Retirement Income Disclosure

Submission to Treasury on Retirement Income Disclosure Consultation Paper

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1 Introduction

1.1 About First State Super

First State Super is one of Australia's largest profit-for-members superannuation funds. The Group, including StatePlus, is responsible for the savings of approximately 730,000 accumulation members and the pension savings of nearly 100,000 retirees. As at February 2019, First State Super manages approximately $93 billion in funds, which includes the funds of StatePlus.

We work to achieve a better financial future of our members, the people whose lives are dedicated to helping others – nurses, teachers, emergency services workers and public servants. We are committed to our member community and to the national interest as they are intrinsically linked.

We thank Treasury for the opportunity to make a submission to the consultation on Retirement Incomes Disclosure and submit this paper in response.

1.2 Starting considerations and background position

We are committed to helping our members make the best decisions about their choice of retirement products.

We are therefore broadly supportive of the Government's stated objective for the proposed "Fact Sheet" disclosure regime. We also agree with the sentiments contained in the consultation paper on the limitations and shortfalls of the current PDS based disclosure regime.

While we are supportive of the ideal, we hold some concerns that the difficulties involved in achieving it may have been underestimated in the current proposal. Our experience working with members and clients suggests that an emphasis on simplicity above all else runs the risk of misleading members, or guiding them into products that may not be appropriate for them.

We urge the Government to take the time required to give the design parameters of CIPRs and the design of a disclosure regime continued deep thought and careful consumer testing to ensure the disclosure approach is fit for purpose prior to implementation.

It is difficult to overstate the complexity, and personalised nature, of retirement income solutions. We continue to hold the view that neither members' needs nor retirement income solutions conform to a "one size fits all" approach.

We believe it is important therefore to frame the development and public offering of retirement income products within this understanding. This means recognising that the Treasury's requirement to offer simple education tools must be balanced by the need to take into account a member's individual circumstances. First State Super is committed to assisting members make optimum decisions in respect of their retirement outcomes through the provision of financial advice delivered by one of the largest groups of financial planners in Australia and through the provision of leading-edge digital solutions. The initial focus is on retirement calculators, however these will evolve to more sophisticated digital solutions that allow members to make informed trade-off decisions. The proposed retirement income disclosure fact sheet should be complementary to these initiatives. We once again note that pooled retirement products are a new direction for many accumulation members, especially those who have not had experience of the defined benefit model, and those who have been encouraged to think of MySuper as MyMoney – this is a generational shift and needs supporting campaigns as well as disclosure design.

2 Members and their needs

2.1 The importance of members' circumstances

First State Super considers that the disclosure of retirement income risk information at the product level, with no regard for a members' circumstances is fraught with difficulty.

In our experience, and based on our retirement income analysis, the nature of the risks/trade-offs in retirement products depends as much on the circumstances and retirement goals of an individual, as it does on the product's specific features.

> Critical life factors such as the existence of personal health constraints, disabled partners, or dependent adult children have profound impacts on a person's financial needs and capacity.

Individual themselves are also likely to make either intuitive or explicit trade/offs and assess risk in relation to their own circumstances.

We do not believe it is possible to disaggregate product risk and overall risk for a member (ie, those attitudinal, behavioural or life factors which contribute to a person's risk profile). Personal information could have an obvious and significant impact on the appropriateness of the product, and this may not be obvious to the member in question based on the proposed factsheet.

Age Pension eligibility also has a significant impact on the design of an appropriate investment strategy for retirees. If this is not captured in the risk metric of the Factsheet, the risk shown is likely to overstate the inflation and longevity risk the member faces and nudge them towards a less appropriate product.

A member's retirement income goal, or more precisely the ratio of desired income to superannuation balance, is also a key determinant of the risk associated with a given product. For any product that has an ABP component, income is at the member's discretion (irrespective of the "expected income" that might be disclosed in the factsheet).

2.2 Consumer testing considerations

First State Super is highly supportive of the Government's intention to use member testing to inform the design and content of the fact sheet. From our experience, the use of member centred design principles and consumer testing are critical to the successful development of member-friendly products and effective communications.

We suggest that in undertaking consumer testing, the Government examines the preferred form the disclosure should take. This would require testing a range of disclosure approaches, for example:

- Proposed member agnostic factsheet: understand what, if any, trade-offs exist between simplicity, effectiveness and comprehensibility,
- Segmentation approach: a series of factsheets based on a standard and comprehensive set of "people like me",
- Calculators/other tools that empower members to tailor the disclosed information to more closely reflect their circumstances and to examine the various trade-offs involved,
- The minimum information required to provide members with an understanding of the nature of the risks and trade-offs involved without giving rise to undue cognitive load; this should include consideration of whether:
  - it is possible for members to appreciate and compare retirement income risks through a single metric, or

  - a metric/score for each key risk/product feature (income certainty, flexibility, longevity risk) is required, and
  - which form, design, and content, does the best job of empowering members to make the most appropriate decisions for them, given their circumstances,
- Given the context, consider the degree to which consumer preferences can take precedence over the ability to inform or engender good decision making.

