Australian National University

4 August 2021

College of Business and Economics (Building 26C)
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Attention:
Director - Retirement, Advice, and Investment Division
The Treasury
Langton Crescent, PARKES, ACT, 2600
superannuation@treasury.gov.au

Re: Submission on the Retirement Income Covenant

Dear Director,

I welcome the opportunity to make a submission on the Retirement Income Covenant, in response to the Position Paper dated 19 July 2021.

This submission is based on my own research and knowledge, and does not represent the official view of the Australian National University (ANU). Further, other ANU representatives may make submissions on their own behalf that may not agree with my comments or suggestions.

My submission follows after this covering letter. It is supported by an opinion piece that I have written in conjunction with David Bell of the Conexus Institute, which has been submitted as supplementary material. In addition, I have been conducting substantial research into the design of retirement strategies over recent years and refer to a number of my papers, which are listed at the end of the submission. I can make any of these papers available upon request.

I would be pleased to provide more input or discuss my submission if that would be of assistance. My email address and mobile number appear below.

Yours sincerely,

G Warren

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Submission on the Retirement Income Covenant

A/Prof. Geoff Warren

College of Business and Economics, The Australian National University

1. Overview

The Retirement Income Covenant (RIC) will be an important component of Australia's retirement policy framework. In particular, it should act as a catalyst for development of retirement strategies by superannuation funds. The heart and soul of the RIC will be the obligations that it places on fund trustees, which should drive progress by requiring funds to undertake certain actions. ***The scope and nature of the obligations placed on fund trustees are thus the main focus of this submission.***

The RIC Position Paper is penned around placing an obligation on trustees to develop and give effect to retirement strategies for their members. In this regard:

- I support the proposed principles-based (i.e. non-prescriptive) nature of these obligations. I also presume that direction and guidance around giving effect to these obligations will largely be left to the regulators in terms of APRA Prudential Standards and ASIC Regulatory Guidance, along with supplementary policy direction and legislation where required. This seems an appropriate approach that allows a suitable degree of flexibility.
- I broadly support the principle that retirement income strategies should *primarily* be designed to balance the three stated objectives of: (a) maximising retirement income; (b) managing risks to the sustainability and stability of retirement income; and (c) provide some flexible access to savings during retirement. I support them being written into the RIC as primary objectives, but query below the extent to which trustees will be permitted to pursue *other* objectives that some members may have.

Notwithstanding my broad support for how the RIC Position Paper describes the potential obligations around retirement strategies, I offer suggestions for improvement in five areas:

A. **Scope of the obligation to pursue the three objectives** – The RIC should make clear ***whether or not trustees are required to deliver retirement strategies directed exclusively at the three primary objectives, or whether there is scope to cater for other objectives held by members.*** The need to be clear in this regard is highlighted by considering the role of bequests. Would fund trustees be permitted to develop strategies that cater for retirees with a strong bequest motive; or would this be deemed in contravention of the RIC? See Section 2.

B. **Addressing member differences** – An explicit obligation should be placed on trustees to ***identify and take into account all factors that lead to significant differences in the needs of their retired members***. The RIC Position Paper takes the stance that identification of relevant factors should be at the discretion of trustees. This leaves too much room to skirt around the need to address the widely differing needs of retirees. A more definitive obligation should be placed on trustees to directly address member heterogeneity. See Section 3.

C. **Preferred delivery mechanism** – An obligation should be placed on fund trustees to ***establish the member's preferred mechanism under which suitable retirement strategies are chosen, and then give effect to these preferences.*** A key aim would to be to accommodate 'fund-guided choice', as described in my joint paper with David Bell of the Conexus Institute that is provided as supplementary material. See Section 4.

D. **Addressing disengaged members** – An avenue should be established to ***address members who are likely to be retired but do not choose a retirement strategy***, to help ensure that they are not inadvertently left in the accumulation phase. See Section 5.

E. **Review requirements** – Regular reviews of fund performance seem impractical, given the nature of retirement income streams and existence of multiple objectives. It is suggested that the proposal for a ***'1-year' performance review be ditched, and reliance be placed on the '3-year' review of the overall retirement strategy augmented by evaluation of selected measureable elements***. See Section 6.

Finally, the Appendix outlines the key factors that need to be addressed in order to develop appropriately tailored retirement strategies. It also discusses how strategies might be implemented under a 'building blocks' approach.

It would be ideal to have all five matters listed above addressed within the RIC, to the extent that it is the pinnacle policy document establishing trustee obligations with regard to designing and giving effect to retirement strategies. Nevertheless, it may not be practically feasible to implement all suggestions within the RIC at this time, given the legacy framework in existence and the short time frame over which the RIC is to come into operation. In this regard, the scope of trustee obligations regarding the objectives (point A), strengthening the requirement to address heterogeneity (point B) and the review process (point E) should be addressed in the drafting of the RIC at this time.

Choice of delivery mechanism (point C) and addressing disengaged members (point D) may be difficult to implement immediately, but are matters that I consider to be very important to incorporate within the overall retirement framework. These matters are discussed in the hope that they will be placed on the agenda, perhaps with a view to revising the RIC in due course. In particular, 'fund-guided choice' may be tricky to bring into effect under the current financial advice rules, which may not be revised until after the quality of advice review scheduled for 2022. Section 4 and Section 5 offer thoughts on how these two features might be implemented. This includes a suggestion that fund trustees might be given an exemption from providing a full Statement of Advice when a member elects for fund-guided choice, substituted with a requirement to check with members that any retirement strategy they are offered is suitable for their needs.

