TOWNSENDS BUSINESS
& CORPORATE **LAWYERS**

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The Manager
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Submission – Retirement Income Covenant

Townsends Business and Corporate Lawyers is a Sydney based legal firm which has a substantial SMSF practice covering both establishment and documentation for self managed superannuation funds ("SMSFs") as well as pension matters and transactional work for SMSFs.

This submission is intended to inform the consultation as to the practical issues which would arise for SMSFs should the Retirement Incomes Covenant ("RI Covenant"), as detailed, in the Position Paper dated 19 July 2021 be implemented.

This submission is not confidential.

If required or if it would be of assistance we can elaborate on any aspect of this submission.

This submission is in two parts. The first part is the body of this letter which provides a summary of the main points of our submission. The second part is in the schedule accompanying this letter which provides our detailed comments on various proposals set out in the Position Paper.

SMSF Sector – Particular Features

There are five significant features of SMSFs which should be considered in relation to the application of the RI Covenant, namely

1 self management,

2 operation on a cost only basis,

3 no retained earnings,

4 small membership base, and

5 restrictions on the types of retirement income products which can be issued.

We elaborate on each of these as follows.

Self management

The first feature is that of self management. In general, each member must participate in the management of the fund by being a trustee (or a director of the corporate trustee entity) and each trustee (or director of the corporate trustee entity) must be a member[1]. While it is possible to have child members of an SMSF, this is extremely rare. As the ATO has not published data on the child membership, it cannot be stated with certainty. However, as less than 0.5% of the total SMSF membership is aged less than 25[2], the total SMSF membership aged less than 18 is likely to be considerably smaller than 0.5% figure.

Operation on cost only basis

The second significant feature is that SMSFs operate on (and are required by the *Superannuation Industry (Supervision) Act 1993* ("SIS Act") to operate on) a cost only basis. All expenses of the operation of the SMSF are borne by the members either directly (such as the cost of tax arising from the receipt of deductible contributions) or indirectly (for example tax costs arising from investment earnings, audit fees, accounting fees, legal fees).

No retained earnings

The third significant feature is that the vast majority of SMSFs have neither retained earnings nor assets not directly supporting member interests. A very small number of SMSFs may have defined benefit pensions[3] still in payment or may be still attempting to operate (despite the ATO's publically stated position about reserves) investment reserves or contingency reserves. In general, all net contributions and net investment earnings are allocated directly to the members and constitute benefit liabilities of the SMSF.

Small membership base

The fourth significant feature is that over 90% SMSFs have two members or less. The most recent ATO statistics[4] indicate that 23.5% of all SMSFs are single member funds; 69.5% of all SMSFs are two member funds and the balance are three member funds (3.4%) and four member funds (3.6%). In short, more than 93% of SMSFs have two members or less.

In our experience, two member funds generally tend to consist of a spouse couple and three and four member funds tend to consist of parents and their child or children.

Restrictions as to types of income stream products which can be issued

The final significant feature is that SMSFs can only issue income stream products which are in the form of account-based pensions. In particular, the SMSFs cannot issue defined benefit products (such as income streams to which *Superannuation Industry (Superannuation) Regulation* 1.06A applies; namely "innovative superannuation income streams" as these income streams must be payable throughout the life of the beneficiary (primary or reversionary)[5]).

For completeness it should be noted that legacy defined benefit income streams and legacy market linked income streams can be provided by an SMSF if the former were issued before 2006 and if the latter were first issued before 20 September 2007. Additionally, SMSFs can issue market linked income streams on or after 20 September 2007 if the purchase price for the income stream can be traced to a defined benefit pension or market linked income stream which commenced before 20 September 2007.

Proposed RI Covenant

In summary, the proposed RI Covenant will impose a duty on SMSF trustees to develop and document their strategy to assist retirement or near retirement aged members to achieve and balance three objectives; namely to maximise their retirement income; to managed risks to the sustainability and stability of their retirement income and to have some flexibility to access super savings during their retirement.

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[1] The main exceptions are (1) members who have not reached their majority can be trustee/director (2) a single member SMSF which does not have a corporate trustee must have a second natural person trustee.

