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Retirement Income Disclosure Consultation Response

Thank you for the opportunity to participate in the above consultation process.

We strongly support the Government's efforts to develop a retirement income framework to improve the retirement outcomes for Australians and is aligned with the objectives of the superannuation system.

We strongly support having a consistent approach to describing different retirement product features - framed through an income lens. Not only will this assist members and their advisers to better comprehend the features of each retirement product, it will assist all participants in the industry to understand the key issues and build a common language around them. We think the AGA has done an excellent job in taking the three major risks in retirement and translating them into a single simple risk metric that respects the right background issues.

Optimum Pensions ("Optimum") has developed a product, the Real Lifetime Pension, which we believe gives retirees the best of both worlds – the ability to have investment choice including exposure to growth assets and the benefits of longevity protection that ensures retirees cannot outlive their pension. The longevity risk is fully reinsured via our partnership with Hannover Re, the fourth largest reinsurer in the world.

This letter provides our feedback and comments on the Disclosure Consultation paper.

We would be delighted to discuss our feedback and comments.

Yours sincerely

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Feedback regarding the proposed disclosure metrics and presentation

In the interests of brevity, we have not commented on every observation we made but have instead focussed our comments on certain items where our input may be valuable or where we wish to draw extra attention to something. We confirm we have read the consultation fully and considered the issues thoroughly.

Optimum fully supports the proposals to develop a simple retirement income product disclosure fact sheet. Overall, we think the proposed approach is both professional and pragmatic and shows a maturity that our industry can be proud of.

Any form of simplification of complex matters inevitably requires careful trade-offs between ease of comprehension and disclosure of technical detail. We agree with most of the decisions that have been proposed around achieving simplicity.

Risk metric: One of the most complex aspects of the Fact Sheet is the retirement income risk metric and we support the AGA's recommendations to condense a significant number of issues and risks into one pragmatic metric. We have provided comprehensive comments about the deeper modelling required in the attached Appendix. We have done this in the hope you may find it useful when developing more specific guidance for product providers about how to perform the required calculations. We think the high-level approach is sound.

Note: We do not support a risk score for guaranteed annuities that indicates they are zero risk. All annuity providers carry a small amount of credit risk – particularly when their commitments involve guaranteeing market, inflation and life expectancy risks 30 years in advance! Financial advisers are aware of the very real “asset-liability mismatching risk” that can occur – particularly where they are not given details of the assets backing the annuity obligations. Our Appendix contains further commentary on this point.

We support the risk metric calculation extending to age 100.

Account based pensions: It is imperative that the disclosure rules also apply to account-based pensions (ABPs). These are widely used products and, as such, need to have the same measures applied to them.

Provision of income charts: We note that the Behavioural Economic Team of the Australian Government study ('Supporting retirees in retirement income planning') found charts to be less effective than a table of descriptions in words with key numerical results highlighted.

If you do decide the Fact Sheets will include a chart of average real income year by year then we suggest this chart continue to the end of the Australian Life Tables - currently age 109 rather than ending at age 97. It is important to draw attention to the fact that some Australians live that long.

Using an age that is younger than the end of the life tables is arbitrary. It's also important to change Australia's current heuristic for retirement i.e. only planning to live until age 84.

Age Pension Rules: Consideration should be given to including a green flag in Fact Sheets which indicates if the product is eligible for the new means testing rules for eligible lifetime income products. Some products attract more Age Pension than others and financial advisers are required by law to take the Age Pension into account in their advice.

Other suggestions

Life expectancy disclosure. We strongly advocate for formal disclosure by superannuation funds and/or their financial planners around the life expectancy of their members and the range of possible lifespans that each household could face. We have been shocked to see examples of super fund websites giving a life expectancy figure which is based on life expectancy from birth – without any allowance for past and expected future improvements in mortality or any indication of the *range* to which their lifespan could extend. **This can lead to members making poor decisions about retirement.** For example, how much to save to have enough money to retire and how to spread their remaining assets over their expected remaining lifetimes.

