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RE: CHALLENGER AND MERCER JOINT SUBMISSION: THE COMPREHENSIVE INCOME PRODUCT FOR RETIREMENT

1. The comprehensive income product for retirement

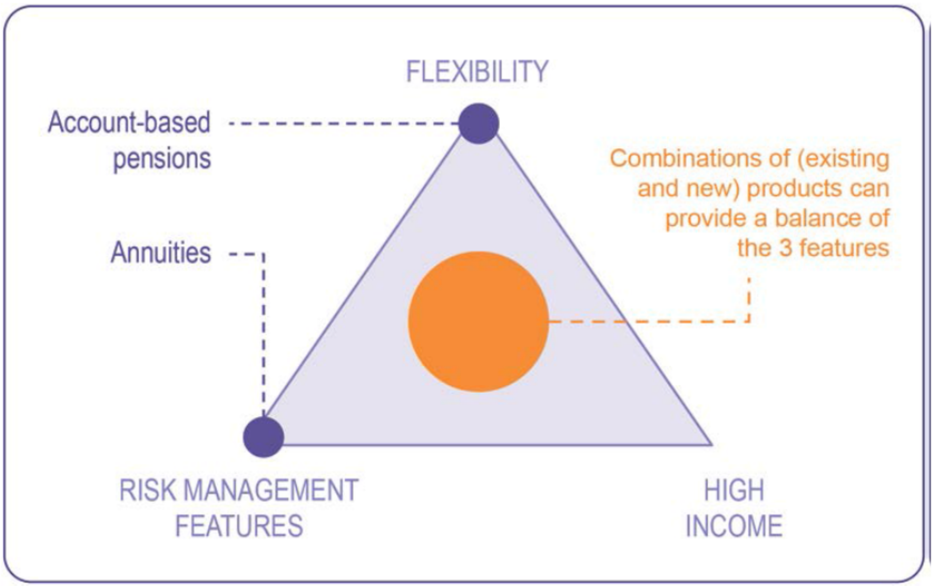
Recommendation 11 of the final report of the 2014 Financial System Inquiry (FSI) recommended that all large APRA-regulated super funds be required to 'pre-select' a comprehensive income product for retirement (CIPR) that addressed the need for retirees to have:

- a regular and stable income stream;
- longevity risk management; and
- flexibility.

It was suggested that this requirement is likely to be satisfied by using a combination of products, starting with the well-known account-based pension (ABP). This was illustrated in figure 9 of the FSI's final report as follows:[1]

[1] Page 122 of the FSI final report – 7 December 2014.

Desired features of retirement income products



Other comments suggested that a CIPR could include:

- a flexible transition from the accumulation phase;
- a cooling off period;
- diminishing return of capital on death.

The final report provided an inclusive range of examples of CIPRs, which included ABPs combined with:

- a deferred lifetime annuity;
- a group self-annuity (GSA); and
- a deferred GSA.

Other products that could form part of a CIPR include:

- term annuities, ranging from 100% to zero residual capital value, coupled with deferred lifetime annuities;
- lifetime annuities;
- other capital market solutions based on derivatives; and
- other innovations.

2. Link to FSI recommendation 9

Recommendation 9 of the FSI suggests that the primary and subsidiary objectives of superannuation should be clearly legislated. The recommendation articulates the primary objective as being to provide income in retirement to substitute or supplement the Age Pension.

If this recommendation were adopted by government, it would be highly desirable for the legislation establishing the CIPR to enunciate that the CIPR was intended to form a key part of giving effect to the primary objective of superannuation. This would give some clear guidance to the industry, and the regulators, about the central role that the CIPR would play in delivering income in retirement.

To take our retirement income system to the next stage of its evolution, the CIPR concept must be impactful, while at the same time allowing some choice for super funds, innovation in product development and flexibility for individual retirees.

3. Who would administer the CIPR regime?

Each fund and its trustees (in consultation with suitably qualified experts where necessary) would have to consider what was the appropriate CIPR design (or designs) for their members, but this should be done within a framework administered by APRA and supported by legislation. This theme is explored in more detail below.

APRA would be the appropriate agency to administer the CIPR regime. It can be given a broad, principles-based mandate in legislation and then use its prudential standard-making power to make the regime work in practice. This would give APRA the flexibility necessary to make CIPRs work for the benefit of retirees, while allowing for innovation and different circumstances from fund to fund.

