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Manager, Retirement Income Framework
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Retirement Income Disclosure Consultation Paper

Dear Sir/Madam

Industry Super Australia welcomes the opportunity to comment on the issues raised by the Retirement Income Disclosure Consultation Paper ('the Disclosure Paper').

<u>Summary</u>

The retirement income framework that has been in development by Treasury since 2016 involves requiring fund members to make a choice from a potentially large and complex range of income products when they retire. Treasury acknowledges that making such complex choices may lead fund members to rely on behavioural biases that result in choosing products that may not be in their best interests.

Treasury's proposed solution to this problem is to require that every retirement income product is accompanied by a factsheet that contains a set of standardised metrics relating to income, longevity and capital access that will enable members to choose the most appropriate product.

The Disclosure Paper seeks views on the appropriateness of a set of potential metrics and whether they will assist retirees to make appropriate choices between income products.

The evidence from Australia and abroad is that disclosure, even in simplified and standardised form, is not effective in countering low financial literacy, irrational consumer behaviours and the marketing strategies of for-profit financial service providers. ISA therefore does not agree that disclosure is a sufficient response to the risks that retirees will be sold and marketed into poor quality and inappropriate income products.

ISA recommends that policy should focus instead on implementing a retirement system framework in which (i) members are defaulted into whole-of-life products that have been subject to a quality filter applied by the Fair Work Commission, (ii) such products are selected for default status primarily on the basis of the retirement income they are projected to deliver, and therefore (iii) complex financial choices are not imposed on those who are ill-equipped to make them.

The submission ends by highlighting some specific concerns that ISA holds about the draft metrics and how they may be consumer tested.

Simplified Disclosure in Consumer Finance Does Not Work

Recent years have seen a growing interest among policymakers in Australia and abroad in mandating simplified forms of disclosure for use by consumers when they are presented with choices between financial products.

Interest in simplification in the form of dashboards, factsheets and summary prospectuses follows the experience of multiple financial collapses and scandals in which the provision of long and complex disclosure documents repeatedly failed to protect consumers from being sold into expensive or high-risk products that only providers fully understood.

However, while there is much enthusiasm for simplification as a means of supporting consumers to make appropriate choices, the evidence is that it does not work.[1] This is the conclusion of a number of academic studies, and is also clear from the experience of MySuper dashboards.

a) Simplified Disclosure and Mutual Fund Choices[2]

In the United States, the Securities and Exchange Commission (SEC) concluded that the statutory prospectuses issued by mutual funds were too long, complex and legalistic, and used presentation formats that did little to enhance readability. The SEC therefore adopted a new simplified disclosure document of between two and four pages that presented key information about the mutual fund's investment objectives, strategies, risks, costs and performance.

[1] Most research on the effectiveness of disclosure as a form of consumer protection has focused on long-form disclosure and has established that the large majority of people do not read or understand lengthy disclosure documents when purchasing insurance, consumer loans and mortgages. However, there has as yet been relatively little independent scholarly research into the effectiveness of *simplified* disclosure. See: Ben-Shahar, O. and C. E. Schneider (2014) *More Than You Wanted to Know: The Failure of Mandated Disclosure*, Princeton University Press. It has been argued that one reason for the scarce interest in testing the effectiveness of simplification is the prevalence of neoclassical welfare economics within policymaking circles and the related assumption that the benefits of simplification are so obvious as to not require evaluation. See: Willis, L. E. (2006) "Decisionmaking and the Limits of Disclosure: The Problem of Predatory Lending: Price", *Maryland Law Review*, Vol. 65, Issue 3.
[2] Beshears, J. et al (2010) "How Does Simplified Disclosure Affect Individuals' Mutual Fund Choices?", National Bureau of Economic Research, Working Paper Number 14859.

Researchers based at Harvard and Yale tested how the new simplified prospectus affect investor portfolio choices by presenting groups of Harvard University non-faculty employees with three variations of mutual fund disclosure: a full statutory prospectus, a simplified prospectus, and the simplified prospectus with the option of having access to the full version. Group members were then asked to allocate notional amounts of money between various mutual funds using these disclosures.

The research found that the summary prospectus did not change or improve the portfolio choices that were made. Poor choices were replicated across the groups regardless of disclosure type. The differences between them were found to be statistically insignificant.

The research concluded that "simpler disclosure does not appear to be a useful channel for making mutual fund investors more sophisticated and for creating competitive pricing pressure on mutual fund companies" (p. 13).

b) Ineffective Disclosure and Home Contents Insurance[3]

Researchers at Monash University sought to evaluate how consumers engage with mandated disclosure information for home contents insurance in Australia. Insurers are required to provide a product disclosure statement (PDS) and a simplified two-page key fact sheet (KFS) before a purchase is made.

