Colonial First State Investments Limited
GPO Box 3956 Sydney NSW 2001

colonialfirststate.com.au

Director
Retirement, Advice, and Investment Division
The Treasury
Langton Cres
Parkes ACT 2600

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Submission: Retirement Income Covenant

Thank you for the opportunity to provide feedback on the Retirement Income Covenant Position Paper (the Paper).

About Colonial First State

Established in 1988, Colonial First State (CFS) provides investment, superannuation and retirement products to individuals and companies. CFS has a significant footprint in the retirement market in Australia. As the largest account-based pension provider in the market CFS makes more pension payments than any non-government entity[1]. As at 30 June 2021, CFS managed approximately $47.9 billion in retirement income products (around 180,000 accounts). These funds mainly reside in the FirstChoice Wholesale Pension, FirstChoice Pension, and wrap products. We are also the second largest administrator of retail funds with $140 billion Funds Under Administration[2] (FUA) and $57 billion in superannuation FUA. Approximately 90 per cent of our total superannuation membership has a financial adviser attached.

CFS has long supported a greater focus on enhancing outcomes in the retirement phase of superannuation. Through previous submissions, including in response to previous consultations on *Comprehensive Income Products for Retirement* and the *Retirement Income Covenant* (the Covenant), CFS has outlined our support for the development of the retirement market. We have also actively engaged in previous consultations in this area including the Retirement Income Review and Treasury's review of income stream regulations both through direct submissions and through industry bodies.

Whilst CFS has contributed to our major industry body submissions in relation to this consultation, we take this opportunity to emphasise our position on certain key topics here.

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[1] APRA Annual fund-level superannuation statistics June 2020
[2] Plan For Life December 2020

Executive Summary

CFS welcomes the release of the Paper. We agree with the focus placed on flexibility, both for trustees in developing retirement income strategies, as well as providing members with flexibility to manage and access their retirement savings.

The drawdown phase of superannuation depends on important regulatory frameworks including the broader retirement income system itself, and its interaction with tax and social security, and the rules relating to the delivery of financial product advice. To ensure a cohesive approach to policy development CFS recommends the Covenant is developed in conjunction with, or following, government's full response to the Retirement Income Review and its consideration of the Quality of Advice Review. We also believe it may be appropriate to reconsider the objective for trustees to assist members to 'maximise retirement income' which may have unintended consequences. The Covenant should also take into consideration the propensity for members to exercise choice of fund in retirement.

CFS believes in the importance of access to quality financial advice in retirement. Noting the important role of financial advice, the Covenant should afford trustees discretion to determine whether a retirement income strategy is required for advised members. Given the complexity of the advice system, and to maintain a regulatory level playing field, the advice rules with respect to retirement products (including the commencement of a retirement product) should apply equally to trustees and financial advisers providing advice to members. It will be important for the retirement income strategy requirements to not impede or impact the existing financial advice process.

Our submission makes the following recommendations:

- Recommendation 1: Government should consider responding comprehensively to the findings of the Retirement Income Review and address any findings of the Quality of Advice Review prior to, or in conjunction with, the Covenant.

- Recommendation 2: The propensity of members to change superannuation funds at retirement to access products which better meet their needs and objectives should be reflected in the Covenant

- Recommendation 3: Trustees should have flexibility in how they manage longevity and investment risk as part of their retirement income strategy.

- Recommendation 4: Reconsider the inclusion of the objective "maximising retirement income" until the completion of the Government's response to the Retirement Income Review.

- Recommendation 5: Trustees should be afforded discretion and flexibility to determine whether a retirement income strategy is appropriate or necessary for cohorts of advised members.

- Recommendation 6: The Quality of Advice Review (2022) should consider opportunities to permitting both trustees and advisers to provide meaningful scaled advice to retiring members, based on a regulatory level playing field. This should ideally be finalised before trustees are required to implement the Covenant.

Sequencing of reforms

CFS supports further development of the regulatory framework for trustees to improve retirement outcomes for individuals, while enabling choice and competition in the retirement phase. As is evident in the Paper, the drawdown phase of super is dependent on other important regulatory and policy frameworks.

The Paper draws on certain conclusions from the Retirement Income Review (the Review). In particular, the view that members are not drawing down their balances efficiently in retirement and focusing on bequests.[3] This is one of a number of interdependent findings from the Review, and has been challenged by certain stakeholders.[4] The Government has not yet completed a comprehensive response to the Retirement Income Review and so it is difficult to judge the Covenant against the adoption of other potential policy reforms implemented as a result of Review's observations.