2. Scope of the obligation to pursue the three primary objectives

The RIC Position Paper is very clear that fund trustees will be required to develop strategies that assist retired members to balance the three objectives of maximising income, managing income risk and providing some flexible access to savings. What is unclear is whether trustees have scope to develop retirement strategies that cater for other objectives that members may have. This issue relates to the philosophy underpinning the formulation of retirement policy. Should fund trustees be permitted to accommodate the personal desires of their members? Or is their role under the RIC to help give effect to the policy goal of encouraging members to better utilise their retirement savings by converting more of those savings into income? ***The obligations of trustees in this regard should be made apparent within the RIC. It should be explicitly stated either that retirement strategies should be designed exclusively towards the three objectives as outlined, or that trustees have latitude to develop and offer strategies that may cater for other objectives.*** My personal preference would be to provide scope to cater for other objectives, coupled with strong encouragement for trustees to guide members towards strategies that address the three objectives.

The litmus test of this issue is how bequest motives will be treated. The RIC Position Paper (page 13) adopts the stance that the primary intent of retirement strategies should not be to generate bequests for non-dependents; while recognising that incidental bequests may occur nonetheless, and that retirees may choose to manage their affairs to generate bequests if they so desire. The latter implies that it is acceptable for members to pursue bequests under their own volition. The question that is not answered is what happens if a fund caters for these members by developing and offering a retirement strategy designed to generate substantial bequests? Would they be in contravention of the RIC? Whether or not a contravention would occur should be set out in the drafting.

3. Obligation to identify significant factors, and take them into account

One of the biggest challenges in developing an appropriate range of retirement strategies is dealing with individual differences, i.e. member heterogeneity. The impact of member heterogeneity on retirement strategies is a topic that I have been researching in recent years, partly in conjunction with colleagues at ANU.[1] Desired outcomes and hence the retirement strategy that is most suitable can vary across retirees in fundamental ways, depending on both their financial circumstances and preferences.[2] The Appendix provides a sense for the degree and

[1] See Bell and Warren (2021), Butt, Khemka and Warren (2021a, 2021b) and Warren (2021).

[2] Butt, Khemka and Warren (2021a) show how that 'optimal' retirement strategies vary substantially with balance, homeownership, income objective and risk appetite.

importance of this heterogeneity by discussing the key factors that may influence the design of ‘optimal’ retirement strategies. These include total available assets (i.e. not just the retirement account balance in isolation), homeownership, partnered status, the type of income stream desired and risk appetite. It is also noted that bequest motives can be influential where they are strong. The RIC should be framed to ensure that fund trustees ***directly address heterogeneity*** of their retired members in order to cater for their needs in an appropriate manner.

The RIC Position Paper recognises the presence of member differences. It states that trustees will be required “*to ensure that all the members of the fund are covered by the strategy*” (page 9) under a cohorting approach, and acknowledges that a range of factors may be important in this regard. However, it also states that the selection of these factors should be left to the discretion of trustees.[3] While I broadly support not being overly prescriptive around strategy design within the RIC, something a bit stronger is needed to ensure that trustees address heterogeneity in meaningful way, and don’t brush it aside.

My suggestion is that the RIC includes an obligation on trustees to ***“identify and take into account all factors that may lead to significant differences in the needs of their retired members”*** as they develop and give effect to the range of retirement strategies offered (or some other statement to this effect).[4] The operative words here are “identify”, “take into account” and “significant”. The aim would be to create an explicit obligation to identify and consider important member differences, without going as far as requiring that these differences *must* be addressed. This recognises that doing so may be practically infeasible or prohibitively expensive.

Implementation Considerations

The obligation being suggested here would *work in conjunction with member outcome assessments and the design and distribution obligations (DDO)*. It may even be appropriate for *regulatory guidance* to specify the most important factors that trustees should consider in due course. A further consideration is *removing barriers to fund trustees accessing the required member information*. Potential information sources may be opened up by permitting funds to ask members to furnish information without triggering the need for a full Statement of Advice (see advice discussion in Section 4); and perhaps making certain information more available from Government bodies such as the ATO or Centrelink.

4. Obligation to engage over preferred delivery mechanism, and accommodate accordingly

My comments here are based on Bell and Warren (2021), which is provided as supplementary material. The underlying thesis is that retirees can be viewed as differing along two dimensions. The first dimension is their financial circumstances and preferences, which are directly relevant for determining the retirement strategy that is most suitable for their needs. The second dimension is their willingness and capacity to engage with financial decisions, including their preparedness to pay for financial advice. The proposition is that the retirement framework should be designed to ensure retirees are offered choices along both dimensions. That is, they should not only be able to choose the strategy they prefer, but also how that strategy is identified and delivered.

Bell and Warren (2021) argue that many members would prefer their fund to select a retirement solution on their behalf, which is called ‘fund-guided choice’. Fund-guided choice might be delivered through either the fund making a recommendation that the retiree could accept or otherwise; or through the member requesting that their fund assigns them to a strategy. The latter would involve a sign-off process. Bell and Warren (2021) set out why fund-guided choice might be embraced by some members; how it may lead to better choice in some situations; and the benefits it offers in terms of accommodating the introduction of potentially beneficial nudges.

Member choice with regard to how a suitable retirement solution is identified could be given effect by placing an obligation on fund trustees to engage with members at retirement to establish their preferred delivery mechanism, and then accommodate these preferences. Accommodating these preferences might entail the

[3] The Position Paper (page 9) states “*The factors used to identify cohorts of their members are at the discretion of the trustee*”, before going on to list examples of some factors.

[4] This suggestion is largely aimed at ensuring strategies are designed for cohorts in a way that accounts for significant dimensions along which members differ. If this obligation is to be implemented at the individual member level, then consideration may need to be given to the interaction with the financial advice rules. See Section 4 for further discussion.

combination of a process to identify the most suitable strategy to offer for those who select fund-guided choice, making available appropriate information and decision support tools for retirees who prefer to choose for themselves, and offering referrals to financial planners for those who want comprehensive financial advice. These functions might be provided by the fund directly, or outsourced to external parties.