It is critical that the wider disclosure rules for superannuation funds include a requirement to inform members about their own possible lifespans. It is most likely that members considering a lifetime income product are in the group who are healthier lives. Therefore, funds should make it clear that healthy life expectancy is longer than average life expectancy. Average life expectancy includes those who are of poor health and have a shorter life expectancy.

These topics are obvious to those who think about them but the public have limited, if any access to good information in this area. Lack of access to this information will mean there is an increased likelihood that retirees will exercise poor judgement and decision making. This must be addressed if the Retirement Income Framework is to succeed. Our partners at Hannover Re have offered to provide online tools that ask a small number of health questions and can provide each user with a *personal* life expectancy range – using data from global reinsurance experience. Personalised longevity is a developed field in markets like the UK. We would be very happy to discuss these ideas further.

Personal characteristics of the member: The personal characteristics of the member and their spouse obviously affect how prone they are to longevity risk. For example:

- For a single person in poor health the risk of using an ABP without longevity protection is less than it is for a very healthy couple
- For a healthy couple, a retirement income product with a reversionary spouse's income is lower risk than a product that doesn't have a reversionary spouse's benefit

Fact sheets should make it very clear that they are illustrative only – based on an example retiree. To assist further, and potentially assuage concerns that a member could be placed into the wrong product, Fact Sheets could potentially include a list of ‘red flags’ to alert people when not to use the product. For example, a lifetime income product might say:

“If any of the following applies then you should seek professional advice before proceeding with this product:

- I am single and in poor health
- My priority is to leave this money as a bequest when I die rather than use it for my own retirement income
- I intend to fully withdraw my investment in the future”

Personalised underwriting: In the UK, many annuity products can generate a personal rate for each applicant based on their actual health status. This means retirees in poor health receive a higher annual income than retirees who have longer life expectancies. Optimum’s Real Life Pension product plans to introduce this feature.

All retirees have uncertainty around the duration of their future lifespan and this translates to uncertainty about how long their financial planning time horizon will be. Personalised underwriting can bring the risk management benefits of lifetime income stream products to all retirees - not just the super-healthy. UK experience demonstrates that these products are popular so long as the rates are fair based on the customer’s own health status.

The presence of personal underwriting may impact the way Australia’s product Fact Sheets are prepared. In particular, if the product has this feature then the fact sheet could be based on average rates rather than only using rates for select lives. If personalised underwriting is available, then the product is relevant to the average retiree of average health. Whereas if there is no personal underwriting then the product may be only relevant to the very healthy.

Product options: Many retirement income products are likely to have various options for retirees to choose from. For the purpose of comparison, and consistent with the objective for the superannuation industry, fact sheets should probably be prepared with all options switched off – so they are framed as a pure retirement income tool. It should be made clear that selecting additional features such as guarantee periods will carry a cost – e.g. in the form of a lower retirement income.

It may be worth considering having different versions of each Fact Sheet for males, females and couples. ABPs may be permitted to have a single fact sheet for males and females (as the outcomes are likely to be the same) but not couples – as their needs are more and their joint life expectancy longer (second death).

Personal illustrations (quotes): We envisage that the first part of the application process when a new investor decides to take out a retirement income product is to request a personalised

illustration. Presumably guidance will be developed to apply the proposed disclosure ideas to these illustrations. This is a chance to personalise many of the disclosure items further in a consistent way.

Annual statements: It would make sense that members of retirement income products are given an annual statement showing the income they have received in the prior year along with updated information about their ongoing benefits - in a format similar to what they received initially.

Future considerations:

Further work - aged care: Whilst not directly related to this consultation we understand some people are concerned that if they purchase a lifetime income stream then they are giving up capital which may have been needed to fund lump sum age care needs later in life. They fear that they will regret the decision to take out an (irrevocable) lifetime income stream. The government should take steps to assuage these concerns – via education if the fears are unwarranted and/or policies to reduce the chance of regret if someone had age care needs later in life which require lump sums that are no longer accessible.

Appendix: Retirement income risk metric modelling – detailed commentary

We believe the following detailed comments support that the proposed retirement income metric is indeed workable.

