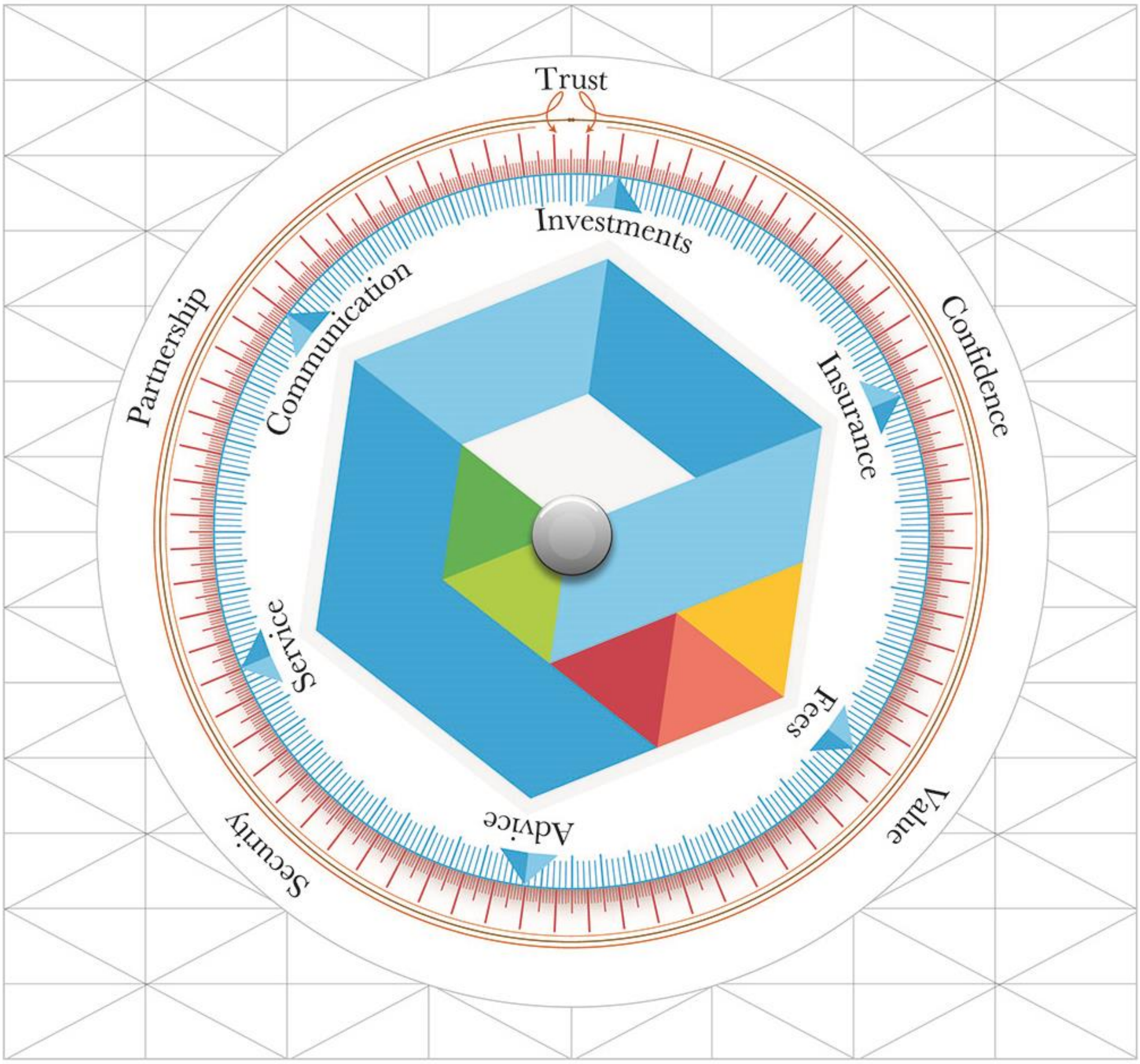
Financial System Inquiry

Submission in Response to Final Report



March 2015

Danielle Press, CEO

About Equip

Equip is a multi-sector superannuation fund that has delivered confidence and financial security in retirement to members for over 80 years. The fund's members and employers are drawn from a cross-section of Australian commercial sectors. We manage $7 billion in assets on behalf of about 50,000 members and provide financial planning services to a growing proportion of them.