The researchers note that requirements for insurers to do so is based on an assumption that "if the information is made more comprehensible, then consumers will become better informed, which in turn will lead them to make rational choices about the product they are intending to purchase. However, this assumption is rarely if ever tested" (p. 6).

The study recruited 406 participants from across Australia who were asked to evaluate 'good', 'okay' and 'bad' hypothetical home insurance policies under conditions where they were given access to a PDS only, a KFS only, or both. The study found that the nature of disclosure had no systematic effect on the quality of choices that were made. The researchers drew the following conclusions:

> "The outcomes of the study raise doubts about the effectiveness of mandated disclosure in nudging consumers towards making rational insurance product choices…The study does suggest that even in idealised circumstances where consumers are provided KFSs for making a simple choice between a good and a bad policy, there is no systematic increase in the number of consumers who will purchase the good product….Overall, this study suggests that the mandated disclosure information [PDSs and KFSs] does not reliably assist consumers in making better purchase decisions" (p. 7).

[3] Malbon, J. and H. Oppewal (2018) "(In)effective disclosure: An experimental study of consumers purchasing home contents insurance", Monash Business School and Monash Faculty of Law.

c) MySuper dashboards

Since 2013 MySuper products have been subject to product dashboard requirements. The dashboard is intended to provide members with key information such as return targets, past returns and fees that will enable them to choose a MySuper product that is in their best interests.

To date there has been no attempt to systematically evaluate if MySuper dashboards actually function to protect members and advance their financial interests. Unfortunately, during its recently completed inquiry into the efficiency and competitiveness of the superannuation system, the Productivity Commission choose not to undertake such research, preferring instead to assume that dashboards are effective and that they should therefore be extended to choice products.[4]

However, there is strong reason to believe dashboards have not been effective.

Firstly, there is anecdotal evidence from superannuation funds that by far the most frequent users of dashboards are those who work in the superannuation industry and who access dashboards for the purposes of generating market intelligence on what other funds are doing.

Secondly, many of those with professional knowledge of superannuation find the simplified dashboard metrics difficult to interpret. According to the Institute of Actuaries of Australia even a dashboard that comprises simplified metrics remains "so complex that even superannuation experts have difficulty understanding it."[5]

Thirdly, the Productivity Commission inquiry found that there are nearly 2 million accounts in MySuper products that underperform. If members impacted by this underperformance made effective use of MySuper dashboards it is reasonable to conclude that there would be many fewer. However, because members do not make effective use of dashboards it has recently fallen to APRA to intervene on their behalf to challenge trustees about the performance of their MySuper products.

In the context of MySuper the attempt to secure rational choices by members via simplified disclosure has demonstrably failed.

We note that ASIC consumer-tested MySuper dashboards in 2013. Participants self-reported some positive reactions to aspects of the draft dashboards.[6] However, that very few MySuper members appear to have then engaged with dashboards once they

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[4] See Productivity Commission (2018) *Superannuation: Assessing Efficiency and Competitiveness, Inquiry Report*, pp. 38-9.

[5] Institute of Actuaries of Australia (2017) *Proposed MySuper Product Dashboards*, letter to ASIC: https://www.actuaries.asn.au/Library/Submissions/FinancialServicesReform/2017/20171219SubASICMySuper.pdf

[6] ASIC (2013) *REP 378 Consumer testing of the MySuper product dashboard*, https://asic.gov.au/regulatory-resources/find-a-document/reports/rep-378-consumer-testing-of-the-mysuper-product-dashboard/

were introduced should warn against assuming that positive responses under artificial testing conditions will translate into actual and effective use.

Why is Simplified Disclosure Ineffective?

Advocates of simplified disclosure assume that poor choices are the result of biases held by individual consumers that can be corrected by how information is prioritised and presented. In short, there is an "information fix" to irrational behaviour.

However, research indicates that the sources of poor consumer choice run deeper, and are more extensive, than believers in simplified disclosure allow. Drivers of poor choices include:

a) The Marketing Strategies of Product Providers

The simplified disclosure model ignores the commercial context in which many financial products are designed and sold to consumers. Most financial product providers are not passive suppliers of products to consumers. They are profit-maximising firms with a strong incentive to market their products in ways that will secure the maximum possible quantity of sales.

