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Retirement Income Disclosure Consultation Paper

Introduction

Mercer greatly appreciates the opportunity to make a submission in respect of the Retirement Income Disclosure Consultation Paper, released in December 2018 and which forms Stage Two of the Retirement Income Framework.

As outlined on page 2 of the Consultation Paper, we note that the Government has removed two barriers relating to lifetime income products. We applaud the tax changes and the recently revised means test changes, which commence on 1 July 2019. We also support the introduction of the Retirement income covenant into the SIS Act which would highlight the major purpose of the superannuation system. Of course, the next stage of this framework is the development of a simplified, standardised disclosure for retirement products which is the subject of this Consultation Paper.

Some initial comments

Before presenting our views and comments on various aspects of the Consultation Paper, we recognise that this is a very difficult area. There is no simple and perfect answer as there are many risks faced by retirees and several potential product features which all need to be considered.

Furthermore, every retiree is different due to the home ownership position, marital status, health, income needs, risk attitude, expectations, financial position (including debts), need for capital (either immediately or in the future) etc.

Hence, our starting position is that the standardised disclosure should be relatively simple and easy to understand. One of our concerns is that the current proposal is trying to show too much

which makes it harder to follow. It is interesting to note that the CPF in Singapore, which has an experience driven longevity pool, only indicates a range of likely income.

Therefore, we would suggest that consideration be given to the following way forward:

- Agree on the best way to disclose expected retirement income for a range of retirement income products
- Develop several measures (or metrics) of the risks faced by retirees
- Through consumer testing and focus groups, determine which risk measures are the most effective
- Combine income and risk metrics into a range of presentations and undertake further testing
- Ensure that the final approach adopted can be further extended and personalised to show the impact of introducing the age pension

As suggested above, consumer testing will be really important to get these disclosure requirements as useful as possible for a broad audience. With this in mind, we suggest that the testing should not only review any proposals but should also ask the question, which piece(s) of information are most valuable? In other words, what are most retirees looking for?

Now let's turn to the Consultation Paper.

The basic framework

We accept that as outlined on page 3 of the Consultation Paper, most retirees desire:

- A relatively stable level of income that is paid regularly
- Income that continues to be paid whilst they are alive, no matter how long they live
- Access to some underlying capital to meet significant one-off expenses

Naturally, there is a tension between these three desires and this trade-off is sometimes known as the retirement trilemma. This trilemma also means that it is very difficult, if not impossible, to develop a single metric that will show all retirees which is the "best" retirement product for them. Hence any metric should be considered to be a starting point for discussion rather than the end game.

The two major sources of income for most Australian retirees are superannuation and the means-tested age pension (which may be paid in part or in full).

As each retiree's access to the age pension during their retirement will be determined by a range of factors, some of which are likely to change during retirement, we recognise that it is not

Page 3
Retirement Income Disclosure Consultation Paper
4 April 2019

feasible to develop standardised metrics for retirement products that allow for the age pension. However, as mentioned above, we believe that any standardised disclosure should be developed so that it is feasible to add more personal information into the model and thereby produce a more personalised set of metrics.

Presentation of income

Page 4 of the Consultation Paper discusses the concept of ‘take home pay’ or ‘expected retirement income’ and the numerical presentation.

We prefer ‘expected retirement income’ as it accurately represents what is going to happen whereas ‘take home pay’ may suggest that someone else (eg the previous employer or the Government) is going to make some payments. Clearly this is not the case, as the income will come from the retiree’s assets. On the other hand, as will be mentioned later, ‘expected retirement income’ may also be misleading.

We agree that it is helpful to express the expected income as both an annual amount and a smaller amount per period. We would suggest monthly; as most super funds pay retirees a monthly pension rather than fortnightly.

Variation in expected income

As noted in the Consultation Paper, the challenge is for a metric that measures income variation, with a particular focus on downside risk. The suggested measure considers the level of income each year when it is below the expected first year income.

But, is the first year of retirement, the best measure for the income benchmark? After all, many retirees are relatively cash rich in the first year of retirement due to accrued leave payments and products may be deliberately developed with a reduced payment in year 1. We therefore suggest an average of the expected payments over the first five years would be a better benchmark to assess future income levels.

Presentation of income variation

The Consultation Paper proposes a seven-point scale relating to ‘income security’. That is a score of seven would indicate an expected income that is reliable and stable (in real terms) whereas a lower score would indicate a lower level of security. However, we suggest that the use of the term ‘income security’ is misleading in this context. For example, a non-indexed life

annuity is given a score of one in the AGA's paper¹ suggesting that its income is not secure. In fact, the income itself is guaranteed and very secure; it's just not indexed.