The RIC seems the appropriate instrument to carry any obligation to engage with members over the preferred delivery mechanism, so it sits alongside the obligation to develop retirement strategies. However, it may be difficult to include this obligation within the first iteration of the RIC in way that supports fund-guided choice, if it is to come into effect on 1 July 2022. A major hurdle is the ability of funds to seek personal information from members and then recommend a suitable strategy is tenuous under the existing advice rules. A suggestion is offered further below for how the advice rules might be adjusted rules to accommodate fund-guided choice. Consideration might be given to updating the RIC after any adjustment to the rules around financial advice.

Implementation Considerations

Implementing choice of delivery mechanism would require funds to engage with members who have indicated that they have retired over two matters:

(i) *Ascertain how the retiring member wants their superannuation balance to be deployed* – Trustees would need to establish the amount to be transferred into a retirement strategy offered by the fund, and the amount that the member wishes to be paid out as either a lump sum or transferred to another provider.[5]

(ii) *Ask the member to elect a preferred delivery mechanism* – The member might be asked to nominate one of the four options appearing in the figure below as their preferred means for identifying a suitable retirement strategy with respect to any balance retained within the fund. Option A and B amount to fund-guided choice, and might then be followed by an invitation to furnish the fund with additional information to assist in making the selection of a suitable solution.

Choices that might put to a retiring member by their fund

Please choose one of the following options:	
A. Please assign me to a retirement solution	○
B. Recommend a retirement solution to me	○
C. I want to choose a retirement solution for myself	○
D. Please refer me to a financial planner	○

Discussion on each of the above choices appears in Bell and Warren (2021).

Relief from Comprehensive Advice Rules

The existing advice rules create a significant hurdle to achieving fund-guided choice, and indeed act to inhibit the ability of funds to assist members in choosing a suitable retirement strategy in general. Even if members may be looking for their fund to provide some direction, fund trustees will remain reluctant to do so under the advice rules as they stand. The current situation runs a risk that members (at least those unwilling to pay for financial advice) are left to their own devices and could make poor decisions. ***The rules surrounding financial advice need a reboot.*** I am sure that I am not the only one who will be making this point.

To accommodate fund-guided choice, a path is required that allows fund trustees to collect information from members and recommend a retirement strategy without falling foul of the advice rules. ***Could it be possible to use a request by a member for the fund to select a retirement strategy on their behalf (i.e. option A or B) as a trigger for exemption from the requirement to provide a full Statement of Advice?*** This could be replaced by

[5] The scope to utilise other providers might be brought to the attention of retiring members at this stage of the process, in order to introduce an element of competitive tension.

an alternative requirement to communicate with members in a way that allows them to gauge whether the proposed strategy is actually suitable for their needs. A rough indication of how such a communication process could operate can be found in Warren (2021).[6] The communication might entail: (a) setting out the key features of the strategy that has been selected, (b) describing the type of member for which the strategy is designed, and (c) stating the assumptions made about the retiree in question when choosing that strategy for them. The communication would be aimed at allowing the retiree to judge for themselves if the strategy is suitable for their needs (i.e. they are of the member 'type' described in the communication), before proceeding to sign-off. The retiree might also be alerted to the existence of alternative strategies and the availability of comprehensive financial advice, in case they feel that the strategy being proposed is unsuitable.

Under this type of system, fund trustees would still remain subject to the general requirements to operate in the best interests of members, as well as the DDO. This would provide the required consumer protections.

5. Addressing retired members who do not make a choice

Bell and Warren (2021) also raise the need to address retirees who do not make a choice even when approached "*either because they are totally disengaged, suffer from inertia or are simply too confused*" (page 7); and that this may be justified on consumer protection grounds. ***The retirement framework should be designed to cater for heavily disengaged members.*** As discussed above, if this matter is not addressed in the current draft of the RIC, it should be placed on the agenda.

A key issue is whether addressing such members should entail a default mechanism, or a process involving less compulsion. At a minimum, there might be an obligation placed on fund trustees to regularly attempt engagement with retirement age members who have registered no response, with a view to establishing their retirement status and preferences in line with the procedure outlined in Section 4. However, this could result in some retired members being left in the accumulation phase inappropriately.

The most effective way of ensuring that heavily disengaged members are addressed would be to empower trustees to default members into a retirement option under certain conditions. This solution gives rise to the challenge of specifying the conditions under which trustees are permitted to make an assignment. Some issues include establishing that transferring the member's balance into the retirement phase is their best interests, and operational hurdles including obtaining bank account details for income payments and checking that the member is not limited by the ($1.7 million) transfer cap due to the existence of other accounts. A default mechanism would also run counter to a purely choice-based system. A simple policy solution might be to legislate automatic transfer into a retirement account at age 65 (an unrestricted trigger of release), with the ability for members to opt-out.

6. Review of Retirement Strategies

The RIC Position Paper discusses the intentions with regard to "*reviewing the strategy*" on pages 15-16. I am supportive of the proposals regarding the '3-year' review into the "*appropriateness, effectiveness and adequacy of their retirement income strategy*" and communicating the conclusions of reviews to members. However, the proposal to regularly "*review their fund's performance against their retirement income strategy*" is quite problematic. ***The requirement for regular performance reviews should be discarded, and reliance placed on the '3-year' review of the overall retirement strategy augmented by evaluation of selected measureable elements.***

Performance evaluation needs to occur against objectives. The RIC Position Paper mentions three objectives of maximising income, managing income risks and some flexible access to savings. Assessing performance against multiple objectives is extremely challenging, especially when trade-offs between the objectives are involved. In addition, performance with regard to each of these objectives is difficult to evaluate. Performance metrics are hard to devise, as are the benchmarks against which performance will be measured. For instance, the objective of maximising income refers to a stream of payments over the entire retirement phase. This cannot be easily observed on a yearly basis, given that much of the income stream sits in the future and is yet to occur. A metric might be

[6] Communications along the lines suggested here are illustrated in Figure 2, Table 4 and Table 5 of Warren (2021).

crafted around the sum of realised plus future projected retirement income, which might be benchmarked against the value of that income stream as estimated previously. However, this is somewhat tricky to do, and ultimately subjective as projected income depends on many assumptions. Meanwhile, any risk management (e.g. annuity purchases) may come at the cost of lower income, requiring a means of trading off income level and income risk.[7] The mind boggles to think of how the totality of a retirement strategy might be evaluated versus objectives in a manner that could be readily applied by most funds, and without opening up scope for gaming of outcomes.