Among the most common strategies used by financial firms is "confusion marketing": the proliferation of products that are presented and priced in ways that are intended to confuse consumers into buying products that are the most profitable for the provider. The prevalence of such strategies in the financial industry has been noted by the Productivity Commission:

> "Much of what passes for competition is more accurately described as persistent marketing and brand activity designed to promote a blizzard of barely differentiated products…While not all financial institutions are the same, the vast majority are using tactics designed to lure new customers in and then exploit system complexity to retain them."[7]

On the relative influence of marketing versus disclosure, ASIC has stated:

> "Our research has indicated that marketing information plays a particularly strong role in product distribution and may influence investors' decision making more than other product disclosure."[8]

In the Australian context the risks to consumers generated by confusion marketing are further compounded by the conflicted nature of financial advice – much of which is best understood as a wing of marketing and sales, not a service intended to promote the interests of consumers. In its recent report on the superannuation system the

[7] Productivity Commission (2018) *Draft Report: Competition in the Australian Financial System*, p. 2, 27
[8] ASIC (2014) *Regulating complex products*, January, Report 384, p. 32

Productivity Commission noted that the conflicted nature of much advice poses a particular risk in the context of CIPR products:

> "Their complexity, limited scope for reversibility and major deficiencies in the credibility, independence and affordability of financial advice for retirement products leaves significant scope for member detriment arising from the requirement to supply risk-pooled products."[9]

b) The Barriers to Better Financial Decisions

Simplified disclosure assumes that choice errors are susceptible to correction by informational means. However, the research discussed above in which consumers repeatedly and persistently fail to make good choices in response to simplified disclosures suggests otherwise. This is also suggested by the stubborn failure of financial literacy programmes in Australia and abroad to improve outcomes for consumers when they are sold financial products.

ASIC has noted there is "little reliable, conclusive research about whether financial literacy campaigns and programs work (i.e. whether they result in sustained changes in behaviour and improved financial outcomes)."[10]

The view that consumers of financial products can be educated or nudged into good choices is not supported by research that has identified a number of significant barriers to better financial decisions. In addition to the marketing strategies of profit-maximising firms, further barriers to effective choices that are commonly cited in the literature include:

Poor understanding for practical purposes

While some adults self-report that they understand key financial metrics such as interest rates in the abstract, they are often unable to apply those metrics to their own financial situation in ways that enable them to distinguish between appropriate and inappropriate products.

In short, there is evidence of a clear and persistent gap between being able to define a metric and being able to use that metric to actually make a good choice in a real-world environment. Financial literacy, which is known to be generally poor across the Australian population, is not the same as financial capability.[11]

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[9] Productivity Commission (2018) *Superannuation: Assessing Efficiency and Competitiveness*, p. 236
[10] ASIC (2011) *Financial literacy and behavioural change*, Report 230, p. 4
[11] Johnson, E., & Sherraden, M.S. (2007) "From financial literacy to financial capability among youth", *Journal of Sociology and Social Welfare*, Vol. 34(3).

The Productivity Commission has noted that "about 30 per cent of Australians have low financial literacy, and a quarter do not understand basic financial concepts."[12]

These figures very likely underestimate the problem of poor practical capabilities. But even using these estimates, it is not clear how the 25 per cent of Australians who do not understand "basic financial concepts" will make effective use of a retirement income factsheet that attempts to communicate concepts such as average real income, the weightings used to estimate future income volatility, and purchase price withdrawals.

For reasons already discussed, recourse to financial advice is likely to increase the risk of financial harm for such retirees.

Cognitive and emotional constraints

Confronted with unfamiliar financial information and choices consumers often experience cognitive dissonance and a resulting desire to avoid negative emotions. People instinctively dislike being made to feel uncomfortable by being presented with information that they feel they should understand, but do not.

They therefore seek to avoid resulting negative emotions by making their choice on the basis of non-financial criteria such as brand familiarity or the views of friends and family members. They may also make a snap choice (to shorten their experience of discomfort) or defer to the views of others (such as a sales person or advisor) who appear to be more knowledgeable than they are.

Much of the financial industry is aware of these traits. This is why sales staff are often trained to exploit peoples' desire for emotional comfort by, for example, displaying empathy with the worries of customers and complementing them on the choices they make.

These habits of seeking to minimise cognitive and emotional discomfort are deeply embedded in human psychology, are typically unconscious, and are therefore not subject to being "corrected" by informational means.[13]

In sum, there is strong reason and evidence to conclude that disclosure, including in simplified form, will not be used by many retirees to make good choices – particularly in a context where they are confronted by a large range of complex products being marketed by profit-maximising firms and where much advice is unreliable.

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[12] Productivity Commission (2018) p. 21

[13] A formal theory of the cognitive and emotional barriers to effective financial decisions, "The Intangible Transaction Costs Schematic", is elaborated in: Willis, L. E. (2006) "Decisionmaking and the Limits of Disclosure: The Problem of Predatory Lending: Price", *Maryland Law Review*, Vol. 65, Issue 3.

