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Retirement Income Covenant - Exposure Draft

The Retirement Income Covenant (the covenant) is an opportunity to set clearer obligations on industry. It will require trustees to contemplate how they can best maximise their members retirement income, manage risks to sustainability and ensure flexibility. This will mean funds must develop strategies that address the previous failures of the retirement system.

The biggest failure is that too often the superannuation industry has done the bare minimum when collecting member information. The inclusion of requirements on trustees to take reasonable steps to gather the information necessary to inform the formulation and review of their retirement strategy is a welcome step forward. The inclusion of examples in the explanatory materials that highlight how member information should be used to determine cohorts is the necessary level of prescription that funds have previously lacked. These two obligations will work together to ensure member information is actually gathered and used.

The exposure draft could be further strengthened by requiring trustees to provide key retirement information when assisting their members. Without adequate guidance consumers are unlikely to be better off and may actually face greater complexity navigating a market which will see more complex products made available. As drafted, trustees are afforded complete discretion as to whether or not to offer guidance. Those that choose to offer guidance also have a large amount of discretion about what to provide. We see value in funds being given greater prescription on shared assumptions to ensure consumers are not given inappropriate information as part of their retirement planning.

The carve out of SMSFs runs counter to the Retirement Income Covenant and the findings of the Retirement Income Review. This decision needs to be reviewed to ensure fairness and equity in the system. Failure to do so risks seeing the SMSF sector being maligned as a haven for those who wish to take advantage of generous retirement savings tax concessions and not spend down those savings in retirement. There is an opportunity to address this issue by developing a more nuanced solution for SMSFs that ensures members are protected by the core obligations of the covenant.

The requirement to collect and use member information strikes the right balance

Funds have significant scope for improvement in how they collect and use member information to ensure they are meeting their obligations to members. We welcome the requirement for trustees to take reasonable steps to gather general information about their members necessary to inform the formulation and review of their retirement strategy. This will put a greater onus on funds to actually collect relevant data to help them understand their membership.

As part of meeting obligations relating to member outcomes assessments, trustees are required to conduct cohort analysis. Using the information they are required to gather and then identifying cohorts of people in retirement for the purposes of formulating a retirement income strategy is expected to involve similar analysis. We therefore support the inclusion of examples in the explanatory materials that can be used to determine cohorts. Prescription in the explanatory materials is important because we expect funds to follow it. Our member outcome assessment research found that in the absence of prescription funds are unlikely to disclose information to consumers adequately. With these examples it will mean the information that funds are required to reasonably gather is put to use.

We also welcome the requirement for funds to record their steps taken to gather information about their members and the reason for taking those steps. Funds continually claim they do not have appropriate access to information about their members. It is unclear whether this is the reality. The Productivity Commission found "superannuation funds make insufficient use of their own (or imputed from sources such as the ABS, DSS etc) data to develop and price products (including insurance)".[1] They went on to find that some funds have successfully used broader research and data (such as census data) to cost-effectively impute the characteristics and preferences of the fund's membership. This legislation will now bring this to the fore. However, if funds can demonstrate a strong case that they cannot reasonably gather information, there will now be a recorded market wide evidence base. This evidence can then be used to determine any real gaps in data and open up the required channels to attain it.

Key finding:

The exposure draft finds the right balance between discretion and prescription with regards to collecting member information. It will put a greater onus on funds to deliver for specific cohorts of their membership.

[1] Productivity Commission Inquiry Report: Superannuation: Assessing efficiency and competitiveness, p56

The need for factual information on key retirement topics

The covenant exposure draft gives discretion to trustees to consider assistance that could be provided to members. This ranges from providing resources such as expenditure and retirement calculators and factual information to how products are presented on fund sites. We understand the intention for the first iteration of the covenant is to ensure funds are not restricted in their approach to creating retirement assistance models. This may spur innovative and new ways for funds to tailor their assistance models to their products. We are sceptical as to whether this 'innovation' will necessarily lead to better outcomes for consumers.

The explanatory material correctly identifies key factual information that consumers need to help make retirement planning decisions. The retirement strategies of funds would be boosted if everyone was given this information, so giving funds discretion on whether to provide it makes little sense. Key retirement topics, such as eligibility for the Age Pension, the concept of drawing down capital as a form of income, or the different types of income streams are all important factors in consumer decision making.[2] Our own 2021 research found that superannuation rules and procedures, how much you need to save for retirement and age pension eligibility were the top three researched topics by retirees and pre-retirees. Given the high value of this information in retirement decision making we see a strong case for ensuring all funds offer some standard guidance to their members. This can best be achieved by making provision of the information sources outlined in the explanatory material mandatory.

Longer term we see a strong need for a new model to provide conflict free, affordable information and guidance at scale. There are inherent conflicts in super funds providing this information. By way of a simple example, a fund in which the average member has a very low retirement balance may justify only providing an account based pension in the retirement phase on the grounds that this is the best solution for its members. This fund has no incentive to inform its customers about other types of products that may help them achieve their retirement goals. This would be a disservice to members who make up a cohort which the fund has decided aren't significant enough to develop specific strategies. This group would most likely take up the products their fund has on offer, which may be totally inappropriate for their needs. To avoid this fund trustees should be required to provide factual information on the key retirement topics outlined in the explanatory material.