In the absence of being able to readily evaluate the performance of the overall retirement strategy, an alternative approach would be to focus on whether the strategy is well-designed to meet the needs of retired members. As the proposed 'three-year' strategy review is aimed at achieving just this, it is suggested that this review be made the focal point. The review could incorporate retrospective performance evaluations to a degree through examining selected elements that are measurable and may assist in making improvements. A few examples of the type of elements that might be examined include:

- Investment performance within any return-seeking component of the strategy
- Effectiveness of risk hedging mechanisms in protecting income if investing returns are poor
- Manner in which the strategy adjusts drawdowns over time, and whether this has operated efficiently
- Extent to which members use various strategies, to help gauge whether the menu of options is appropriate
- Member engagement with the choice of retirement strategies, especially at the point of retirement
- Member feedback on satisfaction with the strategies they have chosen, including a review of any issues and problems communicated by members

APPENDIX

Important Factors for Tailoring Retirement Strategies, and Feasibility of Catering for Them

Listed below are factors that can have the largest influence[8] on the type of outcomes that may be desired by retirees, and hence how retirement strategies should be designed to meet their needs and wants. This list largely derives from Butt, Khemka and Warren (2021a, 2021b), noting that the latter considered research undertaken by others. It also relies on some (hopefully informed) judgement.

- **Total available financial resources** – The total assets available[9] to support the generation of retirement income is what matters, and not just the retirement account balance in isolation. Research indicates that financial resources are a major driver of the strategy that is most suitable for a retiree, especially where there exists an income target, and given interactions with the Age Pension under means-testing. A key implication is that fund trustees should ideally be allowing for assets sitting outside of the member's superannuation account in both designing and offering retirement strategies.

- **Homeownership status** – Whether a retiree is a homeowner or a renter is an important differentiating factor, as pointed out by the Retirement Income Review completed in November 2020. Renters are likely to require higher income than homeowners to achieve an adequate lifestyle. Homeownership might also be converted into income through reverse mortgages or the pension loans scheme (albeit not widely used at present).

- **Partnered status** – Partnered status can influence total available financial resources (e.g. there may be two superannuation funds), spending needs, Age Pension payments and the period over which income is required

[7] In the context of academic research, utility functions have been used to evaluate the distribution of expected outcomes arising from a strategy, thus accounting for both expected income and the risk surrounding that income. While utility functions can be useful for strategy design (see Warren, 2021), they are less suitable for evaluating realised performance.
[8] Other attributes might include: desire for some precautionary balances, other available income streams, health status, longevity (may differ with gender and socio-economic status), and scope for support from others (e.g. rich, aging parents).
[9] Any debt should ideally be taken into account.

(i.e. survival of the last remaining partner). Retirement strategies should ideally be designed for the household unit, rather than individuals.

- **Access to the Age Pension** – Eligibility for the Age Pension and related supplements needs to be factored into any retirement solution design, as clearly recognised in the RIC Position Paper.
- **Type of income stream desired** – Two broad type of income objective exist. First is a target (i.e. required) level of income, as implied for instance by the ASFA Standards or replacement rates. Second is an objective to maximise the amount of income drawn from available assets over the course of retirement. Each implies quite different drawdown patterns, as well as differing investment strategies to generate those drawdowns. For instance, Butt, Khemka and Warren (2021a) find that it is optimal to draw enough to secure an income target where one exists (no less, and no more – except under an excess of available assets). On the other hand, an objective of maximising income broadly implies determining the drawdown that is affordable given available assets, and then dynamically adjusting the drawdown amount in response to realised investment returns. They also find that it is optimal to speed up drawdowns near the Age Pension taper zone under this objective.
- **Risk appetite** – While outcomes are generated ex post, formulation of retirement strategies is an ex ante exercise that should allow for risk appetite. Retirees may differ in their risk (or loss) aversion. They also may differ in their risk capacity, e.g. inability to bear income falling below some lower threshold. Unsurprisingly, Butt, Khemka and Warren (2021a) find that a retiree with high risk appetite might prefer to invest more aggressively to support higher drawdowns, while running a greater risk that drawdowns need to be wound back if investment returns are poor. Research also indicates that the existence of a minimum acceptable level of income may induce hedging behaviour such as annuity purchase to lock in the minimum.
- **Bequest motive** – Butt, Khemka and Warren (2021a) find that a strong bequest motive gives rise to strategies aimed at building up assets. This includes a greater willingness to take investment risk, reduced drawdowns, and a limited propensity to purchase annuities.

Catering for a Broad Range of Factors Using Building Blocks

The breadth of the factors listed above means that a small number of rigidly defined strategies is unlikely to cater sufficiently for all retired members. Fortunately, accommodating these differences need not be done through creation of a large number of defined products each embedding a specific strategy. A ***building blocks approach*** might be used under which a limited number of components are combined to generate a range of tailored strategies. For example, Butt, Khemka and Warren (2021a) and Warren (2021) formed investment strategies by combining the following:

- An account-based pension comprising various mixes of a growth portfolio and defensive portfolio, which provides both return generation and flexible access to some funds.
- Annuities to provide longevity insurance and underwrite a certain level of income. Note that longevity insurance could be accessed through means other than annuities, including group pooling.
- Two types of drawdown strategy, based around either setting and delivering some specified target income, or alternatively establishing an ‘affordable’ drawdown that is updated in response to investment experience.