[2] SMSF Quarterly Statistical Report March 2021: Table 6

[3] Defined benefit pensions are legacy product income streams which have since 2004 (subject to transitional provisions) been closed to new entrants.

[4] SMSF Quarterly Statistical Report March 2021: Table 4. These figures relate to the 2018/19 financial year. The increase in the maximum size of SMSFs from 4 to 6 occurred on 1 July 2021.

[5] Superannuation Industry (Supervision) Regulation 1.06A(3)(b))

Underlying this Covenant is the desire that bequests (that is death benefits transferring to non-spouse dependants or to the estate of the deceased member) be minimised. It is considered that such bequests undermine the policy or objective of superannuation and reduce the level of retirement income which could have otherwise been enjoyed by the deceased member.

Objections to the Proposed RI Covenant in the SMSF Context

Our principal objections to the Proposed RI Covenant applying to SMSFs are

1. the RI Covenant will not generate any practical benefit to SMSF members;
2. the RI Covenant will simply generate considerable fund expense for SMSF members thereby undermining the stated objective of the Covenant;
3. SMSFs will have no ability to spread the cost of the research, design and implementation of the RI Covenant over a considerable number of members – there is simply no scale in the SMSF context for the expense to be a reasonable imposition on each member's retirement savings; and
4. compliance with the RI Covenant will be formalistic at best and the regulator will be required to challenge performance of the RI Covenant which will be beyond the regulator's resources and skills.

In support of the above objections the following points are made:

Maximisation of retirement income

The only retirement income stream product which can be issued by SMSFs are account-based pensions[6], the only means of increasing retirement income is to dial up the pace of capital consumption or the adoption of investment strategies involving greater investment returns at the cost of higher increased investment risk.

There is no scope for augmenting pension capital by the trustee issuing some form of pooled income stream product – as the membership base of SMSFs is too small for pooled products (even if the regulatory regime permitted such products to be issued by SMSFs). In practice pooled retirement stream products are a form of tontine – where pension capital is transferred from lives which drop short to those which survive.

Sustainability and stability of retirement income

Sustainability is used in the Position Paper to mean that the retirement income is reliable and durable over time with particular reference to longevity risk, investment risk and selection risk.

As pooled retirement income products cannot be issued by SMSFs

- longevity risk can only be managed by moderating the pension drawdown rate;
- investment risk can only be moderated by a weighting towards defensive assets as against growth assets; and
- selection risk can only be moderated by having a cash component sufficient to support one or two years' pension payments.

The member could purchase, from a third party, a lifetime income stream (whether pension or annuity). However, this is a decision best left to the individual member and their willingness to accept the significant capital cost of such guarantees.

[6] Given the very restricted ability to issue new market linked pensions, such pensions are not further considered.

Finally, it should be noted that the current regulatory design features of account-based pensions are at cross purposes with the sustainability and stability goal set out in the Paper and, also, the retirement consumption pattern noted in the Retirement Incomes Review. The age-related and increasing minimum draw down requirement undermines management of the longevity risk and the requirement to make pension payments in cash rather in specie asset transfers increases both investment and selection risks.

Flexibility to access savings capital

As account-based pensions permit the member to access all or part of the pension account balance by means of either commutation or large pension drawdown, this objective can be currently achieved by SMSFs.

We wish to thank the Treasury for the opportunity to comment upon the Position Paper and hope that our comments may assist in the development of the Retirement Incomes Covenant as it applies to SMSFs.

As previously noted, if it would be of assistance, we can expand upon or clarify our comments.

Yours faithfully
TOWNSENDS BUSINESS & CORPORATE **LAWYERS**

PETER TOWNSEND BA LLB FAICD FCLA AFPA
PRINCIPAL

Schedule: Submission to Treasury re Retirement Income Covenant

Detailed Comments on the Position Paper

Justification for having an RI Strategy –Page 2, 2nd-5th paragraphs

Position Paper

- The justification for having an RI Strategy – the fact that most superannuation members are not supported to effectively manage their superannuation when they retire and superannuation trustees should provide this support.