The Paper also comments on the importance of appropriate advice and guidance for members approaching and throughout their retirement, and notes the limitations of the current advice framework inhibit trustees' ability to provide appropriate and affordable advice solutions to members to assist them meet their retirement objectives[5]. The further development of the retirement income system will necessitate greater need for access to affordable advice or appropriate guidance and disclosure. We agree with these comments and have addressed considerations relating to financial advice in more detail later in this submission.

However, recognising that the commencement of the Retirement Income Covenant will increase the complexity of the retirement system and hence increase the need for access to affordable advice, CFS recommends reforms to the financial advice framework should be considered before commencement of the Covenant. We believe this is an important step to mitigate potential risks to member outcomes due to an increasingly complex and difficult to navigate system.

- **Recommendation 1:** Government should consider responding comprehensively to the findings of the Retirement Income Review and address any findings of the Quality of Advice Review prior to, or in conjunction with, the Covenant.

Retirement income strategy

Flexibility

CFS believes trustee flexibility is an important element of any reforms to establish a retirement covenant relating to income stream solutions for superannuation members, and we support the position taken in the Paper to allow trustee discretion over how longevity and investment risk are managed.

We welcome the change in proposed approach from the previous consultation. It is important this policy does not impose a mandate that trustees offer specific product types or strategies, recognising each fund's membership and their needs differs.

Not only is it important to provide trustees with flexibility in how their retirement income strategy is developed for members, we support providing flexibility to members on how they access their savings. In the drawdown phase, a 'one size fits all' approach is not appropriate given members' objectives, needs and circumstances vary greatly and will depend on the mix of super and non-super assets.

Importance of Choice in retirement

The Covenant is presented on the basis that trustees will manage retirement income strategies and products for the retired members of their fund, and the members of their fund approaching retirement[6].

[3] Retirement Income Covenant Position Paper, page 4
[4] ASFA analysis completed in March 2021: https://www.superannuation.asn.au/ArticleDocuments/359/2103-Super-balances-just-before-death-Paper.pdf.aspx?Embed=Y
[5] Retirement Income Covenant Position Paper, page 5
[6] Retirement Income Covenant Position Paper, page 6

Although we support the broad policy objective underpinning this proposal, the Paper does not contemplate the propensity of members to choose a different fund or product for retirement. This limits the ability of trustees to consider the broader needs of Australians when developing products, which may lead to sub-optimal member outcomes.

Whilst members in the accumulation phase tend to have simpler and more consistent objectives, as individuals approach retirement, members often have a greater need for flexibility, enhanced product features, or financial advice, leading many to seek out products in retirement which can address their more complex needs. The fund which has the most appropriate product for a member's accumulation phase may not necessarily offer the most appropriate product for a member's retirement.

These Choice members do not appear to have been addressed in the Paper. With trustees being directed to create a retirement income strategy for the existing members of their fund, this embeds an inherently self-limiting approach and may stifle competition in the retirement industry. To the extent trustees include actions such as providing internal retirement product recommendations to members within their strategy there may be obvious difficulties navigating the best interest duty and conflicted remuneration provisions.

The requirement for trustees to only consider their existing membership in the development of their retirement income strategy may also lead members in stapled funds to assume their fund is the only option in the market suitable for them. This applies counter to the principles embedded within the personal advice framework where the adviser will generally consider the client's broader circumstances and consider the range of appropriate products on the market before making a recommendation.

- **Recommendation 2:** The propensity of members to change superannuation funds at retirement to access products which better meet their needs and objectives should be reflected in the Covenant.

Objectives

CFS is broadly supportive of the direction taken in respect of the proposed objectives to be included in a retirement income strategy although we have some reservations with a trustee requirement to maximise retirement income for members.

CFS supports the inclusion of providing retirees with flexible access to their savings during retirement, recognising the wide range of circumstances in which retirees may need to access their savings.

We support the ability for trustee flexibility in the management of longevity risk and investment risk. As the retirement income stream product market continues to evolve, it is important that trustees have the ability to offer a retirement income solution that best suits the potential needs of its membership. In its simplest terms this may include an account-based pension or a similar style product offered in combination with an income stream which provides longevity protection, such as a deferred lifetime annuity. Innovation in this area of the market is likely to continue to develop new and interesting product solutions in response to members' needs. Ultimately trustees will need to consider a range of factors including an assessment of broader risks to members.

