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Development of the framework for CIPRs

Submission by UniSuper

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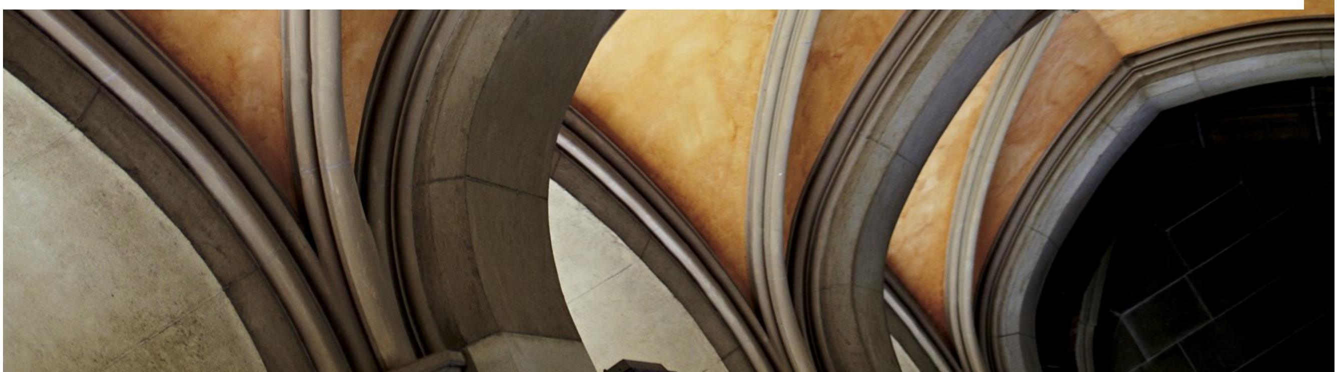

About UniSuper

UniSuper[1] is the superannuation fund dedicated to people working in Australia's higher education and research sector. With approximately 400,000 members and around $63 billion in assets under management, UniSuper is one of Australia's largest superannuation funds and has one of the very few open defined benefit schemes.

UniSuper Management Pty Ltd would welcome the opportunity to discuss the submission further and to provide additional information in respect of the comments made in this submission. Should you have further queries, please contact Benedict Davies on (03) 8831 6670 or benedict.davies@unisuper.com.au

[1] This submission has been prepared by UniSuper Management Pty Ltd (ABN 91 006 961 799), which acts as the administrator of the Trustee, UniSuper Limited (ABN 54 006 027 121).

Overview

UniSuper has a long history of providing retirement incomes to its members, and we currently offer the “full-suite” of pension products allowed by law. We are committed to providing income to our members in retirement and we have undertaken considerable research of pooled risk schemes overseas.

In 2014, we made a submission to the Financial System Inquiry arguing that Trustees should be given more flexibility to develop new retirement income products to address the needs of their members.[2] We continue to believe that Trustees, rather than policy makers, should be at the forefront of developing appropriate retirement income strategies and products for their membership. Ultimately, the responsibility for developing new products should rest with Trustees – acting under a best interest duty – to understand and respond to the changing needs of their membership.

In this submission, therefore, we argue that:

- The primary focus should be on a framework rather than on product features;
- Trustees should develop products and strategies appropriate to their membership under a Retirement Income Framework (RIF), similar to the Insurance Management Framework (IMF)
- A safe harbour is generally not necessary because the onus is on trustees to develop appropriate products; however, a limited form of safe harbour should be considered if it becomes compulsory for trustees to offer CIPRs (the limited safe harbour would be from having to compulsorily offer a standardised CIPR which might be inappropriate for some members)
- The two main technical actuarial tests, viz:. the income efficiency test and the average annual real income test, should allow for different treatments for guaranteed and non-guaranteed products / components
- The risk adjustment factor makes guaranteed products (e.g. immediate annuities purchased from a life office) more likely to pass the test than similar products pooled and managed internally by superannuation funds without either an explicit capital or employer guarantee
- The income efficiency test is useful for making product comparisons but care is required in its application to ensure neutrality (wherever possible) between guaranteed and non-guaranteed products

[2] http://fsi.gov.au/files/2014/08/UniSuper_Management_Pty_Ltd.pdf

The rationale for CIPRs

While the Discussion Paper canvasses many issues, this submission focusses on the principle of a Retirement Income Framework and what members and trustees would want from such a framework. To that end, we think the framework for regulating and offering CIPRs is more valuable than actually defining minimum product features.