TBCL Comment

- As SMSF members have made an active choice for intensive involvement with their superannuation, they are not passive recipients of superannuation; they are engaged superannuation recipients; they can obtain retirement, social security or aged care advice directly from relevant service providers.
- Consequently the justification for having an RI Strategy is absent in the SMSF context

Content of RI Strategy – Page 2 – 6th paragraph

Position Paper

- The strategy should reflect a trustee's broad understanding of their membership.

TBC Comment

- Given the effective identity of members and trustees in the SMSF context, SMSF trustees cannot have a broad (in the sense 'general') understanding of the membership; they have an intensive understanding of the membership base of the SMSF.

- Given SMSF trustees cannot have a broad understanding of the membership, any "guidance" or "assistance" provided to the SMSF members will almost certainly constitute general financial advice, if not personal financial advice. The rationale for guidance not constituting financial advice being that the provider has only a broad understanding of the membership base will be absent. We make no comment whether this rationale, even in the context of a large APRA regulated fund, has any substance.

Reference to median super balance of $179,000 (male) and $137,000 (female) – Page 3, 2nd Paragraph

TBCL Comment

- This reference is presumably made to justify the proposition that superannuation members do not have the financial resources to obtain their own retirement, social security or aged care advice and, so, superannuation trustees should provide guidance.

- The median superannuation balance for SMSF members is $423,736 (2018/19). Consequently, SMSF members have the financial means to seek their own retirement, social security or aged care advice. Further, in operating their own superannuation funds, SMSF trustees will not be unused to engaging professional advisers.

Nest Egg Framing of Superannuation - Page 3, 5th Paragraph

Position Paper

- The "nest egg" framing of superannuation compounds the complexities around deciding how to manage their superannuation in retirement. Partly because they have only ever been primed to save as a large sum as possible, retirees struggle with the concept that superannuation is be consumed to fund their retirement.

TBCL Comment

- The criticism of the "nest egg" view of superannuation is that it leads to concentration on balance maintenance and also to a reluctance to draw down on the balance.

- There is no inherent problem with a superannuation member viewing their superannuation balance as a nest egg. Most superannuation members will have two material retirement assets – their family home and their superannuation balance. The "nest framing" of superannuation conveys both the importance and significance of superannuation given once retirement occurs it is a limited resource which cannot be replenished and which is not immunised from adverse investment returns.

- In any event the minimum drawdown requirement of account-based pensions addresses the issues of "balance maintenance" and reluctance to drawdown.

Retirees struggle to develop effective retirement income strategies – thereby superannuation is not used to provide retirement income but remain unspent and provide bequests - Page 3, Ultimate Paragraph

TBCL Comment

- Realistically the need for complex retirement strategies will only arise for retirees with total asset value (excluding asset test exempt assets –typically, the family home) of $588,250 (single homeowner) and $884,000 (couple homeowners)[7] – as these figures are the asset test threshold at which entitlement to the age pension ceases.

- For individuals whose total asset threshold are below the relevant asset test threshold a simple strategy of an account-based pension and entitlement to the age pension may be the most appropriate strategy: for these retirees and there is no need for complex retirement strategies.

- For individuals with considerably larger superannuation balances, they are in a financial position to seek out their own professional assistance.

- The issue of "bequests" on the death of a superannuation member (assuming the balance does not transfer to a spouse) is greatly overstated and is controlled by the minimum drawdown requirement of account-based pensions and the 15% tax rate on the taxable portion (taxed element) of the death benefit.

Low consumption of superannuation resulting in lower living standards - Page 3, 2nd Paragraph

TBCL Comment

- Possibly this assertion is a reference to most superannuation retirees drawing down on their pension at or near the minimum drawdown levels.

- This level of drawdown reflects the individual retiree's choice as to the pace at which retirement capital is to be consumed. This choice could also be an informed and rational choice having regard to the issues of investment risk, longevity risk and selection risk.

- Equally, a minimum level of drawdown may reflect prudence, the assessment of sovereign risk in superannuation and social security policy and personal preference.