The above basic building blocks may be combined in a way that addresses variation in the factors identified above across cohorts.[10] A building blocks approach may even support individually-tailored strategies in due course. The challenges in combining building blocks into a retirement strategy relate to system design, rather than product design *per se*.

[10] For instance, a homeowner with modest financial assets might be better off in a strategy that invests in more growth assets, aims to maximise drawdowns taken over time, and relies on the Age Pension for income protection and longevity insurance. Meanwhile, a renter with a specific income need might be more willing to combine a balanced portfolio with an element of guaranteed income (e.g. through annuities), while drawing down in a manner that delivers their required income.

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Papers Referred to in this Submission

Bell, D and Warren, G. (2021). "Ensuring All Retirees Find a Suitable Retirement Solution", *Conexus Institute*, July, https://theconexusinstitute.org.au/wp-content/uploads/2021/07/Ensuring-all-retirees-find-a-suitable-retirement-solution-27-July-2021-Final.pdf.

Butt, A., Khemka, G. and Warren, G.J. (2021a). "Heterogeneity in Optimal Investment and Drawdown Strategies in Retirement", *working paper*, July, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3750414

Butt, A., Khemka, G. and Warren, G.J. (2021b). "Principles and Rules for Translating Retirement Objectives into Strategies", *working paper*, February, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3777664.

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Thought Pieces with The Conexus Institute

Ensuring all retirees find a suitable retirement solution

3 August 2021

Geoff Warren
Associate Professor
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Introduction[1]

The Government is currently drafting the Retirement Income Covenant (RIC), which is expected to come into operation on 1 July 2022. The RIC will "codify the requirements and obligations of superannuation trustees to improve the retirement outcomes for individuals".[2] This paper outlines what is needed to establish a retirement framework that ensures super funds assist *all* retiring members to find their way to retirement solutions that are not only suitable for their needs, but also accord with how they want to engage with the process.

Our central theme is the need to cater for substantial differences in the willingness and capacity to make financial decisions, and to seek financial advice. We argue that reliance should not be placed entirely on retirees to actively choose a retirement solution for themselves. The ability for retirees to request that their super fund either recommend or select an option on their behalf should be accommodated, which we call 'fund-guided choice'.[3] A mechanism is also needed to

[1] Our thanks to the following people for very helpful comments and suggestions: Anthony Asher, Hazel Bateman, Ron Bird, Marisa Broome, Adam Butt, John Coombe, Jeremy Cooper, Jeremy Duffield, Don Ezra, David Gallagher, Graham Hand, Pamela Hanrahan, Graham Harman, Ashton Jones, David Knox, Estelle Liu, Aaron Minney, Xavier O'Halloran, Deborah Ralston, John de Ravin, Nicolette Rubinsztein and Young Tan.
[2] RIC Position Paper, Treasury (2021, page 2). See: https://treasury.gov.au/consultation/c2021-188347.
[3] The expression 'guided choice' was also used by the Retirement Income Review (RIR, 2020) to describe much the same thing (see pages 454-458).

address fund members who do not choose at all, which might entail a 'safety net' provision whereby trustees can assign retirees to an option under certain conditions.

Our focus is the delivery mechanisms for suitable retirement solutions by APRA-regulated funds. We do not let the existing legal and regulatory environment nor policy guidance constrain our considerations, although do attempt to identify where our recommended mechanisms sit outside existing and indicative constraints. We also offer suggestions on how the RIC might be framed to accommodate differences across member types in their preferred mode of engagement.

Where we currently seem to be heading

The RIC will establish the principles under which super funds provide retirement solutions, which might be seen as comprising a joint drawdown and investment strategy involving one or a combination of products. The fact that accumulated savings of retirees are stapled to a super fund under the *Your Future, Your Super* legislation makes it more likely that super funds will be the dominant provider of retirement solutions and services to their retiring members, at least initially. The Government has indicated a strong emphasis on consumers making an active choice, which is confirmed by the RIC Position Paper (Treasury, 2021). A substantially choice-based architecture in retirement would be quite different from that in accumulation. Diagram 1 outlines what such a system might look like, based on current indications from Government representatives.

<u>Figure 1</u>: Indicated choice architecture for accumulation and retirement.

	Accumulation	**Retirement**	**Assistance**
Within member's 'stapled' fund	1) MySuper default 2) Choice of investment option	1) Role of defaults? 2) Choice of retirement option	• Information • Guidance / tools • Advice offered by fund
External choice	3a) Choice of fund 3b) Choice of investment option	3) Choice from large range of retirement products	• Information • Guidance / tools • Advice by financial planners

Note: This diagram accounts for indicated changes under the RIC and stapling as introduced under Your Future, Your Super.

The choice architecture outlined in Diagram 1 generates some observations worthy of further reflection. Default settings have an important role during accumulation: we estimate that 59.4% of accumulation assets in APRA-regulated fund are invested in MySuper options.[4] However, there has been no mention of comparable arrangements in retirement, with the RIC Position Paper making only indirect references to defaults. This implies that default members during accumulation will need to become active choice-makers once they enter retirement. Under such a choice-based architecture, the ability of consumers to compare retirement products and access the necessary assistance to make an informed decision will become even more critical. The

[4] Based on the APRA (2021). Note that this statistic probably understates the degree of choice, as it does not capture choice of fund or active selection of the MySuper option. We thank Aaron Minney for assistance with this calculation.

potential dissonance in choice architecture between accumulation and retirement runs the risk of exposing many retirees to a complex decision problem that they are not well-equipped to make.

