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Division Head
Retirement Income Policy Division
The Treasury
Langton Crescent
PARKES ACT 2600

Dear Sir/Madam

*Submission on consultation:* ***Development of the framework for Comprehensive Income Products for Retirement (CIPR)***

Morningstar is pleased to have the opportunity to respond to the Development of the framework for Comprehensive Income Products for Retirement, discussion paper.

**Background: Together we can help drive better retiree outcomes**

At Morningstar, we are driven by a simple but powerful belief that when everyday investors win, we all win. This belief drives everything we do and has helped us become a globally trusted provider of independent investment research actively advocating for better investor outcomes worldwide.

For more than 33 years, Morningstar has led conversations about how the industry can continue to level the playing field for investors by distilling investments to their fundamentals, understanding how the investments work and whether they're worthwhile, and the role they should play in a holistic investment strategy. We study markets worldwide to evaluate how fair they are, and we strengthen our relationships with regulators globally to weigh in on changes we think will benefit investors most, such as the proposed framework for Comprehensive Income Products for Retirement, or MyRetirement products.

We welcome the Government's push to innovate in this space to increase individuals' standard of living in retirement, and empower trustees to provide members with an easier transition into retirement. We also strongly believe in the value of advice in helping retirees achieve their goals, along with ongoing investment in technologies that improve the delivery and accessibility of advice to superannuation members and retirees.

As more and more Australians face a gap between their expectations of retirement and reality, there is a great social and economic responsibility for the industry to continue to evolve by giving investors what they need to achieve their life goals and to live with dignity. "Accidental investors" like everyday superannuation fund members and retirees need our help most to recognise what investing can do for them and what steps they can take to improve their standard of living.

We are at an important juncture in the evolution of our industry; one that is making investing fairer for all and easier to understand. It is now possible for anyone to learn about investments and the people who manage them, as well as which companies best represent their interests. Costs are lower than ever, helping people preserve more of what they earn. But there is a lot more we can do. We are excited about this evolution and look forward to working with Government and the broader industry to continue to drive better investor outcomes through the proposed MyRetirement framework.

**About Morningstar**

Morningstar, Inc. is a leading provider of independent investment research in North America, Europe, Australia, and Asia. The company offers an extensive line of products and services for individual investors, financial advisers, asset managers, retirement plan providers and sponsors, and institutional investors in the private capital markets. Morningstar provides data and research insights on a wide range of investment offerings, including managed investment products, publicly listed companies, private capital markets, and real-time global market data. Morningstar also offers investment management services through its investment advisory subsidiaries, with more than USD200 billion in assets under advisement and management as of March 31, 2017. The company has operations in 27 countries.

## *Executive Summary*
### *Mechanics and Preferences – Driving Retirement Outcomes for Australians*

Morningstar supports the move to provide greater focus on retirement outcomes and facilitate regulations that make it easier for trustees to provide default solutions for retirement income.

Retirement outcomes for Australians will be improved by defining the CIPR as a *solution* that utilises relevant component products as opposed to a *product* alone. The CIPR framework must also make it easier for trustees to provide online advice to address individual requirements in retirement. We believe too much focus has been placed on a "product" to address the issue in the discussion to date.

We support the move to make longevity insurance more readily available but do not believe this should solely be achieved by bundling it with other components into a single product. Longevity insurance in and of itself is a complicated product, adding to this by incorporating additional elements/features will make it more difficult to compare these products and may prevent the formation of a competitive market in such products. Technology and advice should be the instruments used to pull together different product components into an overall retirement income solution for retirees.

Specifically, we note that while a CIPR may be good for some investors, many investors will not benefit because of their unique circumstances. As Szapiro[1] observes, efforts to require or coerce annuitisation generally are not popular and while the CIPR framework being considered is somewhat different from anything that has been tried, there are still relevant lessons to apply. A two-pronged approach that reduced barriers to offering more personalised advice along with the option of utilising CIPRs would be much better than a single product to help retired investors meet their specific goals.

[1] Szapiro, A. Improving the Defined-Contribution System: The U.S. Can Learn from Other Countries' Approaches to Helping Retirees Convert Their Savings into Lifetime Income, *The Journal of Retirement,* Vol. 4, No. 4 (2017), pp. 40-52.

The idea that new “products” alone can lead to higher levels of retirement income for Australians oversimplifies the challenge. The statement “that incomes from CIPRs could be 15 to 30 per cent higher than those from the current typical strategy of drawing the minimum amount from an account-based pension, while providing security of income for life” has been used often in discussing CIPR but has the potential to be misinterpreted out of context.