Recommendation:

That fund trustees be required to provide factual information on the key retirement topics outlined in the explanatory material.

[2] Explanatory Materials - Treasury Laws Amendment Bill 2021: Retirement Income Covenant, p6

SMSFs should have a proportionate retirement covenant

As it stands SMSFs won't be subject to the retirement income covenant. This approach undermines the purpose of the system to ensure people are maximising their retirement savings. A better solution would be to apply the retirement covenant equally to all retirees, but ensure proportionality in how funds fulfill their obligations. This will ensure all consumers are protected without unnecessary regulation.

We are concerned that the carve-out of SMSFs may send the wrong message to SMSF trustees and create a two tier system for retirees. The retirement income review found that the wealthiest superannuation savers with balances exceeding $5 million are receiving more government support in tax concessions than the support received by all low-income households combined.[3] Typically these balances are withheld in SMSFs. While several surveys found 'leaving a bequest' is one of the least important retirement savings, in practice most retirees leave the bulk of their wealth as a bequest.[4] Carving out SMSFs is a rubber stamp for people to use this retirement structure to subvert the purpose of retirement tax concessions.

SMSFs have a significant portion of the funds under management in the retirement phase, totalling $334 billion of the $750 billion in assets.[5] The SMSF sector is also responsible for $35 billion in benefit payments per year.[6] The median age of an SMSF member is 60.6. With such a high percentage of SMSFs in the retirement phase, this proposal would carve out a material part of the retirement sector. If the intention of the retirement income covenant is to ensure all people are maximizing their savings, it must consider the 1 million members in SMSFs.

We would encourage decision makers to see this as an opportunity to significantly improve the SMSF market. For years the SMSFA[7] has rightly been making the case for SMSF trustees to consider relevant retirement strategies, such as cognitive decline, exit strategies and death nominations. Alongside the covenant principles these important factors could be incorporated into a more targeted and relevant set of considerations for SMSFs. Overall this would improve retirement outcomes for SMSF members.

With the recent increase of the maximum number of SMSF members from 4 to 6, there are more scenarios where the interests of trustees may not align with the rest of the membership. For example, an SMSF with two parents in retirement phase and four children in accumulation will mean the fund will likely need a different approach for two cohorts of members. The

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[3] Retirement Income Review, p 243
[4] Retirement Income Review, p181
[5] SMSF Annual Overview data tables, 2018-19
[6] SMSF Annual Overview data tables, 2018-19
[7] https://www.smsfassociation.com/news-articles/when-you-should-close-your-smsf?at_context=49448 , https://www.smsfassociation.com/media-release/elder-abuse-needs-national-approach?at_context=49448, https://www.smsfassociation.com/wp-content/uploads/2018/03/SMSFA-submission-to-ALRC-elder-abuse-discussion-paper_FINAL.pdf

retirement income covenant helps guide this decision making, by requiring trustees to focus on the specific needs of those in retirement.

Other aspects of SMSF management have been improved by operating standards to guide trustees. The SMSF investment strategy, for example, determines how each SMSF's investments meet each member's objectives.

There is an opportunity to address this issue by developing a proportionate solution for SMSFs that ensures members are protected by the core obligations of the covenant. For example, SMSFs could be subject to (8A) (a) to formulate, review regularly and give effect to a retirement income strategy that meets the requirements in section 52AA and (c) to record the strategy in writing. Proportionate regulations and guidance could then be developed to determine how SMSFs can reasonably satisfy and provide evidence of a retirement income strategy. We propose two options to satisfy this requirement, a new stand alone documented retirement strategy or through a slight expansion to the already existing investment strategy.

Option 1 - Standalone documented retirement strategy

Option 1 would require SMSFs to create a retirement strategy in the lead up to the retirement phase. This aligns with the previous Treasury position paper and all other previous editions of the covenant. This will ensure a more substantive and broad consideration of retirement outcomes. This would be on par with existing requirements on SMSF trustees to create an investment strategy for accumulating assets.

Such a strategy could be tailored to the SMSF sector by including exit strategies, cognitive decline plans, enduring powers of attorney, death nominations in addition to retirement considerations. These are common considerations that often go unaddressed. This approach would have the dual benefit of addressing a long standing issue of people remaining in inappropriate SMSFs as well as helping to ensure efficiently maximising their retirement savings.

Tailored guidance could be developed by the ATO that would help SMSF trustees develop their strategy. These could, for example, focus on the key questions trustees must consider under the three main objectives. Questions such as:

- What drawdown rate is appropriate?
- Have you considered other retirement products?
- Are you able to withdraw lump sums?
- Have you considered cognitive decline? and,
- Do you have an exit strategy?