As a general comment, past experience communicating with our members has highlighted the importance of 'plain English', and the need for a combination of text, tables, infographics and charts as different people absorb information differently.

2.3 Need for a prominent 'Health warning'

To the extent the proposed factsheet remains member agnostic, we consider it imperative that a prominent "Health warning" be included on the factsheet to warn members that because personal circumstances have not been taken into account the metrics and comparisons shown could be misleading in their circumstance and that ideally a member should consult with a financial planner or use a retirement calculator in conjunction with the factsheet.

3 Products and metrics

3.1 Account Based Pension products remain relevant

Greater consideration of Account Based Pension products is required

It appears that the current proposal has been designed with CIPRs and/or longevity products more in mind than Account Based Pensions. For example, the risk scoring method makes a lot of sense for these products but leads to anomaly results for an Account Based Pension (ABP), which is the product held by the majority of superannuation members today. We have previously strongly argued that ABPs in conjunction with the Age Pension form the backbone of most members' retirement finances. In future, ABPs are also likely to form part of any CIPR products developed given the flexibility and access to capital that they afford. Therefore, it is important to have a set of measures for retirement income products that work consistently and robustly well for both longevity products and ABPs.

There are several issues in the current framework in regarding to ABPs as highlighted below.

*The **Flexibility/Access to Capital** metric.*

In ABPs the capital that can be accessed is the value of a member's account balance. This is subject to investment risk and hence the *future value* is not known with certainty. Access to 100% of capital could mean different dollar amounts of balance depending on the investment choice, market conditions and investment return, at different times.

We suggest that this uncertainty be reflected by focusing on the ***average amount available for withdrawal*** (which is a preferable description to the maximum percentage/dollars) and also by providing the 5th and 95th percentile over the life of the product, which is consistent with the proposed approach for income variability.

We note that on page 8 of the Paper, an example is provided of a product with 80% Account Based Pension "with minimum drawdown rates". However the accompanying Chart and Table clearly do not envisage minimum withdrawals from the Account Based Pension.

*The benchmark income in the **Income Variability Risk** metric in ABPs*

The current risk metric calculates income shortfalls by comparing every year's income against the ***first-year income*** indexed by CPI and assuming ***minimum drawdown rule*** is applied for ABPs. The combination of these two assumptions leads to several pitfalls when the risk metric is used to assess the risk of ABP products.

- This leads to the counter-intuitive result that investing in the Capital Stable option is risker than investing in the Growth option:
  - The reason for this is because the income target is not appropriately adjusted to the investment option chosen, but rather fixed by the implication of the two assumptions (5% of initial balance constant in real terms).
  - This assumed drawdown rate is more appropriate for a Growth option as it has a higher chance of meeting the assumed drawdown rate, whereas the Capital Stable option is less likely to generate enough return to meet the assumed drawdown rate.
- It may lead to inconsistency between the Income metric and the Income Variability Risk metric.
  - The Income metric may show the expected income over retirement (a chart) or the average expected income over retirement (one number), whereas the Risk metric in

  theory should show the risk around meeting the Income target but in fact is benchmarking against the first year's income.
  - The first year's income may be the same as the average expected income for most of the longevity products but will be different for ABPs.
  - For this reason, the Risk metric is not consistent with the Income metric.
- The assumptions did not take into account the fact that in ABPs the income taken is not predetermined, but rather, is at the members' discretion.
  - The chosen level of income also directly impacts the risks and trade-offs associated with a retirement product (higher income results in a greater risk of running out of money and vice versa).
  - The minimum drawdown rule artificially creates income variability (which could be penalised in the risk metric), gives rise to a low income (for middle to high balance members) compared to the other products assessed (unnecessarily), and may result in a balance at the end of the product's life (which could otherwise have been used to boost income throughout retirement).

In light of these considerations, we suggest that:

a) the average expected income should be used for benchmarking purpose for the Income Variability Risk metric; and

b) the Government provides clear guidance as to how to determine the drawdown rate for ABPs instead of assuming the minimum drawdown rule.

These together provide clear guidance as to how to determine the expected level of income/drawdown rate for ABPs (both for disclosure in the Factsheet and for the purpose of calculating the proposed risk metric).

3.2 Use of a single risk metric

While we are supportive of the Government's desire to simplify disclosure and bring greater focus to the key risks and trade-offs involved in selecting a retirement product, we are concerned that the current proposal risks being a repeat of the Standard Risk Measure. This measure generated wide divergence of opinion in the industry due to classification issues. It has also largely failed to improve member communication, and has in many cases increased confusion, because it is an overly simple answer to a complex issue.