Will longevity “products” increase retirement outcomes for all Australians? When you look at the mechanics, no they will not. Very simply, they will transfer assets between those who die early to those who die later. This will clearly benefit some and has the potential to add certainty and value to many more. However, the mortality credits created do have some implications relative to a simple account-based pension, including:

- product cost structures will be higher due to the additional complexity of the product;
- the capital costs associated with longevity products;
- assets are likely to be allocated to lower risk/return investments due to the capital requirements placed on annuity providers; and
- higher distribution/sales costs due to the additional complexity of the product.

It is true in a narrow sense that annuities are more efficient, but they do not create more economic utility, necessarily. Rather, they create additional income for retirees as long as they live. Further, for retirees who wish to draw down a low percentage of their assets, have other sources of income, or are not concerned about longevity risk, a similar improvement could also be achieved through ABPs with the assistance of better advice tools.

Retirement incomes will be impacted by three main drivers:

1. Mechanics: contributions + investment earnings – product fees – taxes;
2. Preferences: bequest preferences and preferences around what level of certainty people look for in retirement; and
3. Mortality credits: the effectiveness of any pooling of longevity risk made available.

It is clear from a policy perspective that superannuation is not intended to be used as an estate planning tool. This policy objective is managed through minimum drawdown requirements and the tax treatment of superannuation/pension assets. However, it is incorrect to extrapolate this to a position where no superannuation assets should be left to dependants in any instance. Within these policy settings, some Australians will prefer to live more frugally so as their dependants may live better, while for others, the preference will be for more certainty around retirement incomes. People will have different preferences.

The fear of running out of money can be a factor in lowering drawdown rates. In some cases, this can be a justified fear, in other cases, it is more of a behavioural bias. In both instances, the result can be better informed through the utilisation of improved advice tools. If no advice is provided, it is not surprising that members gravitate towards the minimum drawdown rates – a choice of one.

Technology is enabling rapid improvement in data-gathering techniques, modelling engines, and the integration of the two with administration and investment platforms. This must be recognised in the formation of the CIPR framework by allowing for more personalised solutions through the default process and additional protection for trustees looking to do so.

## Discussion Questions

Relevant discussion questions from the Development of the framework for Comprehensive Income Products for Retirement, Discussion Paper 2016 are listed below with our responses.

### A. Defining a CIPR

#### 1. How can trustees design CIPRs to deliver the best outcomes for their members? What are the trade-offs of different design approaches and features?

While it is "envisaged that a CIPR would be a composite product", we believe the solution should be comprised of distinct individual components. The bundling should take place in the way these individual components are combined for reporting purposes to the individual member.

Morningstar has extensive experience in analysing investment products. Those products which have served investors best have tended to be simpler in design with clear objectives and a high degree of transparency. A composite product involving both account-based assets and longevity insurance will add to complexity, making it more difficult to compare products, creating the potential for cross-subsidisation, which will ultimately lead to higher costs for investors.

We believe trustees will be able to design better CIPR outcomes for members by combining best of breed products from each area. MySuper has created a range of large, diversified, easily comparable investment options serving the best interest of members. This framework should be retained in the retirement phase. Longevity products, whether they be deferred annuities, immediate annuities or some combination of both also have very specific characteristics which would be more readily assessed and compared on a standalone basis. Using this building blocks approach will also create a set of products/capabilities that can equally serve the needs of members and advisers who want to build more customised approaches.

We recognise that by bundling underlying components within the member reporting layer, additional costs will be incurred by trustees at the reporting and technology system level. We believe this additional cost will be less than the additional costs likely to come with a bundled option. As demonstrated under the FOFA reforms, the unbundling of the value chain has driven efficiency within each component of the chain leading to better outcomes for investors in the aggregate.

Technology and advice should be the instruments leveraged to pull together different product components into an overall retirement income solution for retirees.

#### 2. Are there any lessons from defined benefit schemes that can be applied to the CIPRs framework?

There are many aspects of defined benefit schemes that could be incorporated into a defined contribution system. Unfortunately, many of these deal with the accumulation phase, namely having a clear objective on what level of income you want in retirement, contributing a sufficient level to achieve this (the combined member and employer contribution rates were typically much higher than the current 9.5% rate) and adjusting this rate based on changing circumstances and having a professionally managed portfolio. By definition, defined benefit members will start retirement in a far better position than somebody on our current superannuation guarantee rate due to higher contributions alone.