The Paper suggests trustees should consider how they intend to support their members to maximise their retirement income, which is defined as providing the highest expected net income possible for members over their retirement[7]. However, as the Paper notes[8], maximising a member's retirement income will be impacted by a broad range of factors external to superannuation. These include the Age Pension and other social security benefits, external savings (including both within and external to the superannuation system), individual retirement objectives and needs, health care, partnership status and home ownership. Not only are trustees unable to access sufficient information relating to many of these external factors (discussed in

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[7] Retirement Income Covenant Position Paper, page 11

[8] Retirement Income Covenant Position Paper, pages 10-11

further detail later in this submission), it is important to acknowledge the importance of members receiving financial advice to address their unique circumstances in managing their retirement income.

There is also an uneasy tension here for trustees given this objective may encourage them to promote investment strategies with higher investment risk in the pursuit of maximising retirement income for members. Whilst this would be mitigated to some degree by the requirement to balance the objectives, this may still leave some residual risk to member outcomes.

- **Recommendation 3:** Trustees should have flexibility in how they manage longevity and investment risk as part of their retirement income strategy

Covenant objective: 'Maximising retirement income'

CFS supports the principle that members should maximise their retirement income where they choose to do so based on their individual circumstances. However, we would be concerned by a general requirement for trustees to maximise members' retirement income and we are unsure as to what specific role trustees should play pursuant to such an objective.

The sole purpose test for superannuation outlined in section 62 of the *Superannuation Industry Supervision Act 1993* includes, amongst other things, that a fund be maintained by a trustee solely for the provision of benefits for each member of the fund on or after the member's retirement (a core purpose) or to any or all of the member's dependants on or after the member's death after retirement (an ancillary purpose).[9]

The Paper relies on conclusions drawn from the Retirement Income Review to prove standards of living in retirement are compromised by the complexity of decision-making retirees face in relation to the appropriate retirement incomes and a lack of confidence to spend their super in retirement. The Review effectively said people should be confident to consume more in retirement and this would lead to improved standards of living. It also cited studies which have "shown that retirees die with around 90% of their assets they had at retirement" and that bequests are growing.[10] CFS challenges whether these studies are a good representation of member experience and whether this is the appropriate place to focus. With respect to the evidence cited by the RIR, this is not consistent with industry analysis nor our experience as a pension provider.

Analysis by ASFA [11] suggests, by life expectancy, the majority of retirees have reduced their super balances to zero (many of whom may not have had any super at retirement anyway) and that it may be a small percentage of individuals who still have substantial super balances at death who are skewing the average. This suggests quite the opposite issue, which is that most individuals are not retiring with adequate superannuation balances. In any case we question the validity of basing the development of this aspect of the policy on these particular conclusions cited in the Retirement Income Review.

CFS' product experience is also instructive. Account-based pensions are the most popular and versatile retirement income products currently on the market, offering members appropriate flexibility to manage their income needs in retirement. When looking at data from CFS' flagship retail account based pension products, FirstChoice Pension and FirstChoice Wholesale Pension, we find the median (male) account balances at age 65 to be: $123k and $255k respectively.[12] Approximately 90% of the members in these

[9] SIS, section 62
[10] RIR, pp432-435
[11] ASFA March 2021
[12] As at 4 June 2021

products have a financial adviser and we think this cohort serves as a helpful gauge of the mass market of self-funded retirees in Australia at present.

Cameo using FirstChoice account-based pensions

A single, male homeowner retiree with no other assets who retires at age 65 with the current median balance[13] in FirstChoice Wholesale Pension and who is entitled to full age pension, can draw the minimum pension payment from the account based pension and meet the annual expenditure for a 'Modest' lifestyle ($28,254) under ASFA's retirement standard. The member's balance in this case would deplete fully once the member reaches their early nineties, beyond current life expectancy. If the same member had invested in FirstChoice Pension his balance would deplete once he reaches his late eighties.[14]

For the same member to meet the 'Comfortable' lifestyle retirement standard (annual expenditure of $44,412) in addition to the full Age Pension, the retiree member must draw well above the minimum[15] at around $19,600 p.a. from their account-based pension. In this scenario the member depletes their account balance in full at age 80 (78 for females) which is less than life expectancy and so the member has not been able to achieve a comfortable lifestyle throughout their retirement. The situation is worse for the same member if he had invested in FirstChoice Pension. Here the account balance will fully deplete at age 71 for a male retiree.

