Manager, Retirement Income Framework   24 March 2019
Retirement Income Policy Division
The Treasury
Langton Crescent
PARKES ACT 2600
Email: superannuation@treasury.gov.au

Response: Retirement income disclosure consultation paper

Dear Madam

The attached submission contains my response to Treasury's Retirement Income
Disclosure Consultation Paper dated 10 December 2018.

I welcome Treasury's invitation to provide feedback on the proposed disclosure metrics
outlined in the consultation paper. I believe my experience as both a practising qualified
actuary (FIAA) in the wealth management space and an independent software
developer positions me well to provide valuable input to this discussion.

As a matter of disclosure, I note that I have presented many of the ideas in this paper to
your division in person. Part of this included an interactive demo of a retirement income
advice tool I am developing that supports those ideas. Should a further demo be
required, either by your division or by members of the public, I would happily consider
that. In particular, I would be interested in assisting with the consumer testing process.

Please do not hesitate to call me on ███████████ or email me at ██████████████
should you wish to discuss any of these matters.

Yours sincerely

Anthony Saliba

Introduction

Simplified and standardised disclosure for retirement products is a sensible goal for the Australian retirement income system. As mentioned in the Consultation Paper, complex disclosure can make it difficult to compare solutions and can lead to people making suboptimal decisions. However, it is my view that the effectiveness of any standardised disclosure metrics will be proportional to the standardisation of product sets that fall under the retirement income covenant. This is because, if a wide array of different retirement products were allowed, then it would be more likely that each of the features of those products may not be accurately represented by those standardised metrics. It would also be extremely difficult to compare features across products if only simple metrics are used. That leaves us with two logical alternatives to solve the problem:

A. Increase the complexity of the standardised metrics to adequately capture the features of all possible permissible products

B. Reduce the scope of permissible products to simple combinations of account-based pensions and longevity products (e.g. immediate and deferred lifetime annuities)

I am of the view that option B should be pursued, as this gives us both simple products and simple disclosure. When we consider that MyRetirement products should be simple enough so that they become much easier to access for unadvised people, this seems like a reasonable target (consider the effectiveness of technology under both options). I also believe not much value is lost by restricting MyRetirement product sets. In fact, the most recent Financial System Inquiry Final Report mentioned that simple combinations of vanilla retirement products can provide significant value to retirees[1]. It may also be argued that the administrative burdens of more complex products (with a risk of becoming legacy products if take-up is low) do not outweigh the different types of benefits that they may provide.

Furthermore, option A will inevitably result in a world of complex products assessed by simple metrics, leading to higher potential for mis-selling and product providers "gaming" the metrics by adjusting their product features.

Given my position above, my responses below to the Consultation Paper proposals are in the context of a retirement income covenant where only simple product variations are allowed. To that end, I recommend that the rules around permissible MyRetirement products are clarified prior to locking in disclosure metrics.

Response to proposals

> **Proposed approach: Expected retirement income**
>
> *For all retirement income products, expected retirement income should be presented numerically and with an income graph using average real annual income from a $100,000 investment, over the period from retirement (currently age 67) to age 97. Income presented should be net of fees and taxes.*

Firstly, it appears as though this proposal assumes that there will be one product that is being assessed using this metric (i.e. a product offering all desired features of flexibility,

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[1] Page 123, Financial System Inquiry Final Report, 2014, David Murray et al.

high income and longevity protection). However, as per my view mentioned above, simple combinations of products can be effectively used to provide a holistic retirement income solution and any income projections should be inclusive of all underlying product building blocks. Ideally, trustees will be able to combine the underlying building blocks into a single solution that is seamlessly delivered to retirees.

That aside, I strongly believe that an appropriate income graph would provide more useful information than a simple expected income number for several reasons:

- Currently, a common drawdown strategy for account-based pensions is to draw down the regulatory minimum, which is a percentage of account balance and changes with age. This variable income profile cannot be summarised in one average number.

- The Consultation Paper proposes reporting an average income number, with no discounting, over a period of 30 years. This would technically allow providers to construct products with back-ended higher income in an attempt to maximise the reported average income number (funded by mortality credits or more aggressive asset allocations).

- Given that most retirees who are the target of the MyRetirement solutions will receive some Age Pension during the projection period, and that the Age Pension can vary significantly over time, it would be unrealistic to assume that a fixed income will be extracted from a retirement income solution, as drawdown products are designed to replace or supplement the Age Pension. For instance, if a fixed total real income level was desired in the first 30 years of retirement and the Age Pension increased significantly during that time (due to means testing), then the MyRetirement solution should be able to allow for a smaller drawdown.

- An income graph would allow the variability of income due to market risk to be conveyed whereas a single average number would not. Although the Consultation Paper proposes separate reporting metrics for income level and income variation, there would actually be no need for this if the income graph was designed appropriately.