**3. Do you agree with the proposed three minimum product requirements of a CIPR? What are the alternatives?**

"a) deliver a **minimum level of income** that would generally exceed an equivalent amount invested fully in an account-based pension that is drawn down at minimum rates, with recognition of the benefit of a guaranteed level of income where relevant;

b) provide, in expectation, a **stream of broadly constant real income for life** (to manage risks such as longevity); and

c) include a component to **provide flexibility** to access a lump sum and/or leave a bequest. "

There are clear benefits in the proposed requirements but while the objectives are understandable, the exact wording may have some unintended biases.

The minimum drawdown rates for account-based pensions are not driven by the same principles that would drive the creation of a CIPR, and as such, we have some hesitation in using them as a benchmark for a minimum level of income. More specifically, in the Safe Withdrawal Rates for Australian Retirees report[2] we identified a range of instances where these minimum rates may be too high and to anchor all trustees and cohorts to these rates may prove sub-optimal.

We believe a system based around disclosure of what is being provided together with some guidelines on minimum levels of flexibility, combined with the broader objective of providing real income for life may be more appropriate.

**4. How important is achieving a minimum additional level of increased income to the introduction of the CIPRs framework?**

This should not be the focus of the CIPR framework but a potential outcome. The CIPR framework should produce more focus on retirement incomes and a competitive market for the provision of these solutions. Setting benchmarks is more likely to distort the market than it is to produce a better and more competitive market. The focus should be on providing an income stream that best meets the needs of the retiree.

**5. How should income efficiency be defined?**

Of the options outlined, our preferred approach would be "putting a cap on the total amount of 'leakage' from retirement incomes (for example, administration costs, capital costs and bequests)."

**6. What minimum level of increased income should be required; that is, what should be the minimum level of income efficiency? How should guaranteed products be accounted for?**

We do not believe a "minimum level of increased income" should be a requirement of the framework. Refer to Discussion question 4.

**7. Which indexation option best achieves the goal of increasing standards of living in retirement?**

CIPRs should be indexed to provide real income. The paper correctly identifies the potential for different spending patterns in retirement, but if this is to be dealt with, it should be done so explicitly, as opposed to partially accounting for it through different indexation treatment.

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[2] Blanchett, D.M., A.M. Serhan and P. Gee. Safe Withdrawal Rates for Australian Retirees, Morningstar, January 2016. http://corporate.morningstar.com/au/documents/WhitePapers/Safe_Withdrawal_Rates_Australian_Retirees.pdf

We also note "real incomes" will be more important for the middle and lower income earners who are more likely to default into a CIPR arrangement, as a greater percentage of the income is likely to be required for non-discretionary spending. However, the attractiveness of indexed options will be dependent on the pricing of this feature, which in turn will be dependent on the ability of product providers to hedge this risk.

### 8. Are there comparability benefits from specifying which indexation option would be required of a CIPR?

Yes. Indexation assumptions can have a material impact on the way longevity products are priced and the way account-based solutions are portrayed.

### 9. What elements/types of flexibility are most valued by individuals in retirement, and does flexibility need to be provided for through a CIPR?

CIPR regulation must recognise superannuation assets belong to the member and as such, any form of default system must incorporate flexibility.

Blanchett's paper Dynamic Choice and Optimal Annuitization[3] demonstrates the difference between a static and dynamic approach to annuitisation. The dynamic model allows for the level of annuitisation both upon and during retirement, as well as the amount withdrawn from the portfolio, to change based on the retiree's situation. This model results in a significant reduction in the optimal levels of annuitisation (and an increase in flexibility), especially immediate annuitisation upon retirement when compared to static models. In addition, the relative costs for delaying the annuity purchase decision is small up until the 10th year of retirement. When considering flexibility, the CIPR should consider not only the need to access capital but also the flexibility to incorporate additional annuities later in retirement.

### 10. To what extent should savings outside superannuation be used to meet unexpected costs in retirement?

While the obvious answer is that savings outside of superannuation should be used for emergencies it is difficult to form policy around this due to the wide range of situations likely to be encountered by members. For this reason, we believe the CIPR should incorporate sufficient flexibility to allow for unexpected costs. If this is not the case, there would need to be a mechanism, similar to the early release of preserved benefits, to allow for the release of assets allocated to annuities. Alternatively, this could be addressed by having transparency around commutation options for annuities, and possibly minimum standards around commutation options.

### 11. Is the proposed structure of a CIPR appropriate?

Further clarification of the proposed structure is required. The paper states "it may be appropriate for CIPRs to be classified as a single financial product". Much of the industry discussion has also been conducted in the context of the single product language. The paper also states "an individual would have beneficial interests in the underlying component products (and associated rights)"[4] .