As a public offer fund, Equip membership is available to any Australian over working age and we welcome nomination as the default fund for any workplace.

We have proven expertise as trustee for both accumulation and defined benefit superannuation plans. Over 80 corporate employers and thousands of smaller enterprises Australia-wide entrust management of their employee superannuation to Equip. Of those, over 40 have defined benefit plans, and over 1,000 members receive an income stream from the Fund. Equip is thus one of the largest 'hybrid' funds in Australia, and consequently brings to this submission views borne of operational expertise in the management of both forms of superannuation plans, as well as being a leading pension provider.

Preliminary Remarks

Equip welcomes the opportunity to comment on, and make a submission in respect of, the final Financial System Inquiry (FSI) report, chaired by David Murray (Murray Inquiry) and released in December 2014.

As a profit-for-member fund with a proud history of serving members across both defined benefit and defined contribution cohorts, Equip is recognised as one of only a handful of true 'hybrid' superannuation funds in Australia. This heritage of managing the retirement savings of Australians, some backed by a plan sponsor's commitment to make lifelong pension payments, places Equip at the heart of the retirement incomes policy debate now gathering momentum. Equip, as an acknowledged innovator in post-retirement thinking, is pleased to make this submission for the Department of Treasury's consideration.

Scope of Equip's Submission

Equip's submission in response to the final FSI report will focus on two key sections of the report, these being Superannuation and Retirement Incomes (Chapter 2) and Appendix 1: Significant matters (Superannuation and retirement incomes).

In relation to Superannuation and Retirement Incomes (Chapter 2), Equip will focus comment on Recommendation 11:

> ***Require superannuation trustees to pre-select a comprehensive income product for members' retirement. The product would commence on the member's instruction, or the member may choose to take their benefits in another way. Impediments to product development should be removed.***

In relation to Appendix 1: Significant matters (Superannuation and retirement incomes), Equip will focus comment on Recommendation 37:

> ***Publish retirement income projections on member statements from defined contribution superannuation schemes using Australian Securities and Investments Commission (ASIC) regulatory guidance.***
>
> ***Facilitate access to consolidated superannuation information from the Australian Taxation Office to use with ASIC's and superannuation funds' retirement income projection calculators.***

Superannuation and Retirement Incomes (Chapter 2)

The retirement phase of superannuation – Recommendation 11

Require superannuation trustees to pre-select a comprehensive income product for members' retirement. The product would commence on the member's instruction, or the member may choose to take their benefits in another way. Impediments to product development should be removed.

Equip broadly concurs with the FSI final report that retirement risks are sub-optimally managed within superannuation at present.

The Institute of Actuaries of Australia recently noted that…. "M*anaging risk in retirement is a complex business for individuals. On approaching retirement, an individual needs to consider a range of risks and make decisions designed to adequately fund an increasingly long life in retirement*".[1] Further, the Association of Superannuation Funds of Australia (ASFA) in its second round FSI submission noted *"…trustees should exercise their fiduciary duty to consider longevity, market risk and inflation risk in designing post-retirement arrangements in much the same way they need to consider investment risk and insurance needs throughout the accumulation stage"*[2].

Equip contends that the nature of risk borne by the retired, and those close to retirement, go beyond longevity, investment (market) and inflation risks. Equip is of the view that people face a broader spectrum of risks in retirement, including the following:

- ***Investment risk:*** The risk that investment returns will fail to meet expectations. Whilst it might reasonably be expected that growth assets will outperform defensive assets over the longer term, growth-biased portfolios may experience extended periods of low or negative returns, accelerating the rate at which retirement capital is exhausted.
- ***Budgetary risk:*** Expenditure patterns can vary considerably during the early (active), mid (passive) and final (frail) stages of retirement. As individuals will move through these stages differently, budgeting for varying expenditure needs across an entire retirement is a considerable challenge.
- ***Sequencing risk***: A defined contribution member's account balance (both approaching and into the early years of retirement) is heavily path-dependent on the sequence of shorter-term returns whilst in the 'retirement risk zone' (broadly the period 10 years prior to and the first 15 years into retirement). Negative investment returns or market dislocations during this critical period can have an outsized effect on retirement outcomes.