As for what the income graph may look like, consider the below example. An annual net real income projection is shown from ages 65 to 110. Varying shades of red are used to illustrate the market risk within the account-based pension. The dark shade represents what would occur in a poor market scenario, the medium shade; an average market scenario and the lightest shade; a strong market scenario. These scenarios may be selected stochastically or deterministically using realistic assumptions about the underlying fund return distribution and using certain percentiles. For example, 5th, 50th and 95th percentiles are used below, however there is no need to use statistical language in the graph.

Figure 1: Retirement income graph projection, demonstrating varying income levels and market risk
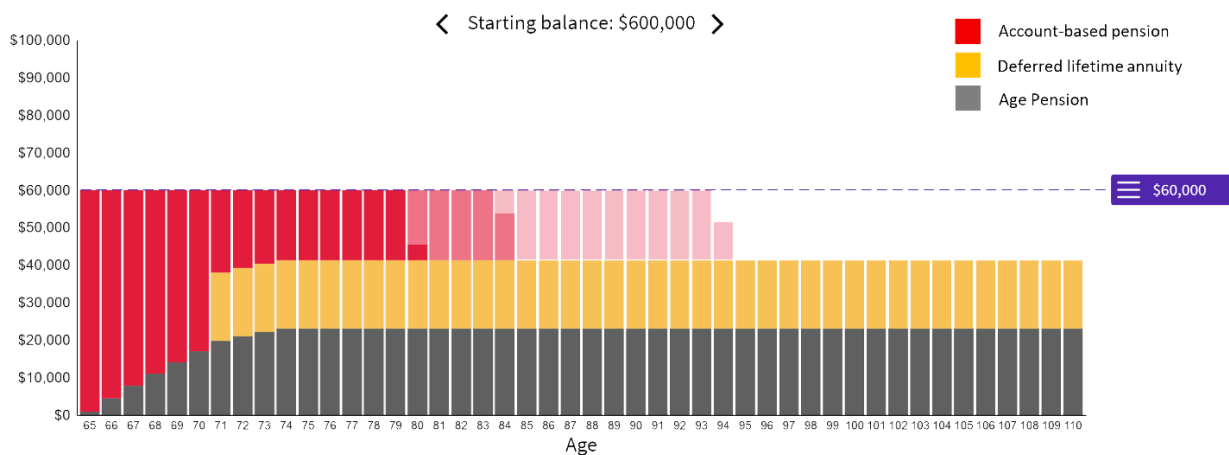
As can be seen, the above visualisation can help to illustrate the trade off between different product building blocks. For example, the account-based pension can be depleted at age 80 (or earlier) or at age 94 (or later), depending on market performance. The deferred lifetime annuity, on the other hand, provides regular income for life, once it commences, irrespective of market performance. I believe this is a cleaner approach of comparing the products as opposed to using an average income measure with a risk score. (Of course, access to capital also needs to be considered also and this will be addressed later in this submission.)

The above graph can be either provided statically or, preferably, dynamically with an allowance for different drawdown levels, strategies and building block compositions. Combining this idea with standardised product building blocks would then allow this graph to be rolled out consistently across the industry as it would be able to handle all product combinations and strategies. (A centralised comparison tool is an objective mentioned in the Consultation Paper.) This consistency would not only give advisers the ability to compare and contrast all MyRetirement solutions across providers, but also the public would slowly become more familiar with this visualisation – aided by the network effect – and financial literacy should increase as a result. Finally, having a standardised income graph would reduce technology costs to trustees as they would be implementing industry standards and not bespoke advice tools and Age Pension calculators to handle their own complex products. These benefits would simply not be possible with an unrestricted product set.

Proposed approach: Calculating income variation

For all retirement income products, income variation should focus on negative or downside variation measured against expected first year real income. The model measures downside income variations and the size of variations.

Products with risk mitigation strategies, protection factors, or conservative investment strategies, create fewer downside variations and therefore have lower risk scores.

For reasons already described, there is no need for a risk score that is separated from the income projection. The problem with a risk measure is that it is implying a utility function for retirees. For example, it is not unreasonable to imagine that a retiree assessing two different products, one with a risk score of 6 and the other with a risk score of 3, may believe that the first product is twice as secure as the second product. Although the

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score may be calculated such that this assumption may not be unreasonable, everyone has their own utility function that can change over time and is not easily extracted, meaning this approach could lead to confusion and unintentional misrepresentation. So, the income graph approach is preferred as it provides insightful information without making a decision about which product mix is better than another.

Another problem is that the drawdown strategy of the account-based pension impacts the risk score significantly, yet nothing has been mentioned about locking in that strategy. This will again mean that the risk score could be gamed by simply selecting the drawdown strategy that maximises the risk score, even though the retiree may move away from this strategy over time.