For clarity, we believe the CIPR is better described as a solution that incorporates one or more component products. The member does have a readily identifiable beneficial interest in those components. At the first level, those components should be presented to the member as a combined income stream. Members would still have the option of looking at the underlying components if required.

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[3] Blanchett, D.M. Dynamic Choice and Optimal Annuitization, *The Journal of Retirement,* Summer 2015, pp. 54-76.

[4] Australian Government (2016), Development of the framework for Comprehensive Income Products for Retirement", Discussion Paper, 15 December 2016, Page 22.

By framing the CIPR as a solution, with best in class components, the ability to provide more customised solutions to members is also maximised. Refer Question 13.

**13. Should trustees be able to offer one or multiple CIPRs as the mass-customised retirement income product offering to members? Why/Why not?**

Trustees should be able to offer multiple CIPRs as mass customised retirement income solutions. Technology and data available today can already facilitate more personalised solutions. These capabilities are developing rapidly and to lock members into a single solution structure at this juncture, would reduce the retirement outcomes available to many members.

The CIPR solution should incorporate a degree of personal financial advice. Regulations need to be updated to facilitate the ability of trustees to provide such advice, including safe-harbour provisions for providing such advice.

Blanchett's "Defaulting Participants in Defined Contribution Plans into Annuities: Are the Potential Benefits Worth the Costs?"[5] makes a number of observations that support a cohort/individual approach to retirement.

"Overall, the values in Exhibit 3 make clear that there is no single 'one-size-fits-all' approach with respect to the optimal level of annuitisation for retirees. This obviously complicates the decision to use an annuity within a DC plan, especially if the default is the same across participants. Therefore, when assessing the potential attractiveness of an annuity as part of the default, it is important for the plan sponsor to consider the attributes of plan participants. While the plan sponsor is unlikely to have complete information about employee facts and circumstances, the sponsor should be aware of the relative importance of different factors. For example, participants in a company with a generous defined benefit plan are less likely to benefit from default annuitisation than participants in one without a defined benefit plan. Additionally, research suggests there is a growing relationship between wealth and life expectancy, in which higher-income individuals (who are also less likely to have significant levels of retirement income replaced from Social Security) have much higher life expectancies than lower income individuals (Bosworth and Burke [2014]). Therefore, the extent to which annuities will benefit or hurt participants in a DC plan depends on the extent to which the default is matched to their personal attributes.

Using an annuity as part of a default would make better sense if the recommendation could be personalized. An example of such an approach would be using managed accounts or some type of independent financial expert to determine the optimal annuity allocation for each participant based on available plan data. Assuming the managed accounts provider is given basic demographic information on each participant, such as age, compensation, savings rate, and balance, coupled with plan-level data on any type of employer pension benefits, it should better enable the annuity recommendation to be tailored to that participant versus a fixed allocation as part of TDF."

The paper goes on to state that the benefits of annuitisation decrease when the level of annuitisation is fixed across participants versus determined individually.

We believe most trustees would have sufficient information to provide cohort-based CIPR solutions that would provide better outcomes than a single solution for all. Importantly, the ability to use data in a digitalised form of advice is increasing at a rapid rate. The CIPR solution needs to be designed in a way that acknowledges likely future capabilities around digitalised advice and not just the tools at hand today.

[5] Blanchett, D.M. "Defaulting Participants in Defined Contribution Plans into Annuities: are the Potential Benefits Worth the Costs?" *The Journal of Retirement,* Summer 2016, pp. 38-49.

**14. If funds were able to offer multiple CIPRs as the mass-customised retirement income product, on what basis would CIPRs differ?**

In discussion Question 1, we outlined a preference for the CIPR to be a variable combination of an ABP, and a longevity product. In this context, we believe a CIPR should differ around the following points:

1. the amount allocated to a longevity product;
2. the asset allocation of the ABP;
3. the drawdown rate from the ABP;
4. the type of longevity product utilised.

A range of data points that should be readily available to a trustee and that could influence these factors are detailed below.

| Factor | Impact |
|---|---|
| Age | Optimal ABP asset allocation. Level of annuitisation. |
| Salary | Impacts life expectancy, optimal replacement rates. |
| Savings rate | Impacts replacement rate calculation. The required retirement income is assessed against salary less taxes less savings rate. |
| Account balance | Optimal ABP asset allocation. Level of annuitisation. Age Pension treatment |
| Gender | Optimal ABP asset allocation. Level of annuitisation. |
| Investment portfolio | The asset allocation of current superannuation savings can be a factor in determining an appropriate ABP asset allocation. The asset allocation of the ABP used will be a factor in determining the other variables. |
| Industry | Impacts life expectancy. Can also impact salary curve for projections prior to retirement. |
| Nomination of beneficiary | If a member has completed a nomination of beneficiary form and stipulates dependants this provides insights into bequest preferences compared to a member that has not nominated dependants. |