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[1] Letter to the Treasurer, the Hon Joe Hockey, MP dated 23 March 2015, 'Financial System Inquiry ', Estelle Pearson, President, Institute of Actuaries of Australia

[2] Association of Superannuation Funds of Australia (ASFA), second round submission to FSI, at page 101.

- ***Inflation risk***: Any increase in the retirement cost of living, if not accompanied by an equivalent increase in pension income, results in a loss of purchasing power and thus a decline in relative living standards.
- ***Longevity risk***: The risk of living *beyond* one's life expectancy, and in so doing outliving one's financial resources. Longevity risk complicates the budgeting process in retirement, often resulting in members drawing private pensions at a sub-optimal rate to mitigate this risk.
- ***Counterparty risk***: Certain retirement income products, such as lifetime annuities, have an element of counterparty risk insofar as the purchaser (retiree) must be confident that the contractual terms will be honoured by the product provider over an extended period of time. Whilst strong prudential regulation can mitigate this risk, it can never fully remove it.
- ***Liquidity risk***: Retirees may need to make lump sum withdrawals (partial commutations) at short notice on occasion. Their ability to do so will be dependent on the legislative and contractual settings embedded in the retirement income products utilised.
- ***Legislative risk***: It is possible that legislative and/or regulatory changes will occur during the span of a member's retirement that will impact on their financial circumstances. Whilst some disadvantageous changes may be 'grandfathered' and their impact thus mitigated, an unstable retirement policy landscape still represents a long-term risk to retirees.

Equip thus views longevity risk, investment risk and inflation risk as just three in a multiplicity of risks that need to be managed by individuals in retirement. Importantly, Equip's definition of longevity risk explicitly references the financial ramifications of living *beyond* one's life expectancy. Thus someone with a life expectancy of 84 whose private financial resources exhaust at age 82 has *not experienced longevity risk* but more likely some other combination of retirement risks. The importance of this distinction, subtle though it might be, should not be too readily dismissed.

Popularity of Account-Based Pensions

The FSI final report notes that the dominant form of retirement income stream in Australia at present is the account-based pension (and legacy allocated pensions). These products account for over 94%[3] of current pension assets. Annual annuity take-up (particularly lifetime annuities) is a small fraction by comparison. As a fund that provides both lifetime defined benefit (DB) pensions and account-based pensions, Equip is of the view that behavioural drivers play a large role in retirement product preferences, a position in agreement with the final FSI report[4].

Equip has undertaken detailed analysis to understand member preferences around the time of retirement. Our findings suggest that most defined contribution (DC) members are aware that account based pensions are subject to market movements and may exhaust prior to life expectancy. They however still prefer the redemption (partial commutation) flexibility, member investment

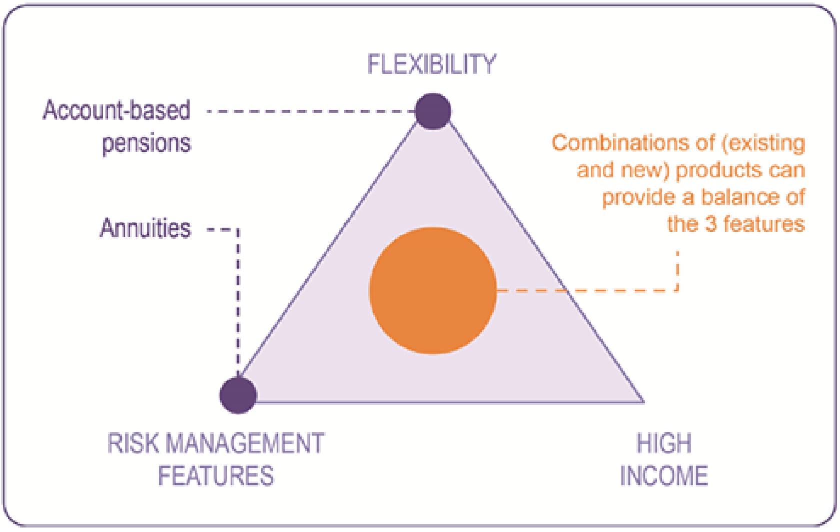
[3] FSI final report at page 120, citing data provided by Plan for Life to the FSI on 23 June 2014.
[4] For example, see 'Behavioural biases' section at page 119, FSI final report.