4. CIPRs must respond to members' needs and risks

This paper suggests an approach where each fund would address the retirement income challenges of its members in its own way, subject to the broad criteria prescribed by the legislative framework, supported by guidance and supervision by APRA. In considering the provision of retirement income by a CIPR, the key financial risks include:

- **longevity risk** – the inherent risk that the uncertainty surrounding a retiree's actual lifespan causes a misallocation of retirement savings either by overspending or underspending. There are two elements of longevity risk: idiosyncratic risk, being the risk that a single person lives longer than the expected average; and systematic risk, being the risk that the mortality experience in a pool of lives or across the whole population changes from levels previously experienced or projected;
- **inflation risk** – the risk that the purchasing power of retirement savings does not keep up with the cost of living as it affects retirees; and
- **market risk** (including the importance of the subset risk, **sequence of returns risk**) – this is most often thought of as the standard deviation of investment returns from the expected mean from period to period, although capital loss might be more relevant for some retirees.

Given the diversity of members, both within and between funds, it is recognised that it would be appropriate for some trustees to address these risks to different levels, giving funds a degree of flexibility to cater for differing member characteristics. The important fact will be that the trustees have considered each risk and its relevance to their members.

5. Higher level issues in designing CIPRs

This paper proposes a way to acknowledge the different ways to manage risks across CIPRs, while enabling APRA to hold the industry to appropriate standards of governance in relation to their design and implementation. It proposes a system of regulatory guidance, without reducing the ability of fund trustees to tailor their offer to the specific needs of their own members (eg taking into account different account balances, demographic factors and the like).

Some key questions will arise about how the CIPR regime would work. For example:

- what process would trustees need to adopt in designing a CIPR for their fund?;
- what is the minimum account balance that the FSI panel suggested be excluded from the CIPR offering?;
- what combinations and proportions of risk management products and ideas are appropriate for creating a CIPR?;
- how many CIPRs could or should a fund offer?

6. Trustee governance: a possible solution

One way to implement the CIPR concept would be for Parliament to legislate some high level objectives of the regime and the obligations imposed on trustees, leaving the detail and administration of the regime to APRA in its role as the prudential regulator. APRA could develop a prudential standard that provided guidance and direction to trustees in designing and implementing a CIPR.

This approach could be similar to that adopted in respect of the provision of insurance within superannuation. APRA’s recently issued prudential standard on risk management for regulated institutions is a rich source of ideas for helping super funds develop an appropriate strategy for managing the risks faced by their retired members in a CIPR.

The idea would be to spell out the issues within the prudential standard that trustees would have to consider. That way, the CIPR concept would have some real impact, but the parameters would be both flexible and transparent. Importantly, setting the CIPR prudential standard would involve consultation with stakeholders in the normal way that APRA uses its standards-making power. The standard and its administration by APRA could be focused principally on trustee governance; aimed at making sure that the trustees had made the appropriate inquiries and were following certain basic procedures in designing and implementing the fund’s CIPR.

Trustees should be aware of the inherent financial risks that their members face in retirement. The CIPR should lower the residual risks for retired members to a level consistent with the risk appetite that the trustees set for them (or a particular cohort of them), remembering that members may always choose another arrangement.

For example, the prudential standard might require certain preparatory work to be undertaken to ascertain what member needs and wants are in retirement. Subject to the outcome of such work, trustees could then be obliged to consider and have a strategy for dealing with the following risks and features of a CIPR:

- Longevity risk
- Inflation risk
- Investment strategy
- Net investment returns
- Market volatility
- Sequencing risk
- Income flows
- Liquidity
- Access to capital
- Late stage cognitive decline

The relative importance of each component should be considered and is likely to differ from fund to fund, but APRA might also set some guidelines or benchmarks in its CIPR standard. Fund trustees would be free to adjust various features in order to deliver a different approach relevant to their members.

The FSI clearly enunciated the need for the Australian superannuation system to move towards income streams through several of its recommendations. The development of CIPRs represents an important step forward in moving Australia’s superannuation system from wealth accumulation to a focus on providing income in retirement.

Yours sincerely

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