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The Treasury
Manager, CIPRs

By Email: superannuation@treasury.gov.au

Dear Sir/Madam

Re: Retirement Income Covenant Position Paper

Key Points

Industry Super Australia (ISA) welcomes the opportunity to comment on Treasury's Retirement Income Covenant Position Paper, as part of its proposed Retirement Income Framework.

In our submission to Treasury's 2016 Discussion Paper into the development of the framework for Comprehensive Income Products for Retirement (CIPRs), ISA highlighted the importance of the industrial system to the successes of Australia's retirement savings system and to the performance of the system as a whole.

Without the benefits provided to it by the long term average net returns of industry funds this system would perform substantially worse overall, lower than the OECD average.

This strong industry fund performance is a result of a member-first ethos, strong connections to industry, and equal representation governance that involves representatives of employers and employees.

By contrast, the segment of the super system based on profit for providers and retail choice (in which 'choice' is often code for 'sales', and sales are opportunities to clip the ticket) has not performed well.

The critical problem with the proposed covenant and the CIPRs framework it advances is that it is based on distribution by retail sale – a method of connecting members to good providers and products that has not proven to be in the best interests of most members.

The industrial default model is a critical component of the superannuation system and has a proven to work in the best interests of members. The key elements of this industrial model are:

- Not-for-profit providers with boards comprising of employer and employee representatives.
- Retirement income product distribution through the workplace and industry-wide or collective agreements between employers and employees, an subject to a quality filter applied by the Fair Work Commission (FWC)

In order to connect members to good quality retirement income products, and also be subject to the protections afforded by the industrial system, the default product would need to be a whole-of-life product joined in the workplace and orientated toward delivering a relatively stable retirement income for as long a member lives.

Increased retail distribution of retirement savings products will increase opportunities for-profit providers to prioritize their own interests over the interests of their members, and assumes a level of member financial literacy and engagement that does not exist.

The proposed framework assumes that members can navigate complex financial decisions and critically evaluate any advice they are offered. The model does not take into account evidence regarding the systematic lack of financial literacy and engagement of members, or evidence that not all trustees can be trusted to act in the best interests of their members.

It exposes members to exploitation via conflicted financial advice, upselling and marketing risk, and proposes nothing to prevent underperformance of existing retail retirement products. It would also likely expand the use of life office annuities in retirement, an intrinsically income inefficient product.

The proposed retirement income covenant is part of a framework that is fundamentally inconsistent with the industrial default system. It seeks to sidestep workplace distribution and the industrial system safety net in favour of retail distribution. Under the proposal, CIPRs will not be subject to a quality filter reviewed by the Fair Work Commission, will not be distributed through the workplace, and will be sold directly by funds to members which will require members to participate in a market of complex retirement income products.

The industry super sector has pointed out the clear flaws in the proposed CIPRs framework before. Despite these repeated criticisms, the new proposals do not explicitly acknowledge or discuss our concerns.

The proposal continues to assume that a distribution model based on sales to individuals will generate the best outcomes for retirees. However, based on the experience of the superannuation system to date, it is entirely foreseeable that forcing choices on individual retirees to engage in a highly complex product market with only minimum product standards to protect them will result in many being sold into products that are not in their best interests and which they may not be able to leave without incurring considerable costs.

This submission makes comments on the detail of the proposed covenant. However, these comments do not imply support for the broader CIPR initiative.

Increased risks to consumers and consumer outcomes

The proposed covenant will put consumers and their retirement outcomes at increased risk of being sold into poor quality and inappropriate income products. The covenant would, via its required offering of a CIPR prior to a member's retirement, cultivate a retail market in products in which requiring a point-of-sale would expose consumers to market risk, sales behaviour, and upselling.

If this covenant were to be implemented, for a point-of-sale to operate without causing poor consumer outcomes, two conditions would need to be satisfied.

Firstly, it would need be certain that the provider of the CIPR (or the provider of the advice regarding the CIPR) was working in the best interests of the member.

Secondly, the member would need to have the requisite knowledge to be capable of making the correct decision on their retirement income choices, which would involve challenging and independently evaluating the advice and sales-orientated information they are being provided with.

These conditions cannot be assumed. It is far more likely that for-profit funds will nudge their members towards poor quality, high-fee, no-exit CIPRs by tailoring and individualizing their flagship CIPR and which would then be marketed to members as a minimum quality or inferior retirement product.

Any reliance on the retiree's part on their fund is therefore likely to lead to poor retirement outcomes for the members. With regards to the effect of competition in the UK pension market, a recent report by the House of Commons Work and Pensions Committee into the 2015 pension freedoms concluded that:

> "…too many drawdown customers are not shopping around and do not understand their options. They are reliant instead on getting a good deal from their existing provider."[1]

In Australia, retail fund sales behaviour has become more increasingly sophisticated and effective, using existing member data, behavioural research and advanced sales techniques designed to push sales that benefit shareholders at the expense of members.

For example, ASIC alleges that BT and Westpac Securities Administration Limited used member data in combination with sales in order to transfer members into their products, with no consideration given to the best interests of the members. The framework around this project was not based on better member outcomes, but based on any increases to BT's funds under management.

The covenant assumes that the average retiree, upon being contacted by their fund around their retirement, will have gained the requisite understanding and cognitive capacities to rationally interact with these advanced sales and marketing techniques, despite a lack of financial knowledge and a lifetime of disengagement.