We are well aware of the Actuaries Institute research paper titled “We asked how 2,500 advisers formulate retirement income advice”¹ (also mentioned below) as it has helped formulate our views.

We confirm that we have carried out hypothetical modelling of our own product as well as on ABPs invested in various investment options and are seeing consistent results with the AGA’s own findings.

Some of our comments below may also assist in the development of more detailed rules and guidance for those tasked with calculating the risk metric. Our thoughts have been formulated during our own internal modelling.

Potential perceived clash with “Investment Risk Profiling”

- The standard financial advice process in Australia considers each investor’s *investment risk profile* and takes this seriously when giving recommendations to clients. Part of this methodology concentrates on the client’s “attitude to investment risk” and the other part focusses on the volatility of various investment portfolios the investor might choose from. In its crudest form the approach simply aligns the client’s attitude (measured on a scale from low to high relative to the general population) with the one-year volatility statistic from a menu of model portfolios (ranging from low volatility cash to high volatility growth assets).
- We get the impression that most advisers feel this methodology needs to be extended¹ (which the AGA’s proposed risk metric achieves). Advisers are conscious that using defensive assets to meet long term goals is inefficient and, in many cases results in a *higher* probability of failing to achieve long term goals than growth assets – because of the much higher chance of failing to keep pace with inflation.
- The AGA’s proposed risk metric demonstrates this effect. We agree with the AGA’s conclusions that an ABP invested in defensive assets will produce higher risk of the retiree not meeting their long-term needs than if growth assets are used. To have this proven in the context of retirement is a fantastic leap forward for Australia.
- We expect that many ‘front line’ financial advisers and investment professionals will agree with these findings as it concurs with their own judgement and experience. However, there may be pushback from those fearful of departing from the status quo “risk profiling” approach described above. The Actuaries Institute research paper titled “We asked how

¹ <https://www.actuaries.asn.au/Library/Events/FSF/2018/AdviceToPreRetireesPaper.pdf>

2,500 advisers formulate retirement income advice”² page 8 indicates that some compliance departments are locked on to “1-year volatility” as the only safe measure of investment risk.

Choice of income benchmark – lower risk investment mixes

- Notwithstanding that defensive assets may be inefficient in meeting long term objectives, some investors do genuinely have a low attitude to investment risk. A good way of thinking about this is they have a low ‘constitution’ towards market volatility – it causes them stress and anxiety that, in the worst cases, can cause them to make erratic decisions such as pulling out of markets when they hit a low point, therefore missing out on the recovery. In some cases, members even become too scared to re-invest in growth assets.
- Low ‘constitution’ toward volatility is a valid consideration when selecting a retirement income product. Some investors will consciously make an informed decision to select lower volatility assets knowing that this will result in a lower long-term lifestyle. They do this to avoid the anxiety that market volatility would otherwise cause them. Unfortunately, the risk aversion to volatility is most often governed by short-term fears and ignores the fact that the long-term risks can have a far worse outcome for them. For these people, the immediate fear outweighs a potential future fear.
- Retirement income products with an element of investment linked outcomes can accommodate low volatility investments in two main ways:
 - A. By having a lower starting income that increases with inflation; or
 - B. By having the same starting income but that is unlikely to increase with inflation
- In our view either of these approaches is valid – as long as the investor is aware of their potential outcomes.
- We note however that the proposed risk measure would give a very high risk score to option B above, but a low risk score to option A. Whereas what’s really going on is the investor has made a conscious decision to accept a lower **objective** when it comes to income increases over time. We are not sure how to solve this without having a different benchmark income for different products. But that might be too complex in the interest of simplicity of comparing products with each other.
- The consequence would be that product providers may feel pressured to design their product in line with option A above rather than B. It is yet to be seen whether advisers (and their compliance officers) could happily recommend the perfectly viable product B to clients who have a low ‘constitution’ toward market volatility.

