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Ms Lynn Kelly
Retirement, Advice and Investment Division
The Treasury
Langton Cres
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Subject: **Exposure draft legislation for the Retirement Income Covenant**

Dear Lynn

Thank you for the opportunity to respond to the exposure draft legislation that will introduce a retirement income covenant for superannuation trustees.

Who is Mercer?

Mercer is one of the world's leading firms for superannuation, investments, health and human resources consulting and products. Across the Pacific, leading organisations look to Mercer for global insights, thought leadership and product innovation to help transform and grow their businesses. Supported by our global team of 22,000, we help our clients challenge conventional thinking to create solutions that drive business results and make a difference in the lives of millions of people every day.

Mercer Australia provides customised administration, technology and total benefits outsourcing solutions to a large number of employer clients and superannuation funds (including industry funds, master trusts and employer sponsored superannuation funds). We have over $280 billion in funds under administration locally and provide services to over 2.2 million superannuation members and 15,000 private clients, including the Mercer Super Trust, which has around 230 participating employers, about 200,000 members and more than $29 billion in assets under management.

Summary of our position and recommendations

Mercer strongly supports the introduction of:

- a retirement income covenant into the SIS Act, thereby highlighting the primary purpose of superannuation
- principles-based legislation relating to the covenant thereby providing flexibility for trustees, as well as competition and diversity within the industry

Mercer recommends that

- APRA publish some draft guidance in respect of the covenant before the end of 2021
- ASIC publish some draft guidance before the end of 2021 on how trustees may assist beneficiaries within the existing financial advice framework
- The ATO and DSS indicate the data that they will be able to provide to industry before 31 March 2021 and in future years
- The Government confirm its long-term financial commitment to the Age Pension, as well as the health and aged care systems
- Treasury contact the OECD to ensure that the Australian retirement income system is being correctly represented in the OECD publications.

Strong support for the covenant

The primary purpose of our retirement income system should be to provide financial security to retirees and to enable the majority of older Australians to maintain their previous standard of living with dignity and confidence. The provision of lifelong retirement income, together with some access to capital, represents a critical component of this goal.

Mercer therefore strongly supports the introduction of the covenant and, subject it to passing Parliament, for it to apply from 1 July 2022. Whilst it could be considered desirable for the objectives of the retirement income system (or superannuation) to be legislated before the introduction of the covenant, we do not believe that the introduction of the covenant legislation should wait for such deliberations. It is important for the focus on the provision of retirement income to begin as soon as possible.

Similarly, whilst we appreciate the importance of the forthcoming Quality of Financial Advice Review, we do not believe the covenant legislation should be held up for the findings of this review and the consequences thereof, which could take years to implement.

Let's get on with strengthening Australia's retirement system through the introduction of the covenant.

Strong support for the principles-based approach

Mercer is pleased to see that the draft legislation adopts a principles-based approach to the development of retirement income strategy by the trustee of a registrable superannuation entity.

The financial needs of retirees vary considerably and a single approach or product is not the best approach. Inevitably there will be considerable variation between members of different funds as well as between members within the same fund. Hence, the lack of any prescription defining a particular product, or suite of products, is welcomed.

The listing of the three overall objectives that a retirement income strategy should encompass is also a positive step. Again, it highlights the considerable variation that exists between the financial needs and risks of individual retirees and therefore the need for flexibility within the development of a fund's retirement income strategy. The legislated covenant and related guidance from APRA and ASIC (see below) will also need to balance this requirement for variation within the industry while at the same time retaining focus on the three objectives.

This principles-based approach should also lead to greater diversity in products, increased competition and more innovation within the industry.

The need for APRA guidance

The proposed legislation would insert a new subsection after subsection 52(8) into the *Superannuation Industry Supervision Act 1993.* Section 52 relates to covenants to be included in governing rules for registrable superannuation entities.

In particular, subsections 52(6), 52(7) and 52(8) relate to investment covenants, insurance covenants and covenants relating to risk respectively. It is noted that APRA has issued Prudential Standards and Prudential Practice Guides in respect of each of these topics, namely: Investment Governance; Insurance in Super; Risk Management; and Operational Risk Financial Requirement.