choice and control over residual benefits on death that an account–based pension provides, as compared to the income stability and sustainability of a lifetime annuity. There appears to be a strong behavioural preference for control of capital (during retirement and at death) over certainty and stability of income during retirement.

Introduction of a Comprehensive Income Product for Retirement

Equip is broadly supportive of Recommendation 11, which seeks to require superannuation trustees to pre-select a comprehensive income product for retirement ("CIPR") for each retiring member, with the option of take-up resting with the member. Properly designed and implemented, a CIPR has the potential to provide a blend of capital control and income sustainability beneficial to both its user and to the superannuation system (and by extension the tax/transfer system).

Equip recognises the inquiry's concern over the lack of longevity risk hedging within the superannuation sector at present. Equip however is concerned with the view that longevity risk is the dominant risk in retirement. Our internal analysis suggests that sequencing and investment risk are at least as important in a system dominated by account-based pensions. In Equip's opinion the 'risk management features' outlined in the below graphic should incorporate the totality of risks as outlined earlier, many of which cannot be mitigated by annuity-like products.



Source: FSI Final Report - Figure 9: Desired features of retirement income products (page 122)

Equip therefore has concerns that the FSI final report somewhat suggests a binary outcome for future retirement products; as either possessing or not possessing longevity risk hedging features. In our opinion the design of any CIPR should be principles-based rather than being overly prescriptive, allowing for the mitigation of as many risk factors as possible.

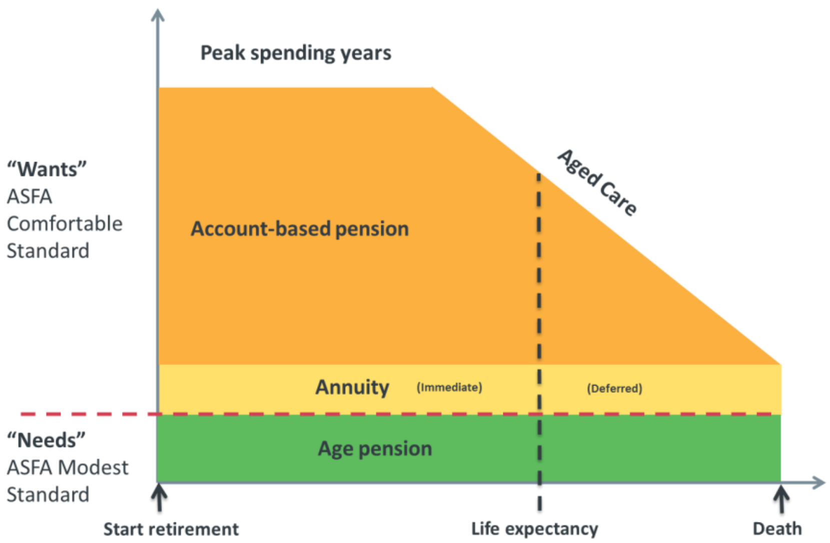
Equip is particularly concerned with the FSI view [at page 127] that "….Government should establish a mechanism to ensure each CIPR provides the required features, which should be specified in regulation". This approach may hinder future retirement income product innovation and inhibit competition.

A Layering Approach to Retirement Income Management

Equip is in agreement with the Inquiry's position that 'people tend to have diverse needs in retirement, and no given product or combination of products will be appropriate for everyone'[5]. Equip thus is supportive of the need for any CIPR to be a combination of underlying products, for example an account-based pension paired with a pooled product[6] that provides an element of longevity risk protection.