The ATO already has guidance on these topics, such as preparing an exit strategy, that are unlikely to be used by many trustees without direction.[8] With a potential start date on July 2022, there will be ample time for trustees to get across these basic obligations.

This proposal has industry support, with the SMSF Association calling for the inclusion of these considerations in a retirement income covenant for SMSFs stating, *"The inclusion of the above components will bring these important issues to the fore. Just like the member insurance considerations for investment strategies, the inclusion of these issues in the covenant acts as a vital prompt for these essential conversations. Incorporating them into the covenant for SMSFs will play an important role in ensuring that trustees have properly considered and prepared for these life events."*[9]

The Australian Law Reform Committee made a similar recommendation in their report on elder abuse, stating the relevant operating standards for self-managed superannuation funds in 4.09 of the SIS Regulations 1994 (Cth), should be amended to add an additional standard that would require the trustee to consider the suitability of the investment plan where an individual trustee or director of the corporate trustee becomes 'under a legal disability'.[10]

The retirement income covenant should be seen as an important opportunity for this sector to address ongoing concerns in the retirement phase. Failure to do so will see SMSF members put at risk of inappropriate retirement strategies.

Option 2 - Expansion to the SMSF investment strategy

Alternatively, regulation could be similarly adapted to assist SMSF trustees in creating an action plan to deal with the retirement phase through their investment strategy. The proposed retirement income covenant complements the current investment strategy covenant on investment composition and risk. Most recently, this was amended to require trustees to consider whether the fund should hold a contract of insurance that provides insurance cover for one or more members of the fund. The codification of this spurred SMSF members and their SMSF advisers to consider the financial risks to members and their beneficiaries of death or disability. From 2012, when the Cooper review found 12.7% of SMSFs had insurance, this has now risen to 20.5%.[11]

Trustees could be required to turn their mind to the three objectives of the retirement covenant. For example, existing investment strategy regulations could add the subsection (f):

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[8] https://www.ato.gov.au/Super/Self-managed-super-funds/Setting-up/Prepare-an-exit-strategy/
[9] SMSFA submission to Retirement Income Covenant Position Paper
[10] ALRC Elder Abuse—A National Legal Response, Recommendation 7-3, p23
[11] Based on table 25 of SMSF overview data tables 18-19 and number of funds reporting expenses.

1) The trustee of the entity must formulate, review regularly and give effect to an investment strategy that has regard to the whole of the circumstances of the entity including, but not limited to, the following:
    a) the risk involved in making, holding and realising, and the likely return from, the entity's investments, having regard to its objectives and expected cash flow requirements;
    b) the composition of the entity's investments as a whole, including the extent to which they are diverse or involve exposure of the entity to risks from inadequate diversification;
    c) the liquidity of the entity's investments, having regard to its expected cash flow requirements;
    d) the ability of the entity to discharge its existing and prospective liabilities;
    e) whether the trustees of the fund should hold a contract of insurance that provides insurance cover for one or more members of the fund.
    f) The balance between maximising retirement income, managing risks to sustainability and stability of income and having flexible access to savings for members approaching and in retirement

If members are thinking and acting on these existing considerations, their investment strategy would already partly reflect these objectives. For example, managing risks and having flexible access to savings are partly reflected in subsections (a) and (d). Including these new considerations as part of an already existing investment strategy is not a big additional step to take, any potential cost of these additional considerations would easily be eclipsed by the benefit that will flow from having a plan to maximise retirement income and having an exit plan in place.

The role of SMSF auditors

The requirements on SMSF auditors to undertake the options we have outlined would be on par with their existing role in auditing investment strategies. As the ATO guidance states, auditors check that:

- an SMSF had an investment strategy in place for the relevant financial year that considered the factors outlined above,
- the fund's investments during the relevant financial year were in accordance with that strategy,
- the strategy had been reviewed at some stage during the relevant financial year.[12]

[12] https://www.ato.gov.au/super/self-managed-super-funds/investing/your-investment-strategy/

Auditors are not required to check if the strategy or investments are adequate for specific SMSF members, or if an appropriate allocation is determined. This is still left to the discretion of the trustee.

A similar framework could exist for the retirement covenant. Guidance could outline that SMSF auditors require enough evidence to see that SMSF trustees have balanced the objectives of the covenant. For example, one element may include an SMSF trustee answering the question of flexible savings by stating that their account based pension provides them with the flexibility to access savings. An auditor would not need to determine if the SMSF member *needs* to have a flexible access to savings. They would only need to determine that the strategy considered the retirement objective.

Recommendation

That the Retirement Income Covenant apply to SMSFs, including SIS Act 8A (a) to formulate, review regularly and give effect to a retirement income strategy that meets the requirements in section 52AA and (c) to record the strategy in writing. In order of preference this requirement should be operationalised by:

1. Creating regulations detailing the operating standards of the retirement strategy encompassing the key retirement objectives as well as an exit strategy, cognitive decline considerations, enduring attorneys and death nominations.

2. Regulations detailing how the retirement objectives should be satisfied through an expanded investment strategy.