For example, the Discussion Paper describes CIPRs as a *composite product* that:

1. delivers a minimum level of income that would generally exceed an equivalent amount invested in an account-based pension drawn down at minimum rates, with recognition of the benefit of a guaranteed level of income where relevant;
2. delivers a stream of broadly constant real income for life, in expectation (in particular, to manage longevity risk); and
3. includes a component to provide flexibility to access a lump sum (for example, via an account-based pension) and/or leave a bequest.

Rather than building CIPRs by reference to account-based pensions, we think a principles-based approach is better. Thus we need to ask: what is the rationale for CIPRs in the first place? According to the Discussion Paper, CIPRs will increase the standard of living in retirement of individual members through increased *availability* and take-up of products that more *efficiently* manage longevity risk.

Availability of CIPR-like products

While it is possible that a lack of availability of longevity products is an explanation for retirees predominantly preferring account-based pensions (ABPs), as longevity products have a long history in the Australian market-place there must also be a variety of other reasons why retirees generally prefer ABPs. After all, CIPR-like arrangements are already an option for retirees e.g. an account-based pension and an annuity or taking a broader view of retirement income / savings by factoring into a retirement plan the role of the Age Pension and/or access to equity in the family home.

It is worth pointing out that if there were an increased availability of longevity products, there is no guarantee that there will be an increased take-up of these products. In our view, shared by many in the industry, is the take-up of these products is likely to be heavily influenced by any concessions offered in law (whether it be tax or social security or both).

Efficiency of CIPRs

The Discussion Paper also makes the point that CIPRs will introduce efficiency in managing longevity risk and outlines two possible ways to define income efficiency:

1. setting a minimum amount of income above a 100 per cent account-based pension drawn down at minimum rates
2. putting a cap on the total amount of 'leakage' from retirement incomes (for example, administration costs, capital costs and bequests)

We note that the Actuarial Certification Test paper has since settled on the first approach (above). We are supportive of that approach and the general principle of defining income efficiency. These rules, once well-established, should prove to be a good way to compare different retirement products, including products that are whole-of-life e.g. CDCs and lifetime GSAs.

One area of efficiency that the Discussion Paper is silent on is the efficiency gains from pooling risks over the lifetime of a member, rather than just at retirement. We maintain that it is easier and more efficient to pool risks between a well-understood and readily definable class or group of members in a particular sector, particularly where a trustee has a long-established relationship with a sector and has deep and extensive data on employment patterns, resignation and retirement ages, along with reliable mortality and life expectancy data. To that end, we continue to advocate for CIPRs to be thought of as more than "purchase at retirement" products and open to being genuine whole-of-life products.

Why would trustees develop CIPRs?

The Discussion Paper argues that the CIPR framework would *enable trustees to provide individuals with an easier transition into retirement through the offering of a standardised retirement income product.*

On the face of it, the ability to offer a "standardised" product is not a particularly compelling reason for trustees to develop new products. A trustee's product offering, after all, should be based on identified needs of its members rather than fitting members to standardised products. CIPRs considered as a framework, rather than a standardised product, makes more sense to us and we would like to see trustees develop their own retirement income framework within which they would develop a range of suitable products for their membership. In our view, retirement income product development should not be about standardisation or ease of development but based on identified needs of members and a trustee committed to the principle of improving retirement outcomes for members.

While there is currently an Insurance Management Framework (SPS 250), there is no Retirement Income Framework. Insurance is an important part of superannuation; however, we would argue that retirement income is even more important, and it is an anomaly that there is no equivalent framework to make retirement income options available to beneficiaries.

Therefore, a Retirement Income Framework (RIF), instead of defined products and prescription, could be considered as an alternative that would require each RSE licensee to

have a policy to manage the retirement income needs of its beneficiaries. In essence, this would give effect to what good trustees are already doing.