Equip holds that optimal retirement outcomes are more likely to be achieved in an environment where individuals have access to a range of complementary income streams, each one delivering one or more distinct benefits, and managing one or more risks. Our position is thus reflective of the '*Tinbergen Principle*[7]'; that sustainable solutions require as many instruments as there are goals.

As depicted below, Equip considers a 'layering' approach to retirement income management to most likely lead to the optimisation of outcomes between flexibility on the one hand and stability-cum-sustainability on the other:



As the above schematic depicts, a truly comprehensive retirement income plan might incorporate elements from one private account-based pension and two annuity sources; one from a private provider and the other from any public Age Pension entitlement that may arise.

[5] FSI final report at page 126.
[6] Such longevity risk pooling products were discussed in the FSI final report and include deferred lifetime annuities (DLA) and group self-annuitisation (GSA) schemes.
[7] So named after Dutch economist Jan Tinbergen, who in 1969 was co-awarded the Nobel prize in economic sciences for his pioneering work in the analysis of dynamic economic processes.

Equip MyPension – A 'CIPR Ready' Retirement Income Solution

Given the strong preference amongst its members for an account-based pension over an annuity driven solution, Equip launched a new retirement income product in July 2014. Equip MyPension is an account-based pension, but one that has been carefully designed to balance investment, sequencing and longevity risk for its members.

Equip MyPension works by combining a bucket approach[8] to portfolio construction with a withdrawal prioritisation system. Only units from the stable and liquid Cash option are routinely redeemed to meet pension payments. Units in two other buckets remain untouched between rebalancing events[9]. Prioritising withdrawals in this manner materially reduces the level of sequencing risk experienced by a member.

A schematic of the Equip MyPension bucket approach is depicted below:

Buckets	Objective	What the money is used for
Cash option	Starting with three years' worth of income, the money in this bucket is designed to meet your income needs over the short time (generally 2-3 years).	Your monthly income is paid from this bucket.
Conservative option	This bucket provides some stability over the medium to longer term, with the goal to generate income and some capital growth.	Any earnings in this bucket will top up the Cash bucket. Lump sum payments (if any) are drawn in equal amounts from the Growth and Conservative buckets.
Growth option	This bucket is designed for your savings to grow and make them last as long as possible. Its return may fluctuate more over shorter time frames than the other buckets, but is expected to produce higher returns over the long term.	Any earnings in this bucket will top up the Cash bucket. Lump sum payments (if any) are drawn in equal amounts from the Growth and Conservative buckets.

A major advantage of Equip's system of withdrawal prioritisation is that an element of mean reversion is built into the process, with the non-Cash options allowed time to recover from short-term falls between annual rebalancing events. Conversely, in rising markets an element of systematised 'profit taking' instils discipline where emotion might otherwise dominate. Equip MyPension's rules-based investment management system thus has the added benefit of mitigating some of the behavioural aspects of retiree behaviour[10]. In addition, by carefully managing the interaction between the buckets Equip MyPension members are able to commence with a higher weighting to growth assets, which in turn assists in mitigating longevity risk.

Equip MyPension stands ready to be a CIPR, either on its own or with the inclusion of a longevity risk hedging bucket. The strength of Equip MyPension is in its modular design, with buckets being able to be tilted, added or subtracted according to requirements; either Equip's or any other superannuation fund who may wish to use it as part of their CIPR solution.

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8 The 'bucket approach' is more formally known as the time segmentation method of portfolio management, where each bucket serves a distinct function and sits at a different point on the risk/return spectrum.
9 Other than to meet member-initiated commutations and to pay fees.
10 In this context these behaviours most commonly include over-confidence in rising markets, followed by loss aversion in rapidly falling markets.

Appendix 1: Significant Matters

Superannuation and retirement incomes

Superannuation member engagement – Recommendation 37

Publish retirement income projections on member statements from defined contribution superannuation schemes using Australian Securities and Investments Commission (ASIC) regulatory guidance.

Facilitate access to consolidated superannuation information from the Australian Taxation Office to use with ASIC's and superannuation funds' retirement income projection calculators.