MySuper dashboards have proven ineffective in this context, and there no reason to believe the experience of retirement income factsheets will be any different

A Better Approach

In previous submissions ISA has outlined what a mature and efficient retirement income system in Australia should look like.

In short, this includes not imposing choice-related risks on members who are ill-equipped to manage them, while focusing the superannuation system on delivering a benefit that is an income for life rather than a pot of money that signals the separation of the system into distinct phases of accumulation and decumulation.

Treasury's current approach to retirement incomes does not achieve either of these aims.

A better approach is to default members into whole-of-life products named in awards and enterprise agreements. Only those products that have met high performance and quality criteria applied by the Fair Work Commissions would be eligible to serve as defaults. A key selection criteria would be their capacity to deliver a projected retirement income for life.

The member experience should resemble that of a defined benefit income stream: members move into retirement expecting an income stream for life, without being forced to choose from a wide range of potentially inappropriate products.

Additional Concerns

In addition to regarding simplified disclosure as an inadequate basis for protecting the interests of retirees, ISA has some specific concerns about the draft metrics in the Consultation Paper and how they may be tested:

a) Return assumptions

To the extent that retirees attempt to make use of any eventual factsheet, "income" is likely to be the metric concept they most immediately recognise. This is the probable basis on which any comparisons between products are made.

It is therefore critical that the estimate of expected real income is reasonable. Key to this will be the net return assumptions made in respect of the underlying assets.

At present it appears that Treasury envisages allowing product providers to set their own return assumptions. There are obvious risks with such a permissive approach, not least that some providers may nudge their assumptions upward in order to help maximise sales. The experience of MySuper dashboards is that that there can be significant and persistent negative differences between what some funds aspire to achieve in terms of returns and what they actually deliver.

The integrity of return projections is arguably more important in a retirement context than during accumulation. Some income products will be irreversible, and age-related factors are likely to mean that retirees engage even less with how their product actually performs over time.

In addition, any use of factsheets will begin in a context where many income products that include a longevity component will be new, with no track record of actual performance against which projections can be judged. In this context the integrity of the projections becomes particularly important.

The Discussion Paper states that funds will “be required to report the assumptions they use to calculate expected income and risk metrics” (p. 10).

However, it is unclear what regulatory purpose this reporting will serve. Once reported, will assumptions be assessed for reasonableness? Will funds that have made unreasonable assumptions be instructed to revise them?

By itself, requiring funds to simply report assumptions without apparent consequence is unlikely to ensure that they are reasonable. And if some are and some are not, making meaningful comparisons will not be possible.

Providers must not be permitted to set their own return assumptions without constraint. Assumptions should be verified by an actuary prior to any related product being made available for sale.

b) Fees and charges

The Discussion Paper states that the projected real income level will be displayed net of “any fees and charges” (p. 4). It is not clear if the intention is that all fees and charges actually charged will be netted-out, or only those that are currently required to be disclosed. We would welcome clarity on this.

c) Consumer testing

While we welcome Treasury’s intention to consumer test the factsheet, the results will be heavily determined by the methodology adopted. Testing of consumers in markets for financial products is often marred by a number of methodological weaknesses.[14] Significant and routine weaknesses include:

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[14] We have discussed these methodological weaknesses in more detail in our response to the government’s consultation on its National Financial Literacy Strategy for 2018. See: https://consultation.asic.gov.au/financial-capability/national-strategy-consultation-2017/consultation/view_respondent?show_all_questions=0&sort=submitted&order=ascending&_q__text=industry&uuId=245635324

- *Self-assessment*. It is common in financial literacy research to measure consumer understanding of key concepts by asking individuals to self-assess their understanding. This tends to generate results that overstate understanding and the extent to which consumers are likely to make effective use of concepts in real world environments. In place of self-assessment, actual choice behaviours should be tested under conditions where a range of potential outcomes can be measured.

- *Unrepresentative samples*. Testing often makes use of self-selected volunteers which can mean the sample over-represents those who are more financially engaged and literate. Samples should be constructed to ensure appropriate representation of those whose understanding of superannuation-related concepts is likely to generate poor decisions. Based on estimates by the Productivity Commission around 68 per cent of superannuation members may fall into this category.[15]

It is not clear if Treasury intends to publically report the methodology and results of the testing it conducts. We recommend that it does.

We appreciate the opportunity to comment on the Disclosure Paper. Please do not hesitate to contact me with any questions.

Yours faithfully

M. Fisher

Michael Fisher
Senior Policy Adviser

[15] See Box 5.2 in the Productivity Commission's draft superannuation report.