member. Spouses and dependents do not appear anywhere in the current position paper and there is no mention of what trustees must consider in the event of a relationship breakdown. At the very least there is merit in considering what guidance, if any, the covenant can provide SMSF trustees on these matters.

Future considerations

We support the development of the additional stages of the retirement income covenant that were identified by the advisory group. Each of these stages – lifetime engagement with fund members, methods of dealing with legacy products - is worthy of detailed exploration. The IPA will participate in each of these stages of consultation as position papers are released for comment.