Publishing Income Projections on Member Statements

Equip holds the view that the lump-sum investment frame of Australia's DC-centric superannuation system currently sends members down a path of looking for answers to the wrong question, that being *'how much super is enough?'*. Asking questions in a consumption frame (i.e. *'how can I achieve an adequate income that can be sustained throughout my retirement years?'*) results in very different considerations, and quite likely choices, both prior to and in retirement.

Equip is therefore in agreement with the view expressed in the final FSI report that 'All members need to understand their projected retirement income to make informed decisions about their retirement savings'[11]. It is the *income equivalent* of an estimated superannuation benefit that members could advantage themselves by 1) being aware of and 2) focusing their efforts on optimising, given their personal circumstances.

Equip acknowledges the work done by ASIC in the development of a possible framework to allow for the provision of a superannuation final balance estimate and its retirement income equivalent. ASIC's Consultation Paper 101 (Superannuation forecasts) of 2008 correctly, in Equip's view, surmised that "….consumers may benefit from some form of personalised superannuation forecast, which could give them an indication of what will be available to them at retirement. We envisage that such forecasts could serve an educative purpose, helping consumers to make choices about their super savings that will assist them to achieve financial security in retirement". Anecdotal evidence by ASFA in its interim FSI submission provides support for this position[12].

The Provisions in Respect of CO 11/1227 and RG229

APRA-regulated superannuation funds are now able to provide individualised superannuation estimates to each member under ASIC class order relief provided by CO 11/1227, without these estimates being seen as personal financial product advice[13]. CO 11/1227 has been updated, effective November 2014, as has the Regulatory Guide 229 (Superannuation forecasts) that explains

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[11] FSI Final report; *superannuation member engagement*, at page 267.

[12] ASFA submission to interim FSI report; engagement benefits by one large APRA-regulated super fund from a trial with 20,000 members who received super estimates, pages 48-49.

[13] Specifically, CO 11/1227 provides relief from Division 2, 3 and 4 of Part 7.7 of the Corporations Act 2001.

its operational requirements. In order for a super fund to rely on CO 11/1227, each member's superannuation estimate must be calculated in a form prescribed in the class order. Likewise, the presentation of the estimate must be done in a highly prescriptive format.

Equip is concerned that the prescriptive nature of the assumptions underlying the calculation methodology in CO 11/1227 may result in the estimates generated being of diminished value to members in guiding their retirement decision making. Specifically Equip has concerns:

- regarding the assumption that a member's wage will rise not at historic rates but at the rate of general economy-wide price inflation[14];
- that the estimate must cover a period of 25 years from age 67 to 92, and that estimates cannot be given to a member 67 years of age or older. This introduces both a level of inequity and inflexibility. It also introduces legislative risk (as discussed earlier) into the calculation, as the Age Pension qualification age may increase at a future, unknowable, time;
- that the estimate must use a rate of return of three per cent per annum, net of inflation and investment fees. Members who self-select investment options with long-term expected returns below or in excess of this figure will likely end up with actual benefits significantly different to the CO 11/1227 generated estimates;
- that the method to calculate the (optional) Age Pension estimate is too restrictive, given the assumptions about a member's relationship and home ownership status, co-retirement date, and that neither the member nor his/her partner has any other assessable assets.
- that the lump sum amount is generated as a 'point estimate', rather than as a range of possible outcomes. Using such a method might create a misplaced level of confidence on the part of the member in the estimate being achieved. Equip contends that a probability-based approach[15] to the lump sum estimate would better account for the variability inherent in any long-term financial forecast; and
- that the CO 11/1227 estimate can only be provided at the same time as the provision of a member's periodic statement[16] (whether embedded in it or provided separately), and cannot be provided at any other time, even if requested by the member.

Equip is, in summary, broadly supportive of measures to provide members with estimates of their future benefits and, more importantly, how these benefits might generate a retirement income. Equip wants our members better engaged with the key decisions needed to be made in their retirement planning, and with information relevant for the task. Whilst a worthy effort, Equip has concerns that CO 11/1227 will not, in its current form, foster the provision of information relevant to insightful retirement decision-making.