Given that that the retirement income covenant is to be inserted into the same section of the SIS Act, it is expected that, over time, APRA will publish both a Prudential Standard and Prudential Practice Guide in respect of the new covenant.

Given that RSEs will be required to have formulated a retirement income strategy by 1 July 2022 (subject to the passage of the legislation), it is essential that APRA issue some draft guidance <u>before 31 December 2021</u>. It is recognised that such guidance could be provided by the inclusion of additional material in existing Standards and Guides rather than through the development of a new Prudential Standard and Practice Guide.

Such development is particularly important as the proposed retirement income covenant will require trustees to formulate a strategy, gather data and information, make decisions and determinations, and publish their strategy in a new and evolving area. With this in mind, it is recommended that the APRA guidance should cover the following topics:

- The matters that trustees must address in the short term (i.e. before 1 July 2022) and those could be considered in the medium term (say before 1 July 2024), including product development, thereby recognising that 1 July 2022 marks the beginning and not the end of the process
- The permitted meanings or definitions of “maximise expected retirement income”
- Whether the concept of “broadly constant” income is to be expressed in real or nominal terms, noting that personal expenditure tends to reduce with age
- The permitted meanings or definitions of “period of retirement”, as this is likely to vary between different cohorts of members, even within the same RSE. Whilst it is recognised that this term may be relevant for developing a strategy, it may be unhelpful when applied to individuals
- The differences between the expected period of retirement for a cohort and the provision of lifetime income for each individual
- The requirements for the regular review process
- The need to consider these issues on an individual or household basis
- The relevance (or otherwise) of certain factors that trustees can use to determine sub-classes of members
- The balance between using industry–wide data (such as that held by the ATO) and information from the fund’s members in the development of the strategy
- The internal governance framework, delegations, processes, resource adequacy and review frequency that APRA expects the trustee to adopt to meet their obligations under the covenant
- The extent to which the trustee can or should assume the ongoing financial support provided by the federal and state governments to future generations of retirees
- The relationship between the requirements under the new covenant and those that already exist under current standards and guides; for example, SPS 515 Strategic Planning and Member Outcomes and SPG 515 Strategic and Business Planning

As mentioned above, it must be recognised that the introduction of the covenant is the beginning of the retirement income journey for the superannuation industry. It cannot be expected that the initial retirement income strategies developed in the first half of 2022 will remain unchanged for years to come. They will inevitably evolve as retirement balances increase and products are developed. This medium term approach should also be recognised in APRA's guidance.

Finally, we are concerned that there has been some discussion about the introduction, over time, of performance tests for retirement income products, possibly similar to the tests for MySuper and Trustee Directed Products. Whilst the development of quality products is to be encouraged, the uncertainty relating to possible future tests in an area that is much more complicated than accumulation products could limit innovation within the industry to the long-term detriment of retirees.

The need for ASIC guidance

The Exposure Draft states in subsection 52AA (2) that the strategy "must address how the trustee will assist those beneficiaries". The Explanatory Materials goes to state in para 1.50 that:

> "It is expected that trustees will consider the broad needs of the beneficiaries covered by the strategy to determine what assistance may best meet these needs."

Para 1.51 then comments that:

> "Trustees must operate within the existing financial advice framework. Trustees can fulfil the requirements of the covenant and create effective retirement income strategies without providing personal advice."

Understandably these comments are very general and leave the trustees with considerable discretion. Nevertheless they create considerable uncertainty for trustees in respect of the extent that they can assist individual beneficiaries.

It is recognised that the Quality of Advice Review next year will tackle these and related issues. Nevertheless, it is likely that any reforms to the legislative framework for advice are unlikely to be resolved for some years.

Therefore, it is recommended that ASIC provide draft guidance before 31 December 2021 on the following matters:

- The extent to which the collection of personal information (as suggested by Para 1.53 in the EM) and the subsequent provision of assistance as set out in the strategy does not result in the provision of personal financial advice,
- The extent to which trustees can assist their members in balancing the three objectives within the Retirement income Covenant without such processes and actions being deemed to be the provision of personal financial advice
- The permitted use (or otherwise) of default products, guided choice or nudges
- The role of robo-advice and calculators within the scope of financial advice
- The development of a limited safe harbour protection for trustees, assuming a fund operates in line with relevant ASIC guidance

Available data from ATO and DSS

Para 1.60 of the EM indicates relevant publicly available demographic data may be accessed from a range of government sources. Mercer believes that the data held by the Australian Taxation Office and the Department of Social Services, in particular, would be extremely helpful for trustees in developing the best retirement income strategy for their members. An industry-wide working group could be established to help work through this concept, possibly through the ATO's Superannuation Industry Stewardship Group.