The wide spectrum of retirees

Retirees vary along many dimensions. Many of these dimensions relate to solution design and member cohorting, including their financial situation (financial means, home ownership, single or partnered), and personal preferences (such as desired income and ability to tolerate risk). Many of these dimensions are mentioned in the RIC Position Paper. Catering for these differences requires a variety of retirement solutions, which will itself present a challenge for superannuation funds and other providers.

However, there is another important dimension that needs to be considered: the willingness and capacity to engage. [5] This gives rise to an arguably even greater challenge: *how to help retirees find their way to a suitable retirement solution*. This is no simple matter under a largely choice-based architecture. Retirees need to address a complex multi-dimensional problem. They are likely to have access to multiple products that many will not fully understand. The problem is only compounded by large differences in the capability to make financial decisions or preparedness to seek and pay for financial advice. Diagram 2 recognises these differences by presenting a spectrum of retiree types based on the mode they might prefer when engaging with their fund in identifying a retirement solution. We also note the decision frame implied for each type.

Figure 2: Retirement solution choice – A spectrum

Type	**Preferred mode**	**Decision frame**	**Who would identify an appropriate solution**
1. Fully-advised	Seeks comprehensive financial advice	Fully-advised	Adviser
2. DIY-active	Wants to choose by themselves, perhaps with some assistance	Self-directed choice	Retiree
3. DIY-reactive	Would welcome a recommendation from their fund, but wants to decide for themselves	Fund-guided choice	Fund and Retiree
4. Guided	Would prefer their fund to choose an option		Fund
5. Disengaged	Does not engage at all	Fund selection	Fund

Some implications for how a super fund might cater for each type of retiree are discussed below. Our comments allude to various desirable features and delivery hurdles, while recognising that adjustments to the legal and regulatory framework may be required to overcome some of these hurdles. These may be viewed as suggestions that policy makers might want to consider.

1. Fully-advised – *Seeks comprehensive financial advice.* Some retirees will be willing to engage with, and pay for, comprehensive financial advice. This might be provided by the super fund or outsourced to external financial planners. This decision frame is currently challenged on three

[5] Research identifies different groups of super fund members by willingness to engage. Deetlefs et al. (2019) form five groups based on trust in their fund and revealed interest in their super. A survey by Super Consumers (2021) identifies three groups denoted 'disengaged', 'engaged delegators' and 'engaged DIY'.

fronts. The first is capacity to service retirees *en masse*. Adviser numbers have fallen significantly, and it might be some time before they recover. Second, comprehensive advice is time-consuming and hence expensive to deliver. Many retirees might be unwilling to pay the $3,000-$4,000 it reputedly costs for a full statement of advice, and cost-effectiveness is problematic for those with low assets. Third is the complexity of retirement. The use of stochastic tools to assess retirement risk and address these risks using a variety of different products is not mainstream practice among the advice community. While digital solutions (e.g. robo-advice) might ultimately address some of these issues by increasing capacity and reducing cost, fully digitized comprehensive advice is a future rather than a present reality.

2. DIY-active – *Wants to choose by themselves, perhaps with some assistance.* A self-directed retiree is dependent on a combination of financial literacy and access to appropriate decision support to help them assess the range of possible retirement outcomes and design their own solution by selecting or combining available products. There are several hurdles to the effectiveness of this decision frame. Most important is the capability of retirees to make informed decisions, which we discuss further below. Another is the rules around delivery of financial advice, which arguably need to be (re)framed to remove the barriers around providing retirees with the support they need (even accounting for scope to offer single issue advice). Finally, the required tools need to be made more widely available to consumers. Digital tools (e.g. interactive calculators) would help, although retirees would still be left to interpret the output by themselves. While provision of decision support tools and services may form part of a super fund's retirement strategy, provision may also come from other financial service providers or even the Government (e.g. through ASIC MoneySmart).

3. DIY-reactive – *Would welcome a recommendation from their fund, but wants to decide for themselves.* Some retirees might prefer a recommendation from their fund, which they can then either accept or decide to look elsewhere (thus transitioning to 'DIY-active'). This decision frame aligns with the framework suggested for Comprehensive Income Products for Retirement (CIPRs) by the Financial System Inquiry (FSI, 2014).[6] The provision of product and other information along with tools such as interactive calculators could assist these retirees to gain comfort that the recommended solution is suitable for their needs. This decision frame might be accommodated by super funds applying a cohort segmentation approach to their membership, and developing cohort-based 'tailored defaults'. The recommendation might be presented as designed for the cohort that appears to be the best match for the retiring member, coupled with highlighting the availability of other options, tools and financial advice.[7,8] Again, the rules around the delivery of financial advice may need to be changed in order to facilitate this decision frame.

4. Guided – *Would prefer their fund to choose an option.* We anticipate there might be some retirees who have no appetite to choose for themselves due to a lack of understanding of even the most basic financial concepts. Such retirees might be willing to make an explicit choice to out-source the selection of their retirement solution to their fund. The choice mechanism to

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[6] In development of the initially proposed framework, a limited degree of member fact-finding was considered to facilitate CIPR customisation, which was to occur under a safe harbour arrangement. For details, see Discussion Paper (2016) at https://consult.treasury.gov.au/retirement-income-policy-division/comprehensive-income-products-for-retirement/.

[7] For example, the fund might say something like: "We have three retirement income options tailored for 'representative members' Bill, Jane and Sue. The representative member most like yourself is Sue, so the option that we tailored for her is more likely to be suitable for you. We recommend that you should choose that option. If you do not view yourself as similar to Sue, we invite you to consider other options or take financial advice. We can also provide a range of information and tools to assist you with your decision."