[14] It is well established that in a normally functioning market economy the rate of salary/wage increase should outpace that of the general level of inflation. The difference between the two is the notional increase in the standard of living over time.

[15] This might involve, inter alia, median and percentile forecasts (e.g. 25th, 50th (median) and 75th percentiles).

[16] See RG229.64 – RG229.71; Regulatory Guide 229 (Superannuation forecasts).

Access to Consolidated Super Information & Use of Financial Calculators

Superannuation funds are currently granted relief, via the operation of ASIC class order CO 05/1122, in providing superannuation retirement calculators to members, most typically on their websites. Where the calculator is an electronic facility or device, as would be the case with a web-based tool, the calculator must allow the user to change any of the assumptions applied in making the calculation (except for certain statutorily fixed factors)[17].

ASIC's view of how super estimates and calculators could work together is that "retirement estimates and calculators both play an important and complementary role. The purpose of retirement estimates is to provide an accessible starting point for members to engage with their superannuation in a personalised manner. Calculators can allow members to explore their retirement needs in greater depth. For example, calculators may be used to illustrate the effect of making alternative decisions, the effect of fees on a member's retirement balance or the effect of retiring at different ages[18]."

Superannuation calculators should therefore ideally capture a more tailored snapshot of a member's current personal and financial circumstances, to produce an estimate or projection that may better reflect that member's future financial position. Whilst the default assumptions for a CO 05/1122 calculator must be 'reasonable'[19], a member should be free thereafter to customise their inputs to conduct 'what/if' scenarios by altering, inter alia, their retirement age, investment options, or types and amounts of superannuation contributions.

Advanced super calculators should have the ability to account for differing personal relationships; the value, type and ownership of non-superannuation assets; and periods of low (or no) contributions (such as might occur with a planned or involuntary period of non-employment).

Issues in Providing Super Estimates and Calculators

Equip broadly concurs with the Inquiry's view that the benefit of a super calculator is maximised where data from a member's various superannuation accounts can be consolidated prior to the member engaging with the tool. The Inquiry's suggestion that the ATO could, in the first instance, provide this data consolidation via its myGov superannuation portal is worthy of further analysis.

Equip is mindful that there are many hurdles to overcome were this approach to be adopted. In the first instance, there may be technical impediments to seamlessly moving data from the myGov database to the CO 05/1122 tool being utilised by any particular superannuation fund. Clearly speed of data access and transfer here are key to member user experience. In addition, there will be a myriad of non-technical matters that will require navigation. These issues might pertain to the legal aspects of data ownership and control, the interaction of the national privacy principles and Privacy Act 1988 and aspects in relation to member data integrity and security.

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[17] Regulatory Guide 229 (Superannuation forecasts) at RG229.76.
[18] Op. cit. at RG229.77.
[19] It is noted that RG229 holds that a super fund might wish to use CO 05/1122 default assumptions as close as possible to those used in its CO 11/1227 superannuation estimates.

Equip is also concerned that the result of CO 05/1122 and CO 11/1227 operating in concert might have unintended consequences. Under CO 11/1227 a superannuation fund is precluded from giving a member estimate other than with a periodic member statement (generally either half-yearly or annually). The highly prescriptive nature of CO 11/1227 (as previously discussed) means that the super estimate is based primarily on a member's super account balance, without regard to any superannuation accounts that might be held with other funds. CO 05/1122, in contrast, can incorporate member-inputted non-superannuation assets, other variables previously discussed and potentially other superannuation balances.

Given the above, it is possible that a member might receive a CO 11/1227 estimate suggesting one particular future financial position, yet use that same super fund's CO 05/1122 calculator and get vastly differing projected outcomes. At that point the member is left not empowered by the information generated by CO 11/1227 and CO 05/1122 working in parallel, but more likely confused about their future financial circumstances in retirement.

It is for the above reason that Equip believes that the two class orders should be reviewed, preferably with the highly prescriptive nature of CO 11/1227 (superannuation estimates) being brought into closer alignment with the more customisable approach adopted by CO 05/1122 (financial calculators).