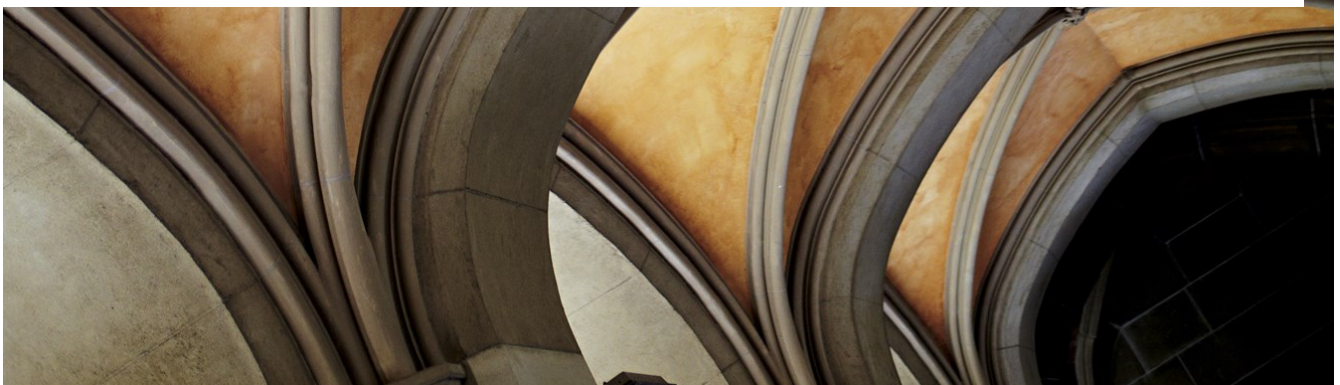# Retirement Income Disclosure Consultation Paper

Submission by UniSuper

28 March 2019

About UniSuper

UniSuper is the super fund dedicated to people working in Australia's higher education and research sector. With over 400,000 members and $70+ billion in net funds under management, we're one of Australia's largest super funds.

UniSuper Management Pty Ltd would welcome the opportunity to discuss the submission further and to provide additional information in respect of the comments made in this submission. Should you have further queries, please contact Benedict Davies on (03) 8831 6670 or benedict.davies@unisuper.com.au

Background

UniSuper has long supported policies that would give trustees more flexibility to develop new retirement income products to address the needs of their members. As far back as 2014, we made a submission to the Financial System Inquiry arguing that trustees, rather than policy makers, should be at the forefront of developing appropriate retirement income strategies and products for their membership. After all, the ultimate responsibility for developing new products rests with trustees – acting under a best interest duty – to understand and respond to the changing needs of their membership.

While we continue to support more flexibility for trustees, we do have concerns with the proposed risk measure in this Consultation Paper. Further, we note that the Consultation Paper, released in December last year, needs now to be read in the light of the subsequently released Productivity Commission (PC) Report *Superannuation: Assessing Efficiency and Competitiveness.*

The PC's Report included a number of findings that are particularly relevant to this consultation, most notably:

In the retirement phase, risk-pooled lifetime income products may meet some members' preferences for a predictable income stream and for managing longevity risk. However, the proposed Retirement Income Covenant may nudge many others into products ill-suited to their long-term needs, may not achieve its desired goal of increasing retirement consumption, and fails to take sufficient account of the diversity in household preferences, incomes and other assets.

The requirement that all funds must offer a 'flagship' risk-pooled product would oblige any fund without a capacity to create such a product to purchase it from a third party — where there are few choices currently on the market. The requirement for a standardised risk-pooled product may conflict with trustees' obligations to act in members' best interests, and many funds do not want to offer them. 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.

As a result of this, the PC went on to make the following recommendation:

The Australian Government should reassess the benefits, costs and detailed design of the Retirement Income Covenant — including the roles of information, guidance and financial advice — and only introduce the Covenant if design imperfections (including equity impacts) can be sufficiently remediated.

Therefore, in light of the uncertainty, we strongly suggest further consultation on this measure, along with the broader retirement income framework.

Comments on the Retirement Income Risk Measure

While this Consultation Paper and the AGA technical paper include only two references to CIPRs (once in the Glossary), both papers are written with CIPRs firmly in mind. The Consultation Paper proposes standardised metrics that would apply to "blended" products; however, no such blended products yet exist so our comments are based on the assumption that the proposed risk measure would apply equally to all "standalone" products such as account-based pensions (ABPs).

While we are broadly comfortable with the expected retirement income and other metrics (access to underlying capital and death/reversionary benefits) and think that they would be useful and relevant for consumers, we think, however, that the risk metric proposed in the AGA paper is problematic and can potentially be misleading as it is applied to blended products without allowing for the Age Pension.