² <https://www.actuaries.asn.au/Library/Events/FSF/2018/AdviceToPreRetireesPaper.pdf>

Choice of income benchmark – retiree needs

- Another consideration relevant to the previous section is that some research seems to be emerging saying that retiree spending needs don't increase as fast as inflation. Please note that we are simply observers of this research rather having own evidence at this point in time. Is this cause or effect, or is it due to behavioural traits of different cohorts (the baby boomers vs the older 'builder' generation for example)?
- Treasury may consider having a benchmark income that increase at CPI -1%. But we know other actuaries who would disagree with this.
- Ultimately our view is that the industry will adapt to whatever is chosen, which is similar to prior experience with other industry wide changes. Our preference is simplicity rather than making the disclosures confusing and therefore ignored.

Risk metric including the Age pension

- We would point out that calculating the risk metric in a way that takes into account the person's projected Age Pension entitlements requires a lot of additional data and modelling in order to take into account the material drivers of these outcomes. Around 40% of age pensioners receive a part pension due to the means testing rules – which are assessed at household level not product level.
- The following items have a material impact on the means tests and hence have a material impact on a person's Age Pension entitlements in each future year:
 - o All superannuation income streams of both spouses
 - o All non-super assessable assets of both spouses (excluding the home)
 - o All other incomes received by each spouse e.g. part time earnings for the first period of retirement
 - o Any future lump sums received (e.g. an incoming inheritance or sale of a business)
 - o The timing of death of each spouse, which changes the Age Pension payment rate and the bands and thresholds used for the means tests
- Whilst this household modelling can be done in a powerful stochastic framework (e.g. www.10e24.com) it is highly involved and cannot be done in any sensible way at product level (e.g. if a single product provider must make assumptions about the above bullet points).

Consistency of results – AGA's proposed risk metric

- We fully support the need to use stochastic stress testing when assessing the risk of retirement income products.

- We agree with the decision to focus the concept of 'risk' as not meeting objectives. I.e. to include down-side risk only, not offset by upside gains
- Note: We use the term 'Economic Scenario Generator' ("ESG") to refer to the model used to produce thousands of possible future return sequences from investment markets and inflation.
- ESGs rely heavily on assumptions about the statistical properties of each asset class, including correlation between asset classes and inflation. Some of the assumptions in an ESG reflect historical observations but others are forward looking based on judgement. As a result, the outcomes from different ESGs produced by different modellers will differ. The better ESGs go far beyond using normal distributions although a well designed lognormal approach can produce reasonable results.
- In calculating the proposed risk metric, we note that the same product could possibly be given different results depending on which ESG is used.
- As such, there should be a requirement for ESG's to be signed off by suitably qualified and experienced members of a professional body who provide professional standards for doing so and has a disciplinary process in place if those standards are breached.
- An alternative could be that the AGA publishes a standard set of ESG simulations in a similar way to the way the Australian Life Tables are published. This could enable the whole industry to use a consistent ESG for the purposes of the risk metric (and other valuable modelling including online retirement calculators).
- With either alternative, the ESG could be required to fall within an acceptable range.
- Obviously, there are trade-offs between these two approaches.

Consistency of results – investment strategies and asset classes

- Different retirement income products will have different underlying investment strategies. Some important considerations are:
 1. Some retirement products may involve sophisticated investment strategies that may claim to deliver 'alpha' (performance in excess of that achieved by index investing)
 2. Other investment strategies may be time varying – where the assumed exposure to growth assets changes based on the age of the retiree
 3. Other strategies may be dynamic – where the exposure to growth assets changes based on certain rules. Bucketing strategies are an example of this.

4. Some products may involve smoothing reserves, either at member level or potentially even intergenerational smoothing³
- Again, we would strongly advocate for the required modelling to be signed off by suitably qualified and experienced members of a professional body with a code of conduct in place, professional standards for carrying out the modelling and a disciplinary process in place if those standards are breached.
 - Even if the AGA published a standard set of ESG simulations for the main asset classes, the above four 'features' and how they are modelled will impact the results of the proposed risk metric. They require a very high degree of integrity as well as industry experience from the modeller.