[8] Warren (2021) outlines a process of this type.

accommodate this situation could be a variation on that discussed above for 'DIY-reactive', with the exception that the retiree could be asked to sign-off on the solution they are provided.[9]

5. Disengaged *– Does not engage at all.* There has been minimal focus on the possibility that there could be a class of members that might not engage at all. How totally disengaged retirees may be addressed under the retirement choice architecture is unclear. Nevertheless, the retirement framework would be incomplete if it failed to cater for these members. This might be done by placing obligations on trustees to address retirement-age members who do not make a choice. Trustees might at least be required to attempt to engage with these members, and potentially be given the power to assign them to a solution without their prior consent under certain conditions. We discuss the issues surrounding this decision frame in more detail further below.

Why accommodate fund-guided choice

There are three reasons why it would be worthwhile to accommodate the fund either recommending a solution to a retiree, or choosing one on their behalf:

1. Some retirees might prefer it
2. Their fund might come up with a better choice in some situations
3. It accommodates nudges

The idea of fund-guided choice accords with the concept of libertarian paternalism (Thaler and Sunstein, 2003). It also accords with the suggestions of the FSI (2014) and the Productivity Commission (PC, 2018), both of which proposed putting forward recommendations to fund members in order to overcome behavioural biases and other hurdles to effective decisions.[10]

1. Some might prefer their fund to choose

The idea that some people just want someone to choose for them not only seems intuitive, but has evidence to support it. Findings from a number of studies[11] are consistent with many super fund members being willing to trust their fund; and many embracing the default option not because they are disengaged, but because trust coincides with lack of self-confidence to make financial decisions. These studies also provide evidence that defaulting behaviour can coincide with broader signs of engagement. There is a strong hint in this research that many retirees are looking towards their fund for guidance, in particular those who are daunted by making financial choices. The fact that decumulation is a more complex problem than accumulation might further fuel apprehension over selecting a retirement solution. Retirees who feel like this might welcome an opportunity to ask their fund to either assign them to an option or be presented with a recommendation, rather than being forced to choose for themselves, or seek out and pay for financial advice. Remember that some retirees might not possess even the basic skills required to use online tools or interpret intra-fund advice, let alone understand a Product Disclosure Statement. A fund-guided choice option might come as a relief for such individuals.

2. Fund-guided choice might (sometimes) provide better outcomes

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[9] This might happen in lieu of highlighting the availability of further options and decision support.

[10] For instance, FSI (2014, page 91) said the following about CIPRs: "Pre-selected options have been demonstrated to influence behaviour but do not limit personal choice and freedom. They would bring the policy philosophy at retirement closer to that of the accumulation phase."

[11] See Bateman et al. (2014), Butt et al. (2018) and Deetlefs et al. (2019).

Fund-guided choice might lead to better outcomes in some situations, specifically for many retirees who are not willing or able to take comprehensive financial advice. A majority of people have quite low financial literacy.[12] Added to this are the findings of behavioural research that suggest people can make poor choices,[13] especially when faced with complexity and choice overload.[14] In these situations, they might resort to making decisions based on simple rules of thumb or 'heuristics'. They can be influenced by biases related to information availability and framing effects, or follow uninformed recommendations from friends, family or social media.[15] People tend to suffer from myopia, and might struggle to account appropriately for the retirement time horizon or the compounding of returns over that horizon. Some might become prey to unscrupulous providers and marketing puff. Status quo bias and inertia can also play a role, as well as cognitive decline as people age. Further, people can struggle with interpreting financial disclosures, as ASIC (2019) points out. The Productivity Commission (see PC, 2018) placed particular emphasis on behavioral effects under choice as lessening the efficiency and competitiveness of the superannuation system.

Signs exist that the type of influences described above are at play. A vast majority of retirees (83%[16]) invest in account-based pensions and follow the minimum drawdown rules, which they appear to anchor on.[17] It is entirely possible that many retirees do so as these options are presented most clearly to them, and are taken as a recommendation. The Retirement Income Review (RIR, 2020) discusses how these features are contributing to inefficient use of retirement savings, serving as a warning of how choice does not necessarily generate the best outcomes.

Whether fund-guided choice would provide better outcomes than retirees choosing for themselves is difficult to assess. On one hand, only the retiree fully knows their own personal circumstances. Funds will not have complete information on their members, and could assign retirees to options built for broad cohorts that might not be entirely suitable. On the other hand, funds could have better capability to determine what is the best option relative to a retiring member who makes poor choices under the influence of low financial literacy and behavioural hurdles. Offering retirees the option to have their fund either recommend or choose an option on their behalf, ideally accompanied by well-presented information and interactive calculators, would allow people to balance these considerations. They can then decide if they are more comfortable with either choosing for themselves, or accepting what their fund recommends.

3. Fund-guided choice can accommodate nudges

Fund-guided choice can have the spin-off benefit of providing scope for nudges[18] to be introduced into the decision process that could lead to better outcomes for retirees. Both FSI (2014) and PC (2018) explicitly suggested putting recommendations to retiring members for this reason. Innovative and beneficial solutions run the risk of receiving minimal take-up in a member choice environment if they fail to get traction with individuals or their advisers. Meanwhile, it is well known that default settings are very influential.[19] Fund-guided choice could help support a broader take-up of beneficial solutions by presenting them as fund recommendations or offerings, thus positioning these solutions as a baseline that retirees might be predisposed to

[12] For example, see Agnew, Bateman and Thorp (2013).
[13] Authors that discuss behavioural effects in a retirement savings context include Mitchell and Utkus (2006) and Benartzi and Thaler (2007).
[14] These issues are addressed in Section 5A of RIR (2020).
[15] Hirshleifer (2020) discusses social transmission bias.
[16] RIR (2020), see page 439.
[17] Discussed in Section 5A of RIR (2020), see page 445.
[18] See Thaler and Sunstein (2009)
[19] See Beshears et al. (2009) and Bateman et al. (2017).

follow. An example of the power of such mechanisms to drive change was including the scope to offer life-cycle options under the MySuper framework. While life-cycle products were previously available in Australia, the introduction of MySuper resulted in 35% of default assets[20] being invested using a life-cycle approach.[21]

Three specific choices are currently being made by many retirees that arguably limit the amount of value they extract from their retirement savings: minimal take-up of longevity insurance, lack of willingness to draw down on savings to the extent affordable, and investing too conservatively. Addressing these issues should allow retirees to enjoy higher income for longer into retirement. Fund-guided choice could assist by offering the member a solution that embeds a suitable mix of longevity insurance, higher drawdowns and growth asset exposure. This could establish a more appropriate point of departure for those retirees who opt for a form of fund-guided choice, from which they might deviate if they so wish.