We suggest consideration, through consumer testing, be given to separating the risk metric into several scores, one for each key risk/product feature (i.e. income certainty, longevity risk, flexibility and investment risk). We believe this may be more informative and better highlight the required trade-off than simply listing the product features that most contributed to the score provided in the proposed single metric.

We note that the BETA group's 2017 research tested two separate risk metrics:

- Protection from running out of income, and
- Protection from fluctuations in income.

This achieved some success regarding comprehension and favourability towards CIPRs.

3.3 Standardised assumptions

The use of standardised assumption brings with it the benefits of comparability and integrity, by limiting the use of selective assumptions or 'gaming' to promote one's own product.

However, there are very real risks of misleading members and dampening product and investment innovation. We note that our approach to investing for retirement differs from our approach for accumulation members. We think it is possible that a trustee might find that it needs to provide two sets of disclosures because it does not think that members are being appropriately informed under the mandated standard assumptions (ie, disclosure of the actual investment approach versus the approach suggested by the standardised assumptions). This would undoubtedly confuse members.

We believe the proposal to use standardised assumptions needs further consideration; we are happy to discuss our views more thoroughly with Treasury in the near future.

3.4 Model assumptions and other matters

Our concerns with standardised assumptions aside, we also have comments on the specific assumptions used in the consultation paper and attachment.

- There are inconsistencies in the end date of calculations in the documents. In the Treasury Consultation Paper age 97 is used; the Australian Government Actuary (AGA) states that age 100 has been used; but the graphs in the AGA paper suggests that the projections actually go to age 105.
- We recommend that the calculation of average income is weighted by survival probabilities. Doing so recognises that income in the near term is worth more to an individual, than income beyond age 90, when members have considerably lower survival rates. Without making this adjustment, products that back-end income, such as some Group Self Annuitisations (GSAs), will be unfairly advantaged by the methodology. The use of age 97 as the end date for calculation of expected income, which is well in excess of the expectation of life, exacerbates this risk.
- We note that the AGA uses CPI increases for benchmarking purposes – not AWE. We agree with this. We would also would prefer ASIC to also use CPI in its guidance on calculators and recommend the Government consider aligning requirements for these disclosure tools.
- Of the two risk scale conversions proposed by the AGA, our preference would be for the non-linear categorisation, which provides for greater differentiation among products across the industry.
- The transformation of the Risk Measure to an income secure score is confusing. The higher the Risk Measure, the higher the level of risk. This is intuitively reasonable and is consistent with the Standard Risk Measure where the higher the Measure, the greater the risk. However, the income secure score works in the opposite direction (the higher the score the lower the risk) which is counter-intuitive and may be misinterpreted.
- Consideration should be given to compliance and whether the fact sheets require audit (and if so, who might perform the audit). This is not a trivial task because of the relatively complex modelling involved.
- We agree that it can be useful to include elements of the product that contribute to the rating. (These elements include inflation, longevity and market risks, counterparty risks and guarantees.) However, there is a risk that members will not understand this commentary and will be confused. This aspect should be subject to member testing.
- In Chart A of the Treasury paper, the language needs to convey less of a promise. Use the phrase “Indicates how much you *might* have if you stopped” rather than “how much you would get if you stopped”.
- Finally, we request that trustees and Government please support the use of plain English, for example:
  - “your starting balance” is easier than “purchase price” and

- “available for you” is preferable to “available for withdrawal”
- avoid words/phrases such as “remaining commutable value”.

4 Conclusion and recommendations

We believe the disclosure proposals need further consideration and, as mentioned, are happy to discuss our views more thoroughly with Treasury in the near future.

4.1 Summary of response to proposed metrics

In relation to the proposed disclosure metrics, their presentation and calculation we make the following points for your consideration:

1. We support the overall objective of making disclosure as meaningful and useful to members in support their decisions, and the importance of simplicity in achieving this.
2. We support the fact sheet approach to disclosure.
3. However, the trade-offs and risks considered by members occur in relation to their actual circumstances; and that while simple product-centric metrics are conceptually possible, there is a risk they will cause greater misunderstanding in practice.
4. A very prominent warning will be required to ensure that members understand their personal circumstances are not being taken into account – this may lead to further uncertainty for members.
5. There is an opportunity for member testing to better understand the value and use of these factsheets in the context of member circumstances including all the other tools and information they have available to them.
6. More work is required to ensure the metrics are appropriate in relation to ABPs.
7. Consumer testing should be carried out to establish if more than one risk measure is appropriate, and we do not believe this will confuse or over burden members.
8. There are a number of small but important changes to the calculation of the metrics that need to be considered.

Once again we thank Treasury for the opportunity to make a submission to the consultation on Retirement Incomes Disclosure. If you wish to discuss any part of this submission, please do not hesitate to get in contact.

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