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## Submission – Retirement Income Disclosure Consultation Paper

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**\*\*\* The views expressed are solely those of the author and should not be assigned to any of the above-listed groups.\*\*\***

### Summary

The *Retirement Income Disclosure Consultation Paper* represents the second component of the Retirement Income Framework. And so, we can see it all beginning to take shape. It is exciting that, should this proceed through parliament, we will begin to see default retirement solutions made available, creating greater protection and awareness for retirees. This is a difficult area for policy and framework development and Treasury and the Australian Government Actuary (AGA) deserve acknowledgement for their efforts to push through and deliver.

Throughout the CIPR framework development it appears that for many industry participants it is easier to critique than provide alternative solutions. This simply confirms the complexity of the retirement challenge. This submission acknowledges the direction that Treasury are heading down with the CIPR design rules and outlines some issues which Treasury and the AGA may wish to consider.

The main areas of feedback in this submission relate to the Age Pension, a request for further clarity around investment assumptions, some of the design elements of the Retirement Income Risk Measure, and some additional suggestions relating to disclosures.

## **The Age Pension Conundrum**

Throughout Treasury's work developing the Retirement Income Framework, the Age Pension has continually represented a thorn in the side of simplicity. A means tested Age Pension provides a varying degree of longevity protection and risk sharing, while introducing a great degree of complexity into retirement income projections.

Treasury appeared to acknowledge this by permitting trustees to offer up to three flagship CIPRs (*Retirement Income Covenant Position Paper*) for membership cohorts likely to be eligible for the full Age Pension, part Age Pension or who are ineligible for the Age Pension.

The reasons for not including the Age Pension in the calculations are obvious (variability in eligibility), but it is important to note the resultant shortcomings, which include:

- Disclosure profiles which understate retirement income and overstate retirement income variability;
- Potentially three different CIPRs which could have large variations in their disclosure profiles (because they do not accommodate the Age Pension benefits that have been incorporated into their design), creating confusion for consumers.

There is no easy way to solve for this in a constrained CIPR framework (key constraints being a restricted product range and no personalisation of disclosure). This in turn highlights the value of personalisation (design and communication) that funds need to aim for over-and-above the default solution being provided by CIPRs.

I reconcile the situation by working on the premise that the Government's view must be that the benefits of a CIPR are viewed as greater than the opportunity cost of the industry not developing solutions which personalise and maximise the interaction with the Age Pension, weighted by the observed low levels of retirement innovation delivered by industry.

## **Consistency of Assumptions Across Industry**

Trustees are left with discretion around assumptions, and the assumptions around investment outcomes (expected returns and measures of variability) have great impact on retirement income disclosures.

Anecdotally there are large differences in investment assumptions across the industry. This can be identified by comparing investment objectives across fund peer groups in accumulation. I am also aware of large differences in volatility assumptions.

This will add to the difficulties in comparing CIPR products.

One specific issue to consider will be investment return assumptions. In the accumulation phase the trustee is obliged to determine an investment objective around which they have a reasonable (undefined) chance of achieving. In this situation there is a trade-off between investment objective and certainty of achievement.

Treasury's consultation paper doesn't consider the degree of certainty in forming return assumptions. My working assumption would be to use expected returns. Such an assumption would distort the ability to compare an account-based pension (ABP) against a CIPR, as the (risk-adjusted) investment objective is likely lower for the ABP than the equivalent expected return used in CIPR modelling. Prescribing standards for consistent inputs would be beneficial. However, it is not easy:

- (i) If expected returns are uniformly applied, then this would lift investment objectives. Trustees may require some sort of safe harbour provision for detailing investment objectives around which they have a roughly 50% chance of achieving.
- (ii) If an investment objective approach is applied (with the trustee needing to determine an appropriate degree of certainty) then this would be more conservative, hence distorting comparison with non-investment linked products such as life annuities.

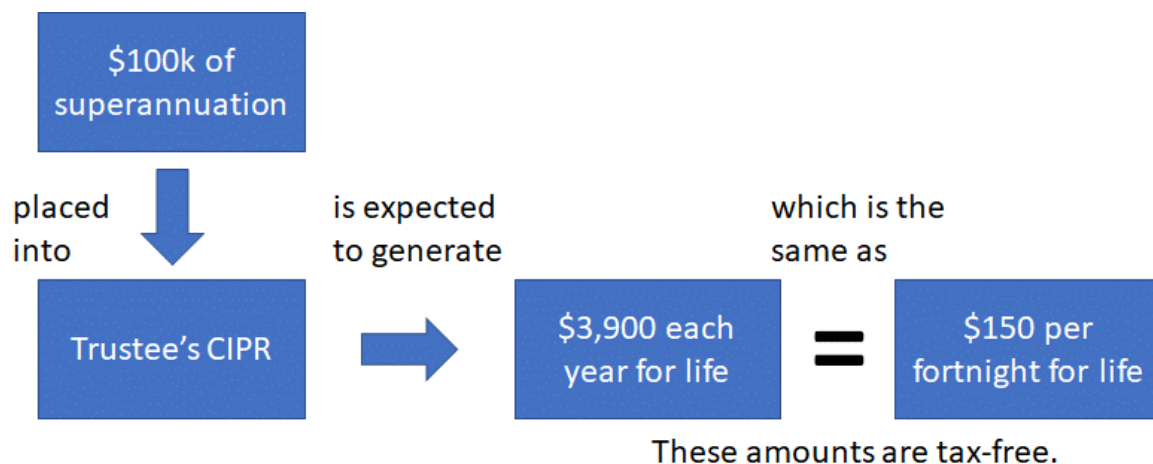
### Does \$100k Create Framing Issues?