The Productivity Commission's recent report into competition in the superannuation sector noted that financial literacy is not of great benefit when dealing with superannuation:

> "While there is no shortage of information, many find it complex, overwhelming and inconsistent with their needs…Members get excessive choice at the expense of less comparability, and even highly engaged and financially literate members struggle."[2]

This is very likely to characterise the market for CIPR products if the initiative proceeds.

Issues with choice

The covenant is motivated partly by the belief, for which there is no evidence that consumer choice and competition will help to deliver efficient and stable retirement incomes. The retail sector has argued that an increased number of retirement income product options will provide improved outcomes to retirees, however the opposite is more likely. The Productivity Commission noted in their recent report: "Excessive variety can lead to choices that do not lead to best outcomes for members, or make them susceptible to poor advice".[3]

The introduction of MySuper has done little to curb the number of Choice products offered to consumers in the accumulation phase.

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[1] Work and Pensions Committee, *Pension freedoms*, House of Commons Paper No. HC 917, Session 2017-19 (5 April 2018), 3

[2] Productivity Commission, *Superannuation: Assessing Efficiency and Competitiveness* (2018) 20

[3] Ibid, 184

According to 2015/16 APRA data, there are 28,012 APRA regulated investment options offered by superannuation funds. Of these, 97% of these were offered by retail funds. This product proliferation is an intentional strategy in the for-profit sector, to use confusion marketing in order to push consumers towards higher fee, poorer performing products. Considering retail fund revenue-generation behaviour in the accumulation phase after the introduction of MySuper, the required point-of-sale will give these funds another avenue through which they can create and offer complex products.

The risks faced by consumers when dealing with confusion marketing and product proliferation in the accumulation phase are likely to be exacerbated in the decumulation phase due to the difficulty faced with switching to an alternative product if a bad decision has been made.

Due to the often permanent nature of CIPRs that use lifetime annuities, consumers who have been shepherded into agreements that are either unsuitable for them or just poor performing products in general will have little recourse. Even if a retiree is successful in ending a lifetime annuity, it would likely be costly at a vulnerable point in their lives.

There is no reason to believe that the 'flagship CIPR' requirements of the proposed covenant will do anything to limit proliferation and its intended 'confusion' impacts. While the flagship principle requires funds to offer up to three products initially, if there are no restrictions on sales or marketing of other products at the point-of-sale funds are very likely to attempt to upsell their members to an amended or tailored CIPR whose value will be difficult for members to compare and assess.

Resulting member reliance on their incumbent fund makes it highly unlikely that a proliferation of competing CIPRs will drive improvements envisaged in the paper. Members are unlikely to take advantage of a competing fund's product if they rely heavily on the advice of their own fund, and the average member's financial literacy would limit their ability to rationally make this decision anyway.

Product standards

The covenant creates numerous problems stemming from an apparent lack of measurable performance related standards for CIPRs, and members may have problems with recourse or assistance in cases of persistent underperformance and miss-selling.

While the paper mentions a certification process, it is not clear how effective it is likely to be given the amount of detail provided. While the proposed CIPRs framework provided some detail as to the measurable income efficiency standards that would be required for certification, measurable standards appear to have been downgraded.

The proposed "principles-based" certification based on loosely defined minimum standards will be less successful at ensuring retirement products are in members' interests, as the many underperforming MySuper certified funds demonstrate. The problem with certification for underperforming products is increased further by a lack of provision allowing for the revocation of certification.

The proposal firmly establishes CIPRs as a "trust product" with offering privileges. This would differentiate it from a pure choice product, and a new retiree would likely interpret the certification process as an endorsement of the performance or quality of a CIPR product, and members who choose their CIPR based on this certification deserve to have their interests protected.

However, the covenant as it stands has no detail as to what protection members will be afforded if placed into poor and inappropriate products. Products such as annuities, from which a member would likely not be able to switch, would require regulation that allowed members who purchased decertified CIPR to cancel the annuity. Regulation such as this could then have a detrimental effect on the market price of annuities, and the income it would deliver to retirees who relied on them.

There are probable income-efficiency issues with the life office and deferred lifetime annuities that the paper appears to assume will be the primary sources of longevity protection in a certified CIPR product.

As we noted in our previous submission, annuities provided by life offices deliver low levels of income relative to the large amount required to be invested in them, due to their investment in conservative assets and the profit taken from the returns on the assets prior to the income being paid to the retiree. Promotion of their use will further embed inefficiency in the retirement income system.

Finally, there is a risk that CIPRs designed around DLAs with commencement ages in the 80s will be sold to members of groups with characteristics that mean they will not, on average, obtain an income proportionate to their investment.

Conclusion

The new proposals do nothing to resolve the problems with the broader CIPR system. It is based on sweeping assumptions about trustee and member behaviour for which there is no evidence. If implemented, the CIPR framework, supported by the proposed covenant, will expose retirees to a heightened risk of being sold into poor quality underperforming products that they may not be able to leave.

ISA is a strong advocate of distributing whole-of-life retirement income products via the industrial safety net precisely because it does not force choice on those unable to defend their own interests, and it would apply a quality filter via the FWC that would ensure members are connecting to the best products.

The proposed CIPRs framework will not achieve comparable outcomes and should be withdrawn and re-thought.

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