For members in this situation, drawing well above the minimum and consuming more in early retirement will allow them to achieve a higher standard of living for part (and in some cases most) of their retirement years. However, there are a number of other observations to make:

- The Modest retirement standard is not a standard of living retirees aspire to. This level of expenditure equates to the standard the Retirement Income Review has criticised retirees for managing to unnecessarily. And so we have focused primarily here on the Comfortable standard which industry believes is more appropriate.
- The required draw down rates are very capital intensive. Members cannot maintain this level of expenditure until life expectancy and it therefore does not cater for the approximately 50% of members who will exceed life expectancy.
- The strategy is heavily reliant on receipt of (full) Age Pension. This is probably the most concerning aspect and, in our view, fuels the behaviour observed by the Retirement Income Review. CFS believes retirees who have amassed reasonable retirement balances aspire to be self-funded, they do not expect to rely significantly on the Age Pension.
- Further, it is entirely rational for such retirees to harbour some level of scepticism as to whether the Age Pension will remain available to them, and at the required rate, throughout their retirement. Potential future economic and policy changes in this respect, whilst not currently foreseeable, are not within their control. In this context it is entirely reasonable for such individuals to aim to attempt to conserve the retirement balance they have generated.

CFS believes the focus on members retaining capital in retirement for the purposes of making bequests may be misplaced. Or, at the very least, further investigation into this issue needs to be undertaken before requiring trustees to address this matter through the proposed retirement income strategy. To the extent some members with very high retirement balances intentionally retain capital *solely* for the purpose of

[13] Median balance at age 65 for a male
[14] Projections use the ASIC MoneySmart Account-based pension calculator
[15] Minimum is approx. $12,750

succession planning then we would expect this to be considered as part of the Government's response to the RIR with consideration of other policy measures which could be employed.

- **Recommendation 4**: Reconsider the inclusion of the objective "maximising retirement income" until the completion of the Government's response to the Retirement Income Review.

The role of quality financial advice

We welcome the Paper's comments relating to the importance of appropriate guidance for members both approaching and during retirement. In particular, we support the comments that guidance does not mean defaulting members into particular products or pushing people towards particular forms of advice, and that guidance should not create competitive distortions in adjacent markets for financial advice[16].

In the following sections, we set out a number of important factors which should be taken into consideration when determining appropriate policy settings for financial advice and guidance in retirement.

Existing advice relationships

Although the Paper recognises the importance of personal financial advice to assist individuals meet their objectives in retirement, it is silent on the interaction of existing advice relationships with a trustee's retirement income strategy.

CFS believes the role of financial advice is particularly important in the pre-retirement stage and throughout retirement. In the accumulation phase of superannuation there is generally a common objective of maximising savings. However, in retirement, needs, circumstances and objectives will vary between individuals with some members having simpler needs than others.

While the Covenant's proposed retirement income strategy is a useful tool to assist non-advised and disengaged members achieve better retirement outcomes, members with an existing financial advice relationship have the opportunity to receive comprehensive advice which has been tailored for their unique circumstances. We believe this tailored approach will lead to better member outcomes for individual members. As such, where a member is receiving financial advice, it will be important for a trustee to ensure the settings of their retirement income strategy do not impede or impact the advice process. A trustee's role for advised members should therefore be to offer a high quality, flexible and customisable product to enable advisers to implement strategies tailored to their clients.

Recognising that a broad-based retirement income strategy cannot by definition provide the same degree of tailoring to individual members as personal financial advice, it may not be appropriate for a trustee to implement a retirement income strategy for advised members. CFS believes trustees should be permitted to consider whether offering a retirement income strategy to cohorts of advised members is appropriate or necessary. This will enable trustees to offer a product suite with sufficient features and flexibility for financial advisers to recommend a tailored retirement income solution to their clients, which we believe will lead to better retirement outcomes for members.

- **Recommendation 5:** Trustees should be afforded discretion and flexibility to determine whether a retirement income strategy is appropriate or necessary for cohorts of advised members.