A safety net required for retirees who do not choose

Our fifth disengaged retiree type are those who take no action once they reach retirement, either because they are totally disengaged, suffer from inertia or are simply too confused. It is hard to gauge how large this cohort might be. However, it is worth noting that there is $175 billion related to 1.2 million member accounts [22] invested in superannuation funds by those of age 65 and over that remains in the accumulation phase. While there are a number of potential explanations,[23] there is a hint that a significant number of retirees might not have transferred their superannuation balance to the retirement phase due to lack of knowledge or apathy, and might be missing out on retirement income as well as paying unnecessary tax. While the spirit of the Government's retirement income policy appears to be that retirees always exercise some form of choice, we are concerned about outcomes for the heavily disengaged. The alternative of leaving them in the accumulation phase and possibly wholly unsuitable solutions needs to be avoided if at all possible. The next section provides suggestions for creating a safety net for this retiree type.

Implications for the retirement system framework

We argue that the retirement framework should cater for all the types of members highlight above, and the associated decision frames. Informed member choice, ideally supported by financial advice, should be seen as the gold standard. Unfortunately, financial literacy is too low and comprehensive advice too costly and capacity constrained for a system based on self-directed and fully-advised choice to operate effectively for all retirees. Rather than relying on these two frames, the boundaries of choice should be expanded to permit retiring members to opt for a form of fund-guided choice. There should also be mechanisms to address retirees who do not engage at all. We now put forward suggestions for how this might occur through placing certain

[20] See Chant, Manokumar and Warren (2014).
[21] We do not comment on the efficacy of life-cycle products here, but merely illustrate the power of defaults.
[22] This estimate arises by comparing Tables 7c and 8a in the APRA Annual Superannuation Bulletin, (APRA, 2021).
[23] Potential explanations include: some members still working beyond 65; accounts over the $1.7 million cap; deliberate decisions to retain the funds in retirement to avoid drawdown; as well as lack of knowledge or apathy. (We thank Jeremy Cooper for suggesting this list.)

obligations on trustees under the RIC. Our suggestions are formed on the basis that the policy intention is for individual choice to sit at the foundation of the retirement system.

Fund-guided choice might be facilitated by placing an obligation on trustees under the RIC to engage with retiring members[24] to ascertain their preferred mode under which a suitable retirement solution is identified, and to accommodate their wishes accordingly. Figure 3 provides an indication of how the engagement process might be initiated by the fund through asking members to make a simple election at retirement. An election of the fund-guided choice options of A or B might then be followed by an invitation to furnish the fund with additional information to assist in making the selection of a suitable solution.

Figure 3: Choices put to a retiring member by their fund

Please choose one of the following options:	
A. Please assign me to a retirement solution	○
B. Recommend a retirement solution to me	○
C. I want to choose a retirement solution for myself	○
D. Please refer me to a financial planner	○

Note: A prior step would establish the balance that the member wishes to transfer into a retirement solution with their fund

For members who fail to respond (i.e. 'disengaged' member type 5), there could be a further requirement to constantly attempt engagement to establish their retirement status and preferences. Those ultimately confirming their retired status could then choose their decision frame, including potentially outsourcing the choice of retirement option to the fund (i.e. request to be treated as 'guided' member type 4). No compulsory retirement default mechanism would be imposed under this approach. However, it could leave the accounts of some retired members in the accumulation phase.

The most effective way of ensuring that totally disengaged members are assigned to a retirement solution would be to empower trustees to default members into a retirement option[25] under certain conditions. A policy solution might be to legislate automatic transfer (say, at age 65) into a retirement account, with the ability for members to opt-out. The main challenge would be specifying the conditions under which an assignment can be made. One major hurdle is that the trustee would need a way of ensuring that the member is indeed retired, and be confident that transferring their balance into the retirement phase is in their best interests. There are also a range of operational challenges (one example being the need for bank account details to direct ABP income payments). While such a compulsory default mechanism runs counter to the pro-choice sentiment outlined by the Government, it could be justified on consumer protection considerations.

Closing comments

[24] Trustees currently have no obligation or incentive to do anything when members meet the age-related condition of release.

[25] This default could be designed to allow full flexibility under a scenario where the member subsequently engages.

Marrying up retiring fund members with a retirement solution that accords with both their desires and their needs is arguably *the* major challenge facing the superannuation industry in catering for retirees. We argue that solely relying on retiring members to choose for themselves – be it either self-directed or advised – might not suffice to deliver reasonable outcomes for all types of retirees. We suggest that some retirees might welcome *another kind of choice*: the option to ask their super fund to select a solution on their behalf, either as a recommendation or an assignment. An effective method for achieving this would be to place an obligation on super fund trustees to engage with their members at retirement to establish their preferred mode for identifying a suitable retirement solution, which funds would then be required to deliver.

Consideration should also be given to how the retirement system will address the heavily disengaged who do not choose at all. While a default mechanism or the development of automatic transfer policy (potentially with the ability to opt-out) would provide a solid safety net, a second-best alternative might be to place onus on the trustee to continue seeking engagement with such members to confirm their wishes.

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