Furthermore, ignoring the Age Pension is not an appropriate position to take when considering income variability. For account-based products, a reduction in account balance due to market performance could result in an increase in Age Pension, somewhat softening the total impact of income variability. I understand the (current) difficulties with collecting sufficient data to model the Age Pension but, given the materiality of Age Pension payments for many retirees (particularly those targeted by MyRetirement solutions), it is my view that ignoring the Age Pension entirely is an unworkable solution.

Finally, any approach of demonstrating income variation, whether an income graph or a risk metric, requires agreed-upon modelling assumptions, the most subjective of which being the volatility and return assumptions for the account-based pension. Modelling assumptions need to be consistent across the industry, otherwise there will be pressure for providers to push their assumptions toward higher return and lower volatility. For this reason, I propose using an industry-wide efficient frontier that sets the limits of expected return for a given volatility. For example, an investment option with an annual volatility of 10%, will not be able to have an expected return greater than 6% p.a. A provider may be able to select a return/volatility combination on or below the efficient frontier, but not above. The efficient frontier may be reset at regular intervals to allow for changes in market conditions, although this may not be necessary if long term economic views are taken. An example efficient frontier is illustrated in Figure 2 below.

Figure 2: Efficient frontier
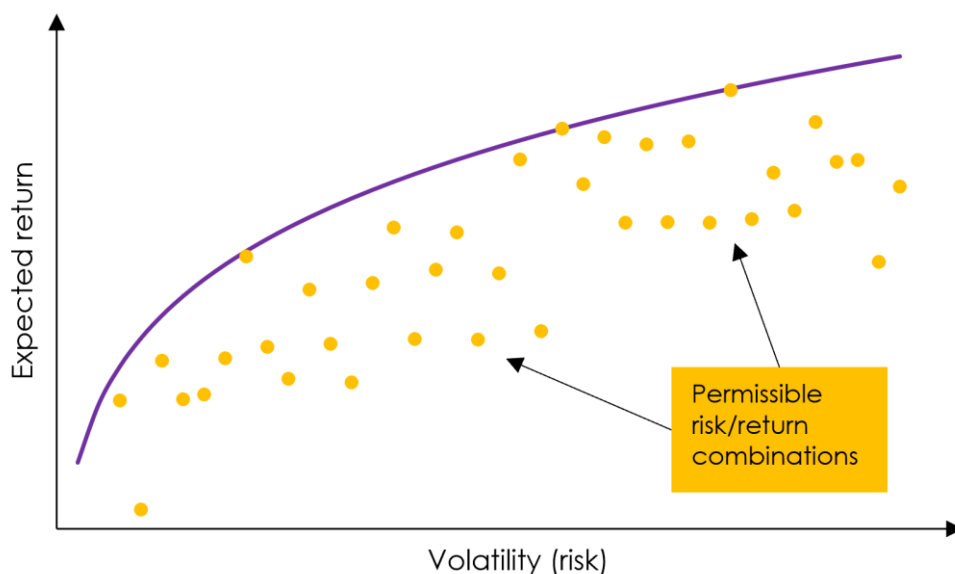
Access to capital over time should be shown in a chart, in a similar way to income and presented alongside income in any prescribed reporting. That would mean showing three hypothetical capital access schedules corresponding to the same 5th, 50th and 95th percentile scenarios shown in the income graph. Again, simple product building blocks would allow for very simple capital access schedules. Otherwise, complex product features may not be fully captured within the capital access graph and this may undermine the effectiveness of this information and provide an excuse to not pay it much attention, even though access to capital is typically a highly desired outcome.

Conclusion

The key recommendation I would like to make in this submission is that the regulation concerning the retirement income covenant should be finalised prior to enforcing any reporting metrics. In particular, I believe simple product combinations (account-based pensions, immediate and deferred lifetime annuities) should be the only permissible building blocks that contribute toward any MyRetirement solution – at least initially. The relevant implication of this would be that the reporting and metrics could also be simple and easily standardised across the industry.

In terms of reporting and metrics, I strongly believe an income projection with three different market scenarios should be required for complying MyRetirement products and that the Age Pension needs to be considered. I am against any simplified expected income number as this does not necessarily accurately represent the drawdown strategy of the given retirement income solution. Also, a risk score implies a universal utility function and this is problematic as every retiree's preferences are different. A simple formula for risk scores can also be gamed by providers and this leads to the potential of actual income variability being obfuscated.

Finally, the Consultation Paper mentions consumer testing as a next step. I would like to offer the use of my retirement income visualisation tool to assist with this testing. The tool has been constructed to inform retirees (with assistance from a trained professional) and therefore assist with financial decision-making. I believe it would be useful to understand how it performs against, or in conjunction with, the risk metrics described in the Consultation Paper.