[16] Retirement Income Covenant Position Paper, page 5

Providing access to affordable advice

The Paper accurately notes the further development of the retirement income system will necessitate greater need for access to affordable advice or appropriate guidance and disclosure[17].

Although trustees have a role to play in offering appropriate and affordable financial advice solutions to their members and provide guidance to members in retirement, there are a range of factors which need to be taken into consideration in order to provide meaningful advice to members in retirement. As the Paper notes, these include Age Pension entitlements, assets outside super, health (individual life expectancy), other super funds, actual retirement age, their desired retirement income levels and expected retirement lifestyle. It is therefore imperative that a person's entire personal circumstances are taken into consideration to understand a retiree's circumstances and objectives for retirement in order to provide the optimal retirement solution for that customer. Without the aid of the personal financial advice process a superannuation trustee cannot undertake the level of inquiry necessary to make a recommendation.

Where retirement planning is concerned we believe superannuation trustees will increasingly play a role in helping to deliver quality financial advice to pre-retiree and retiree members. To the extent the regulatory framework for advice applies to recommendations to commence retirement products, these rules should apply equally to trustees and financial advisers providing advice to members on this topic.

Intra-fund advice has been serviceable in assisting trustees to engage in simple conversations with members about their existing product. However, intra-fund advice is not appropriate for the commencement of a new product such as a retirement income stream or a strategy involving the combination of retirement income streams. This is due to the complexity involved in the decision making process and the importance of ensuring the strategic and product recommendations are suitable to the person's individual circumstances.

To ensure good member outcomes, in the process of developing policy relating to the introduction of a retirement covenant where the application of advice is concerned, policymakers should be careful to ensure an even playing field is maintained. Any potential reforms should be considered in the context of the advice industry as a whole.

The Paper notes Treasury will conduct a Quality of Advice Review in 2022[18], delivering on a recommendation of the Financial Services Royal Commission. Recognising the increasing need for access to affordable advice as the retirement system develops, CFS welcomes this review and looks forward to contributing to submissions.

However, to ensure the complex and significant issues relating to advice can be addressed comprehensively and to maintain a level playing field between advice providers across the financial services sector, we believe government should not consider modifications to the advice / guidance rules relating to trustees, or the provision of a safe harbour, until the Quality of Advice review scheduled for 2022 has been completed.

As the implementation of the Retirement Income Covenant is expected to increase the complexity of the retirement system and hence increase the need for access to affordable advice, CFS believes reforms to the financial advice framework should be implemented before the Covenant commences.

- Recommendation 6: The Quality of Advice Review (2022) should consider opportunities to permit both trustees and advisers to provide meaningful scaled advice to retiring members, based on a regulatory level playing field. This should ideally be finalised before trustees are required to implement the Covenant.

17 Retirement Income Covenant Position Paper, page 4
18 Retirement Income Covenant Position Paper, page 5

Ability for trustees to gather information or make appropriate assumptions

Throughout the Paper, it is suggested that trustees should consider a range of information external to superannuation in the development of the strategy. This includes information about members or assumptions derived from publicly available data.

It is unclear from the Paper the extent to which trustees will be expected to inquire into the attributes of their members and the depth of analysis which should be undertaken on factors outside superannuation. For example, the assessment of Age Pension eligibility differs widely between individuals depending on each member's unique circumstances. As the Paper notes[19], this information may not be available to trustees and will require trustees to source information about their members' circumstances, which the Paper suggests could be derived from surveys of members or assumptions from public data.

The information required to estimate Age Pension eligibility is highly personal in nature, including information such as member assets and income, home ownership status, and partnership status. This information is consistent with data gathered by financial advisers to facilitate the provision of financial advice. Important controls exist in relation to the collection of this degree of personal information when gathered for the preparation of financial advice, and it would not be appropriate for a trustee to collect and store information of this sensitive nature from members to develop a fund strategy.

The Paper alternatively suggests that trustees could infer this information from publicly-available data such as that published by the Australian Bureau of Statistics, the Census, or the Household and Labour Dynamics of Australia Survey. However, the Paper does not contemplate how a trustee could use high-level aggregate data of this nature to make a meaningful estimate of Age Pension eligibility.

Our view is that this degree of complex analysis should be undertaken by financial advisers, further strengthening the need to provide access to high-quality affordable advice.

We would welcome further discussion regarding any of the matters raised in our submission.

[19] Retirement Income Covenant Position Paper, page 10