Better Products – Page 4, Penultimate Paragraph

Position Paper

- The comment is that the RI Covenant will encourage/force trustees to evaluate their income stream products and, possibly, improve their products in light that that evaluation.

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[7] Thresholds as at March 2021.

TBCL Comment

- In the context of SMSFs, the only possible retirement product is an account-based pension[8] the terms of which are largely set by legislation.

- In the context of SMSFs, “innovative super income streams” to which SIS Reg 1.06A applies cannot be offered by SMSF trustees as they are lifetime payable products (1.06A(3)(b)) and SMSFs are excluded from paying defined benefit products.

- Even if the defined benefit product exclusion was removed, the capital reserve required to support the lifetime payment would be borne by the member receiving the lifetime support or by other members (which would operate as a very significant disincentive for the other members remaining and thereby sacrificing their future retirement capital).

Appropriate Guidance - Page 5, 2nd Paragraph

Position Paper

- The Position Paper states that trustees will be required to consider the broad needs of their members and identify what actions the trustee needs to take to assist members to meet those needs which includes consideration of what guidance trustees may need to provide to their members in implementing a fund’s retirement income strategy.

TBCL Comment

- To mandate the trustee to provide such guidance will entail a diminution of retirement capital for support/guidance which the member may not want, may not require or may not value.

- Importantly, as SMSFs would have no scale in the provision of the Guidance – it would be a one-off expense the entire cost of which would be incurred by the relevant member or members.

- Large APRA funds could expect to have significant economies of scale in that the “guidance” could be scaled to apply to many hundreds, if not, thousands of members thereby reducing the cost of such guidance to an acceptable per member level.

Proposed RI Strategy Principles – Page 6, Box 1

Poston Paper

- The Box on page 6 summarises the proposed retirement income strategy principles noting, in particular, the strategy could be for all members or different strategies for different cohorts of member and the strategy should outline how the trustee intends to assist members to maximise their retirement income, manage risks to the sustainability and stability of that income and have access to savings during retirement.

TBCL Comment

- Given the inability of SMSFs to provide defined benefit income streams or group/pooled income streams, the only retirement income product which an SMSF can provide is an account-based pension. Consequently, the super balance will be used to commence an account-based pension or, if the transfer balance cap applies, using the super balance up to the available cap as an account-based pension with the excess (or a part of the excess) being held outside the superannuation system to the extent necessary to exhaust the zero rated tax bracket (and low income or aged related tax credits).

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[8] The very restricted ability of SMSFs to issue legacy pensions is not relevant in this context.

- Given the limited strategies available in an SMSF it is difficult to appreciate what advantage to the members will be derived for the trustee's compliance with the RI Covenant.

Formulation of an RI Strategy is not considered to be financial advice - Page 7, Paragraph 6

Positon Paper

- The Paper asserts that the formulation of an RI strategy by the trustee does not, in and of itself, constitute the provision of financial advice to members.

TBCL comment

- Assuming that the formulation of an RI Strategy may not, in and of itself, constitute the provision of financial advice, once that strategy is communicated to members the position will be very different. Given the recent High Court decision in the Westpac Consolidation Case[9], the communication of the RI strategy to a hypothetical reasonable member of the SMSF would most likely to taken to constitute personal financial product advice.

- Possibly, the communication of the RI Strategy could be so heavily subject to disclaimers and warnings, that no hypothetical reasonable member of the SMSF, could view the communicated RI Strategy as financial advice, but then the disclaimer and warnings would become the message[10] and, if no reliance can be placed on the communicated RI strategy, why bother to communicate at all.

Maximising retirement income Page 11, 3rd Paragraph

Poston Paper

- The Paper states that the RI Strategy needs to consider how the trustees intend to support their members to maximise their retirement income – which entails providing the highest expected net income possible income (from super and from the Age Pension/Service Pension) for the members over their retirement.

TBCL Comment

- Given the identity between the members and the trustees in SMSFs, this mean that the obligations on the trustees under the RI Strategy apply more intensely as the SMSF trustees will know the actual non-super assets of the members? If so, this strengthens the argument that any communication of the RI Strategy will amount to the provision of financial product advice, if not personal financial product advice.