The RIF could include:

- A policy on how the trustee gives consideration to the retirement *income* needs of its overall membership
- A policy to project superannuation benefits as income streams (moving away from thinking of superannuation as a lump-sum or pot of money)
- A policy on the appropriate mix of retirement options for its membership (either developed in-house, in partnership with third parties or via referrals to other providers)
    - This policy should consider a mix of retirement income products that offer real income for life (in particular, to manage longevity risk) as well as products that provide flexibility to access a lump sum and leave a bequest

Similar to an IMF, an RIF would be the totality of the licensee's products, policies, processes, advice (where appropriate) and education offered to beneficiaries.

The RIF would need to be appropriate to the size and complexity of the licensee's business operations and to the types of retirement income products offered.

We believe a framework, similar to the above, offers trustees more flexibility to develop products that are appropriate for their members. A framework is also more responsive to change and the changing needs of members. The development of a CIPR framework would represent one of the most significant changes to superannuation in over 25 years. As such, the changes should be both incremental and rigorously evaluated before the next step is taken.

An RIF is, arguably, a more important first step than a safe harbour. After all, "[I]f a trustee designs a product that meets the proposed minimum product requirements; is in the best interests of the majority of their members; and offers the product in line with the offering requirements"[3] and is done as part of an RIF, then a safe harbour would only be necessary where trustees were required to *compulsorily offer* a standardised CIPR to all members, even those for whom it might not be in their best interest.

[3] Commonwealth Treasury (2016), *Development of the framework for Comprehensive Income Products for Retirement*, p. 3

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Actuarial certification test

The proposed actuarial certification test is going to be extremely important because it will influence the manner in which many product providers develop CIPRs. The test has the potential to influence how and which *existing* products are bundled together (e.g. account-based pensions plus annuities) as well to influence the design, structure and pricing of *new* products, such as GSAs and CDCs. As a result, we are keen to ensure that this test is sufficiently flexibile enough for a broad range of products with a broad range of product features.

Income efficiency test and average annual real income test

These two main technical tests, namely the income efficiency test and the average annual real income test, allow for different treatments for guaranteed and non-guaranteed products / components. Guaranteed products/components are eligible for a risk adjustment factor (as yet unspecified) so that they do not have to score as highly as non-guaranteed products to pass the test.

Importantly, the average annual real income test imposes a floor to ensure the level of income exceeds the level of income produced by an account-based pension. Given the prescribed nature of the real investment return assumption, it appears that the proposed minimum level (an additional 10% of average real income) is unlikely to be achieved by non-guaranteed products (e.g. GSAs with additional mortality credits from the pooling arrangement) with more conservative investment options (e.g. capital stable or cash) under the current low interest rate environment. This may have unintentional influence on providers in developing products with more growth-oriented investments which may not suit some retirees.

Also, the risk adjustment factor makes guaranteed products (e.g. immediate annuities purchased from a life office) more likely to pass the test than similar products pooled and managed internally by superannuation funds without either an explicit capital or employer guarantee. One example is UniSuper’s Commercial Rate Indexed Pension which is a lifetime indexed annuity that has been in successful operation for around 20 years.

Clarification on guaranteed and non-guaranteed products

As a result of the risk adjustment factor, it appears likely that some superannuation funds will need to either partner with a life office or get their own life licence in order to offer guaranteed products which are more likely to pass the test. For superannuation funds looking to develop non-guaranteed products (e.g. GSAs) in-house, their options would be to either consider more growth-oriented investments (e.g. something akin to a balanced fund) or to adopt a long-term investment outcome in the pricing of the non-guaranteed products. This is because it appears unlikely that under the current lower interest environment, non-guaranteed products with more conservative investment options would pass the stringent annual real income test.

As can be seen, much will turn on these certification rules and the differences between guaranteed and non-guaranteed products. Therefore, we think it is important to have this distinction made clear.

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We think it is also important to consider a greater range of risk adjustment factors so that the actuarial certificate test could cater for a range of innovative product designs that do not fit into the current framework of strict guaranteed/non-guaranteed dichotomy. One example would be a GSA arrangement developed in-house by superannuation funds, with its systematic longevity risk insured by a reinsurer.