There are a range of other questions that, if asked and answered through an information gathering process with the member, or a technology-enabled data aggregation process, could facilitate the structuring of a CIPR for an individual. These include:

- bequest preferences;
- income stability preferences;
- other sources of guaranteed retirement income;
- expected dependence on the Age Pension;
- assets and liabilities out of superannuation;
- spouse’s/partner’s situation

While we do not expect all this information to be available for a member who is being defaulted into a CIPR, it does hopefully highlight the ability for even basic information to start better informing an optimal CIPR solution and the need for cohort-based solutions to be available.

The pricing of longevity products, the investment outcomes expected from an ABP and the way these two variables interact with each other and with other factors will also have a material impact on the structuring of a CIPR. Importantly these elements are also likely to change through time.

As previously referenced, improved data gathering techniques and advice technology will further increase the ability for cohort based analysis in the future.

## Disclosure

### 27. What information about CIPRs should be conveyed to members by trustees during the pre-retirement phase and how often should this occur? Should this information, its form and frequency, be prescribed?

Members should be engaged on what retirement income their retirement saving are likely to generate as early as practicable. This could be age 35 or alternatively, as soon as the account balance reaches a meaningful level. We do not believe projections shown at an early age should incorporate CIPR-specific details due to the complexities arising from trying to incorporate CIPR specific data points into a long-term projection. Initial retirement income projections should be based on an ABP solution and expressed in terms relative to current salary or as a real dollar amount.

CIPR specific projections should start five years prior to first available retirement date. Projections provided on member statements will be simplified by necessity but should include: projected retirement income; over what period the income will be paid; and how much of the balance is allocated to a longevity product. The member statement should also include by reference, a web address where the member can obtain additional information on the makeup of the CIPR.

### 28. When should the pre-retirement engagement between a trustee and a member commence and how frequently should it occur? Should this timing be prescribed?

See Discussion question 27.

## Competition

### 31. What is the best way to assist individuals to assess the pros and cons of a CIPR?

As outlined in our response to Discussion question 1, we believe the most important way to assist individual members is to ensure the necessary information on the underlying components of a CIPR are readily available. The easier it is to compare components on a like-for-like basis, the more competitive those components will be.
We make a distinction here between a wider set of disclosure requirements and the best way to present that information to members. There will be some CIPR elements that are critical for third parties to facilitate comparison research, but these may be too complicated for inclusion in a member statement.

For the ABP component of a CIPR, the disclosure requirements around MySuper options should carry forward including fees, portfolio strategy, past returns, expected risk, etc. We also believe Portfolio Holdings Disclosure requirements should be enacted for ABPs.

For longevity components, the type, pricing, term, and indexation elements should all be disclosed.

Only having information disclosed at the combined CIPR level will prevent meaningful analysis and comparison of options.

We support the discussion paper's position on simplified comparisons between CIPR options provided more detailed information is incorporated and disclosed by reference.

### 32. What is the best way to foster competition in the CIPR market and broader retirement income product market?

See Discussion question 31.

### 33. Should CIPRs be able to be provided via direct channels and financial advice?

We support the discussion paper's proposition that CIPRs should also be available through financial advice and direct channels.

We also support the ability for trustees to provide financial advice through the intra-fund advice provisions but believe these provisions should be extended to allow for the member's circumstances outside of superannuation to be allowed for when making a CIPR recommendation, including the default option.

## Fees and pricing of CIPRs

### 34. Is there a need for regulation of fees and pricing of CIPRs? What are the options?

We support regulations that prevent different fees being charged for new versus existing CIPR members who are being provided the same service.

More broadly, we do not believe fee regulation is required provided there is clear ongoing disclosure of fees and members maintain portability of assets.

## E. Products outside the mass-customised CIPRs framework

### 35. Should a retirement income product that meets the minimum product requirements of a CIPR be labelled as such?

Yes. We note the removal of safe harbour provisions under this proposal and, as a result, would expect trustees to require additional disclaimer acknowledgements from members selecting such options.

## F. Other matters

### 36. Is 'MyRetirement' a more appropriate label for a CIPR in both the product and framework sense?

Yes.

Please contact Anthony Serhan to discuss any issues raised in this submission.

Yours Sincerely,

Anthony Serhan, CFA
Managing Director,
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## References

Australian Government (2016), Development of the framework for Comprehensive Income Products for Retirement, Discussion Paper, 15 December 2016, page 22.

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