- As the only retirement income product which SMSFs trustees are able to issue is an account-based pension product, SMSF trustees' ability to maximise net retirement income is very limited. In short, the SMSF trustee would have to dial up the pension drawdown rate (with attendant adverse consequence for longevity of the income stream) or by adopting a more growth orientated investment strategy (with the attendant greater investment risk and selection risk).

- It should be noted that net retirement income of a member cannot be constant over the retirement period given the step up of the minimum drawdown rate based upon the age bracket of the member.

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[9] *Westpac Securities Administration Ltd v Australian Securities and Investments Commission* [2021] HCA 3

[10] As the danger of excessive disclaiming – *refer Australian Securities and Investments Commission v Dover Financial Advisers Pty Ltd* [2019] FCA 1932

Assisting members to balance retirement income objectives - Pages 14 and 15

Position Paper

- The Paper lists seven examples of various means by which trustees could assist their members to meet and balance the retirement income objective of maximising retirement income, managing key risks and having some flexible access to savings during retirement.

TBCL Comment

- In SMSF Context – of the seven listed examples of means of assistance

  First Example – this is not possible in an SMSF context as there can be no pooling longevity risks and there can be no sharing of mortality credits. SMSFs cannot issue pooled products (and, even if they could, the pool would be too small for any actuarially meaningful pooling).

  Second Example – while this could be done in an SMSF context, the current structure of account-based pensions already permits members to dial up the minimum drawdown rate.

  Third Example – given SMSF members are very engaged with super (otherwise they would not participate in an SMSF) and most SMSFs have superannuation advisers, there is little point in offering "nudges".

  Fourth Example – we agree that investment strategies for SMSF members in retirement phase will be (and should be) different to the investment strategies of members who are not in retirement phase. However, as most SMSFs have one or two members (the two members are usually in the same stage of superannuation) then, in practice, most SMSFs will need to have only one investment strategy as the member or members will all be in the same superannuation phase.

  Fifth Example – there is no point in SMSFs being required to provide retirement calculators – given ASIC provides such calculators.

  Sixth Example – again there is little point in SMSFs being required to provide budgeting tools and expenditure calculators – these tools could easily be provided by third parties or industry associations.

  Seventh Example – given that SMSFs can only issue one type of retirement income product, there is little point in the trustee providing information about other retirement income products. It is our practice to include information about Age Pensions in the Product Disclosure Statements for account-based pensions. In relation to Age Care eligibility, this is a complex, very member specific and specialised area of professional practice. It would be prudent for any superannuation trustee to not attempt to provide any information in relation to this area.

Reviewing fund performance under the RI Strategy - Page 15

Position Paper

- The Paper proposes that trustees should review the fund's performance against their RI Strategy on at least an annual basis.

TBCL Comment

- In the SMSF context, the RI Strategy will essentially be that the SMSF will issue account-based pensions (being the only retirement income stream permitted to be issued by SMSFs).

- As the only material variables of the product will be the dial up from the minimum drawdown rate and the investment strategy adopted by the SMSF for members in drawdown phase, there would not be much to review.

- In any event, the member can unilaterally increase or decrease the drawdown rate (subject to the minimum drawdown rate) and has a material influence over the investment strategy as trustee.

Reviewing the retirement income strategy - Page 15-16

Position Paper

- The Paper proposes that the Trustees should regularly and comprehensively review the appropriateness, effectiveness and adequacy of the RI Strategy (including the underpinning assumptions) every three years.

- The Paper also proposes that this review be undertaken by operationally independent, appropriately trained and competent persons.

TBCL Comment

- In the SMSF context this would impose a very considerable financial burden which would, as SMSFs operate on a cost only basis, be entirely borne by the member (at best two members) in retirement phase.

- The cost of such a review would be wholly disproportionate to the supposed benefits to be gained from the review and the implement of the review's recommendations.

Communicating conclusions of reviews to members - Page 16

Position Paper

- The Paper proposes that the "broad" conclusions from both reviews should be communicated to the members

TBCL Comment

- Given the self management nature of SMSFs, this proposal is unnecessary in the SMSF context.

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