The disclosure of what \$100k is expected to deliver may create some unintended consequences. Notably it could be taken as some form of unconscious advice that \$100k is an appropriate amount to invest into a CIPR.

Communicating what \$100k will provide for if three different CIPRs are provided by the one trustee may also create confusion. If CIPR's are designed for a particular minimum balance, then there is an argument that the communication should be tailored to that minimum balance amount.

### Presentation Format: Income

This may be the only chart that some retirees use in making their retirement allocation decision. So, the more detail the better, and anything which makes it more readily understood by someone with low levels of financial literacy would be beneficial. Below, I propose one example which provides more clarity.



## Retirement Income Risk Measure (RIRM)

The retirement income risk measure is a strong attempt to determine a single risk measure for what is a complex problem. I make the following comments / suggestions:

1. There is no need for the statistic to be simplified in any way. Given the calculation is performed by industry but then re-framed into a consumer-friendly format, simplicity need not be a constraint in design.
2. There is inconsistency in framing between the SRM (Standard Risk Measure) and RIRM. For SRM, currently used in disclosure, a higher number implies greater risk. For RIRM, a lower number implies higher risk. Such inconsistency in framing could prove confusing to consumers with low financial literacy. I recommend that the RIRM presentation is reversed.
3. Clarification of the formula. I clarify the formula to be (which I believe is consistent with AGA modelling):

$$\sigma = \sqrt{\frac{\sum_{i=1}^{Sims} \sum_{j=1}^{Year} (I_{i,j} - B_{i,j})^2}{(ij - 1)}}$$

Where i is a simulation number, j is the year, I is the income stream and B the indexed benefit.

4. The RIRM reflects elements built around the experience of the member; the AGA appears to have gone down this path (to a degree) by only considering downside scenarios and placing zero weight on upside experiences. The decision to square outcomes suggests some form of quadratic utility. There is little evidence which supports quadratic utility, over something like power utility. And while behavioralists (and indeed rationalists) believe that most people place greater weight on the negative outcome compared with the positive income, the weighting is not zero on the upside experiences.

I find myself asking whether there is a role for MDUF v1 here... in this case not because the AGA are trying to create a dedicated risk metric rather than a metric which balances outcomes against risk.

5. The considered decision to not weight outcomes by survival probability has the potential to skew product design. Rationally we would design products which manage risk by considering potential events and the likelihood of the event occurring. However, the RIRM is heavily penalising shortfall for an unlikely event. The response would be to bias towards longevity protection. The AGA has been transparent in this desire, but there is an economic cost here (I have not calculated) which is exacerbated once we also acknowledge existence of the Age Pension (which is not being incorporated into these calculations).
6. The RIRM is local to the CIPR, specifically its income target. This makes it difficult to compare CIPR's from a risk basis. It is important that this is communicated clearly to consumers, but I believe it is likely that consumers will compare the RIRM of different CIPRs. The only solution to this problem is to use a generic income stream assumption. Perhaps a comparison table would calculate RIRM's for all CIPR's against the risk-free income of an annuity stream,

though this would mean someone has to model up all CIPRs! Informed comparison by consumers appears difficult...

7. Am I suggesting a better risk measure than RIRM? If it is a firm directive not to weight income streams by survival probability, then I would not change the metric.

## **Potential Income Shape**

When I look at the chart on Page 7 of the Consultation Paper I wonder if including some possible sample paths would aid understanding or create consumer complexity overload. It may be worth considering.

## **Access to Capital**

This is a tricky area. For instance:

- The Potential income Shape is real dollars but Access to Capital is presented in nominal dollars.
- Treasury identify that some products are unitised and have variable asset value, but it may not be clear to the consumer how much variability is in the presented 'Access to Capital' schedule.
- It would also be appropriate to disclose the costs and penalties associated with any access to capital.

## **Death / Reversionary Benefits**

The disclosures on Page 9 may be more informative if they take a tabular format which also considers the case where the CIPR member outlives their partner (i.e. clarify the death benefit). The same issues outlined in 'Access to Capital', notably real outcomes, and variability, carry over here.

## **Summary**

The disclosure challenges for a product which may be a hybrid of other products creates complexity in comparability and risk measurement. Hopefully my suggestions generate further thought / discussion amongst Treasury and the AGA and potentially lead to improved disclosures.