We therefore suggest a different expression is needed to reflect the risk that is being measured. For example, it may be better to express this measure as "the reliability of inflation-linked income for life". We would also suggest that the seven-point scale not be expressed as numbers which have no intrinsic meaning. Rather the numbers could be replaced by words. For example, a seven-point scale could be expressed along the following lines:

Number	Reliability of inflation linked income for life	A possible description
1	Nil	No indexation and the money may run out at older ages
2	Poor	No indexation is likely but the income is likely to last for the lifetime
3	Modest	Partial indexation is likely for a few years and the income should last for the lifetime
4	Reasonable	Partial indexation is likely in most years and the income should last for the lifetime
5	Good	Full indexation is likely in some years and the income should last for the lifetime
6	Very good	Full indexation is likely in most years and the income should last for the lifetime
7	Excellent (ie indexed)	Full indexation is guaranteed for every year of life

In addition, we suggest that the scale must take into account a broad range of products (some of which have not yet been developed) and that there is a clear relationship between the scale

¹ Australian Government Actuary, Retirement Income Risk Measure, 7 December 2018.

adopted and the calculated value. This will also need to consider the scale value if the calculated risk metric for a new product is say double the current maximum value.

Another suggestion is that some colour coding could be used to go across the range (for example from red to green) to improve understanding.

However, we question whether this is really the best measure of risk for the income received by retirees. We believe that their biggest concern is a drop in their income. For example, the graph on page 4 of the AGA's paper shows a rise in income to about age 75 and then a steady drop in income to about age 90 before it rises again. Using this graph as an example, the income drops by almost 40 percent over 15 years which represents a very significant fall. Yet, only about half of that fall is included in the proposed risk measure.

Therefore we suggest an alternative risk measure, as follows:

- First, rather than using the first year income as a benchmark, we recommend using the expected real income, averaged over the first five years. This approach presents a stronger and more realistic benchmark and would prevent "gaming", whereby a product could deliberately have a low income in the first year to minimise future risk as measured by the proposed metric.
- Second, rather than the calculation of a semi-deviation below the benchmark, we recommend that the risk measure should consider a decline in the level of income, either in real or nominal terms.

We also note that the calculation of the risk of income variation is not weighted by the probability of survival, which is a deliberate choice by the AGA as noted in page 5 of his paper.

Notwithstanding this decision and the related encouragement for longevity products, we suggest that this approach could lead to an undue emphasis in some product development on the later years as the risk at age 100 will be given the same weight as at age 70. Yet for most retirees, age 70 is much more important than age 100.

We therefore recommend that the approach be modified in the following way:

- No weighting of mortality to life expectancy age (as measured from age 67 on a unisex basis);
- The use of the probability of survival from life expectancy to each subsequent age.

This approach would continue to encourage longevity products but without the use of an arbitrary age such as age 100.

Page 6
Retirement Income Disclosure Consultation Paper
4 April 2019

We recognise this is more complex than the current proposal and therefore suggest that some modelling be carried out to highlight any significant differences between the alternatives.

It is also noted that the AGA's paper uses age 100 whilst the Treasury paper projects expected retirement income for 30 years, or to age 97. The above recommendation would remove this inconsistency and also provide an automatic adjustment as life expectancy changes.

Page 7 of the Consultation Paper shows a graph of the simulated or potential income with the average, best and worst outcomes from the simulation, where the best and worst represent the 5th and 95th percentiles. A couple of comments:

- We recommend the use of the median and not the average as the average is influenced by extreme results. Of course, we recognise that "median" is not understood by most retirees but it represents a better indicator.
- The terms "best" and "worst" are not correct. There are 5% of the simulations that are better or worse than these simulations.

Therefore we recommend the use of terms such as "the range of most likely outcomes" which could use the 10th and 90th percentiles, thereby representing about 80 per cent of the potential outcomes. Naturally, this will provide a closer set of results than using the 5th and 95th percentiles which should also give retirees more confidence in the product.

We note that most retirees will not be concerned about the best 5 or 10 per cent of outcomes; it is the worst 5 or 10 per cent that will concern them. Whilst such results are obviously possible, such an outcome is likely to be caused by events beyond the individual's or provider's capacity to influence. Indeed, it is probable that under many of these adverse scenarios the Government may step in with additional support. Furthermore, the means-tested age pension provides additional income in these circumstances.

Hence, whilst it is important to provide realistic projections, we must also encourage confidence in these long term products and not unnecessarily scare the potential investors. We therefore recommend using the 10th and 90th percentiles which will still highlight uncertainty.

Access to underlying capital

We support the concept that all retirement products should clearly disclose the capital that is likely to be available in the future. We also agree that the best approach is to assume a full voluntary withdrawal at each age. Otherwise it gets too confusing.