For example, the ATO now holds considerable data in respect of individual members of all APRA-regulated superannuation funds. It is therefore recommended that the ATO provide data to each trustee including:

- the percentage of their members aged between 60 and 70 who have a partner
- the average superannuation balance in the fund for single and partnered members
- the average superannuation balance held by their non-retired members aged over 55 held in other superannuation funds
- the average superannuation balance held by partners of their non-retired members aged over 55

In addition, it would be very helpful to have some national data published relating to the level of non-superannuation wealth (or investment income) for individuals aged over 55, broken down by their superannuation balance.

All such data would be aggregated and therefore should not provide any privacy concerns.

In addition, it is recommended that the Department of Social Service provide aggregate data showing

- the level of financial assets (broken down into superannuation and non-superannuation assets) for each 5-year age group, from age 60
- the level of home ownership for singles and couples who receive a full or part Age Pension, for each 5-year age group

This data would provide trustees with insights which they are unable to obtain directly from their members. In turn, this would enable them to develop a more relevant retirement income strategy for their members approaching or in retirement.

Confidence about the future

The Retirement Income Review found that many older Australians do not spend their superannuation assets during their retirement and hence leave these assets as a bequest on their death. As noted above, this is not the purpose of superannuation.

However, it is also recognised that many retirees have a fear of “running out of money” or are uncertain about the level of government support they may receive in the future relating to the Age Pension or their unknown health and aged care costs.

Indeed, with the economic discussion around the financial consequences of an ageing population, as well as the funding shortfall in aged-care identified by the recent Royal Commission, it is not surprising that many retirees are risk averse and are reluctant to spend.

It is therefore recommended that the government make a very clear statement prior to the forthcoming election that the Age Pension with its current settings is here to stay. After all, the Retirement Income Review showed that the current costs were sustainable into the future. In addition, the government should make a very clear commitment towards the future funding of health and aged care service.

Such announcements would provide trustees with greater confidence and clarity in the development of their retirement income strategies for their members.

Our international comparison

While discussing retirement income, it is interesting to note that the OECD's *Pensions at a Glance* publications showed the net replacement rate for an average income earner in Australia was:

- 42.6% for males and 38.8% for females in their 2017 publication[1]; and
- 41.0% for males and 37.3% for females in their 2019 publication[2].

We have also seen the latest, as yet unpublished, figures which show similar figures in preparation for their 2021 publication.

Yet, as from 1 July 2019, new assets and income tests applied to retirees who purchase lifetime income streams. The OECD modelling assumes that the accumulated retirement benefit from a Defined Contribution plan is converted into a CPI-indexed lifetime annuity which would meet the requirements for a lifetime income stream.

The 2019 OECD publication shows that the average income earner would receive no age pension[3] in the first year of retirement. However our modelling suggests that this individual would be entitled to a part pension, if they purchased an indexed annuity with their superannuation benefit and took advantage of the new rules.

We therefore recommend that Treasury contact the OECD as soon as possible to ensure they understand these revised means test rules and their relevance to the calculation of replacement rates. An increased replacement rate, based on the OECD methodology, would place the Australian system in a better international light and may also lead to an improved score in the Mercer CFA Institute Global Pension Index.

As always, Mercer welcomes the opportunity to contribute to improving Australia's superannuation industry for the benefit of individuals and households. Please do not hesitate to contact me if you would like to arrange a discussion or need further information in respect of any of the above matters.

Yours sincerely,

Dr David Knox
Senior Partner

[1] OECD (2017), *Pensions at a Glance 2017 OECD and G20 Indicators*, Table 4.8
[2] OECD (2019), *Pensions at a Glance 2019 OECD and G20 Indicators*, Table 5.5
[3] OECD (2019), *Pensions at a Glance 2019 OECD and G20 Indicators*, Table 5.3