Impact of mortality experience on outcomes – tables to use

- We note that for some products (including ABPs and guaranteed annuities) modellers won't need to use mortality tables to calculate the risk metric – the projection simply goes to a fixed age. We endorse that approach.
- However, for other product types such as Group Self Annuitisation schemes ("GSA"s), the mortality experience of each specific group of members will directly impact the income outcomes for those members. If the whole pool lives longer than expected then the pool's assets need to be shared across more lives than anticipated and each retiree will see a decline in their retirement income.
- Some products, that pool experience across members rather than insure it, could find themselves in a situation where the weight of previous shortfalls makes the product unattractive to new entrants. Nobody wants to join a product where the pricing they receive is unfavourable for new entrants to add more capital to that pool⁴. This effect could be self-fulfilling where the lack of new entrants exaggerates the product's problem and the shortfalls must therefore be spread across a smaller number of members. The product may enter a 'death spiral' and need to close.
- We strongly recommend this type of 'stochastic mortality' risk be taken into account in the risk metric for products that are exposed to these types of idiosyncratic mortality risk. To do this:
 - The modeller must first make prudent assumptions about pool size and future growth
 - Each market simulation should be re-run multiple times (e.g. many hundreds) to demonstrate the full range of longevity outcomes that could be experienced

³ Note: Intergenerational transfers can create significant problems for products if joining is voluntary. See page 10

⁴ How to make Group Self-Annuitisation a Popular Retirement Product: Practical Challenges and Solutions for Super Funds, Qiao and Minney 2015

- The impact of the longevity outcome on members' incomes should be calculated according to the product's rules for determining how pension payments are adjusted in that scenario, potentially even including how the product might cease.
- Unless there is personal underwriting in place (see page 4) it is imperative that the mortality basis used for longevity products is 'select'. Less healthy lives are unlikely to choose lifetime income products and therefore the life expectancy of those who do take out the products will be longer than average. Refer to the Actuaries Institute's study "Exploring Retiree Mortality"⁵
- Other products may insure idiosyncratic mortality risk but still pass on systematic mortality risk - where the entire Australian population's life expectancy changes over time. If the members of a specific product lived longer than expected but purely by chance, they would be protected through the insurance. But if the entire Australian population experiences a change in life expectancy then this 'systematic' risk gets passed gradually through to members. This 'with profits' type design protects the insurer from financial ruin and allows much keener insurance costs. The impact on members from systematic risk is smaller than the impact of actual experience outcomes from a small GSA pool. Nonetheless we recommend that stochastic mortality impacts should be considered by the actuary when calculating the risk metric (e.g. via a basic sensitivity analysis).

Provider default risk

- Whilst 'guaranteed' products are appealing to those who want certainty, a guarantee is only as strong as the guarantor. **We do not support a Fact Sheet that implies there is no risk at all in guaranteed annuity products.**
- To fully guarantee a contract for 30-40 years is a significant undertaking – taking into account investment risk, inflation risk and the two types of mortality risk described in the previous section. Systematic risks such as high inflation or life expectancy, however low the probability is, are hard for insurers to insure/hedge.
- We recommend that the Fact sheet or risk metric makes some allowance for credit risk of the guarantor. We acknowledge that this is not necessarily simple. To provide a credit rating about an annuity provider is a complex exercise.
- Also, investors in products that protect from both investment risk and longevity risk are relying on guarantees to a much greater extent than investors in products that only insure mortality risk.
- Options could include warnings or require disclosure of the underlying investments that back the annuity and the investments of the shareholder capital that supports the

⁵ <https://actuaries.asn.au/Library/Opinion/2018/AIExploringRetireeMortalityFINAL.pdf>

guarantee. However, rather than propose any methods for this here, we would be happy to discuss our views in person. Ultimately some sort of stress testing must be carried out that is similar to what's required for other retirement income products. But for guaranteed products the analysis needs to 'look through' to assess the extent to which the insurer's underlying resources might be unable to meet all pension payment obligations in all simulations. Any ratings agency must be permitted full transparency of the underlying assets and resources being used to fund those liabilities.

Congratulations again on a well thought out Consultation Paper.