Of course, many retirement products offered by super funds in the future are likely to be a combination of an account-based pension and a longevity product. Whilst access to the capital

from the longevity component is likely to be restricted in line with the capital access schedule, this is not the case for the ABP component. Indeed, to maintain the maximum access to capital under the ABP would require retirees to use the minimum drawdown rules. This may not be a desirable outcome.

Hence, we suggest that an alternative would be to show both the likely level of income that has been received prior to each age with the capital that is likely to be available at that time. The use of median values from the projections may be sufficient to give an indication and to show the trade-off between different levels of income and the future availability of capital.

The options outlined on page 8 only relate to the longevity component and therefore do not represent the full picture. We believe that many retirees will be interested in more than the amount from longevity products as this product is likely to represent only 20-30% of their initial portfolio.

One final issue that needs to be considered is whether this disclosure should be in real or nominal terms. Although we support the disclosure of future income in real terms, we believe that many retirees think in nominal terms (at least in terms of getting their money back) so that a graph or table expressed in nominal terms is OK. With this approach in mind, we would not support the use of percentages as shown in the last column of Option B. Dollar values are much simpler to understand.

Reversionary benefits

With the growing individualism of superannuation and the related decreasing focus on reversionary benefits, we suggest less emphasis be placed on death and reversionary benefits. In fact, in most cases, the amount available on death will be no less than the amount available on withdrawal. Of course, under the capital access schedule, there may be a higher death benefit paid in the early years but this should not be a strong focus. Rather the disclosure should concentrate on the likely level of retirement income.

Other general comments

The AGA's paper uses CPI as the indexation benchmark for future retirement income. There are several alternatives including the use of wages (to reflect community living standards) or a rate slightly below CPI given the evidence that the expenditure pattern of retirees gradually reduces in real terms. In addition, many retirees will receive an increasing age pension during their retirement years. Given these considerations, we believe that CPI represents the maximum indexation rate that should be used. A rate slightly lower than CPI could be justified but, on balance, we believe that the use of CPI is a reasonable approach.

Although it may be obvious to the trained observer, the formula shown on page 5 of the AGA's paper sums over both the simulations (say 1000) as well as all the years to age 100. That is, it is really a double summation which is not clear in the formula presented.

There is some confusion in the use of the term "expected income". For example, on page 8 of the Consultation Paper, the term "median expected income" is used. Whilst not wishing to get bogged down in the statistical use of the term "expected income", it may be better to use terms such as the most likely range of incomes as no level of income is actually expected, unless it is a guaranteed annuity. Under all other arrangements there will be some uncertainty.

The AGA paper shows a graph on page 14 illustrating both initial income and a risk measure. We believe that it would be easier to understand if the income level was on the horizontal axis and the risk measure was on the vertical axis, with the lowest risk at the top of the vertical axis. That is, the trade-off between income and risk would be clearer.

The development of relevant stochastic models covering different asset classes and future inflation represents a key component of the development of disclosure, as outlined in the Consultation Paper. It is therefore necessary that some constraints should be placed on the models used and the development of a professional standard by the Actuaries Institute would be a good step forward.

We also recognise that this required disclosure excludes any reference to the age pension, which represents an important source of income and risk mitigation for many retirees. Hence, while it is understandable these disclosure requirements relate to a particular product and ignore the age pension, it is essential that the modelling could be expanded by super funds and providers to show the impact of the means-tested age pension.

Finally, it is probable, indeed likely, that such required disclosures, as envisaged in the Consultation Paper, will have an impact on the design of future products. Whilst the encouragement of the pooling of longevity risk is to be encouraged, we must be sure that the development of a broad range of innovative retirement income stream products is not discouraged through certain disclosure requirements or the particular risk measure that is used.

Page 9
Retirement Income Disclosure Consultation Paper
4 April 2019

As always, Mercer stands ready to discuss further these issues with Treasury or the AGA. Please do not hesitate to contact me on [REDACTED] or by email if that would be helpful.

Yours sincerely



Dr David Knox
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Who is Mercer?

Mercer is one of the world's leading firms for superannuation, investments, health and human resources consulting and products. Across the Pacific, leading organisations look to Mercer for global insights, thought leadership and product innovation to help transform and grow their businesses. Supported by our global team of 22,000, we help our clients challenge conventional thinking to create solutions that drive business results and make a difference in the lives of millions of people every day.

Mercer Australia provides customised administration, technology and total benefits outsourcing solutions to a large number of employer clients and superannuation funds (including industry funds, master trusts and employer sponsored superannuation funds). We have over \$150 billion in funds under administration locally and provide services to over 2.4 million superannuation members and 15,000 private clients. Our own master trust in Australia, the Mercer Super Trust, has around 230 participating employers, 239,000 members and more than \$22 billion in assets under management.