There is a vast literature on annuities and annuities markets but there is an equally vast literature on economically important institutions that "insure against uncertainties" and "create guarantees [for situations where there] would otherwise be…excessive uncertainty". Barr has argued that "institutions (public or private) …arise which are insurance in the sense of protecting against risk, even if they are not insurance in the strict actuarial sense."[1]

In the Australian context, the Age Pension is clearly an important institution that protects retirees from uncertainty and has significant insurance-like benefits. The PC in its Report notes at least one insurance-like feature of the Age Pension:

As well as its direct role in providing support for older Australians with lower income…acts like a deferred annuity for many people, providing insurance against longevity and other risks.

It is odd, therefore, given the clear importance of the Age Pension that it would be excluded from a retirement income risk measure. After all, the majority of retirees continue to receive the full Age Pension; thus, for many Australian retirees superannuation acts as a *supplement* to their Age Pension.

Failure to take into account the substantial insurance-like value of the Age Pension would likely overstate the risk associated with retirement income products. By way of example, a standalone ABP of $100,000 (under the scenarios modelled in the AGA paper) would receive a risk measure between 14.56 and 26.47. However, a single homeowner with $100,000 in superannuation would also receive the full Age Pension; thus, a better risk measure is something more like the 80:20 life annuity ABP combination modelled in the AGA paper – that combination receives a risk measure between 2.09 and 5.67. In essence, many Age Pensioners already have a blended product i.e. private pension and the public pension. Thus a risk measure that excludes the Age Pension is likely to overstate risks faced by consumers and will not achieve the stated aim of "better informing consumers".

While we see a clear problem with excluding the Age Pension, we do not underestimate the difficulty of including it in a workable risk measure. Thus, we favour alternative metrics (see

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[1] Barr, N (1992), 'Economic Theory and the Welfare State: A Survey and Interpretation', *Journal of Economic Literature*, Vol 30 No 2 June 1992. See also Barr's discussion of Arrow (1963).

below) that remove the focus from blends of products to the income delivered by the product itself, rather than from a product (private and public) blend.[2]

Alternative metrics based on reliability of income

We propose two simple metrics that are likely to be more meaningful and easier-to-understand than the one to seven risk measure framework proposed in the AGA technical paper. We have founds these metrics useful in our own research on retirement income products.

Metric one: Expected frequency of income shortfalls

This metric would show how likely it is that annual income would fall below the benchmark income over, say, a period from retirement (currently age 67) to age 97 so that it is linked to the period during which the expected retirement income is would be required.

The benchmark income would be the expected retirement income (which may vary from year to year[3]) rather than the first year's annual payment as defined in the AGA technical paper. This can be read as:

"Expected frequency of annual income being less than the benchmark income is 12 in 30 years"

This metric would show how likely it is that the benchmark income will not be achieved. However, it does not contain information on how severe the shortfall will be when the benchmark income is not achieved – hence the need for the next metric.

Metric two: Average magnitude of shortfalls when they occur

This metric shows the expected size of the shortfalls when they occur, i.e. when the annual income falls below the benchmark income. This can be read as:

"Expected magnitude of shortfalls (measured against the benchmark income) when they occur is $4,000"[4]

We note that this metric is by no means perfect as it does not present how low the income can get (i.e. in the tail-end of distribution) but it is a relatively simple risk metric for consumers to understand, especially when it is compared across different products.

Measured over different periods of retirement

Importantly, while both metrics above can be determined over the entire 30 years of retirement for simplicity, it may be more beneficial if they are calculated separately over two different periods – i) over the first 15 years of retirement and ii) over the second 15 years of retirement. This would help to highlight how the risk of income variation evolves over time.

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[2] We do, however, see a strong role for advice and on-line tools to allow members to understand the interactions of products and blends of product, including the Age Pension.
[3] For example, a non-indexed lifetime annuity would have a reducing real income benchmark every year.
[4] An alternative would be express this as a % of benchmark income

Benchmark income definition raises issues

While the concept of benchmark income is central to the success of any risk measure, we believe that the definition of the "benchmark income" in the Consultation Paper is potentially problematic. In the AGA paper, the benchmark is defined as the income in the *first* year, indexed to inflation to age 100.

Using the first year income as a benchmark would raise a number of issues and complications:

o It does not clearly show the trade-off between income and risk, especially when considering options such as an ABP drawn-down at the minimum rates.
o The first year income would be something new that consumers need to understand to interpret the results of the risk measure i.e. income variation.
o Using the first year income as the benchmark unnecessarily penalises products (or drawdown strategies) that aim to produce high initial income for the early stage of retirement and slightly lower income for later retirement. Such strategies can be pursued for valid reasons (e.g. to cater for expected lower income needs later in retirement).
o The expected retirement income graph in the Consultation Paper already serves the purpose of showing the expected real income pattern over time in 30 years. Retirees can make decisions about which real income pattern would suit them more before comparing the risk of income variation.

Our suggested approach is for benchmark income, for the purpose of calculating the risk measures, to be the expected retirement income (which may vary from year to year). We believe this benchmark would be simpler to understand and would provide a link between the income metric and the income variation. It would also resolve the counterintuitive results from the AGA's paper for ABPs drawn-down at minimum rates under different investment options.