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Division Head
Retirement Income Policy Division
The Treasury
Langton Crescent
Parkes ACT 2600

This is a personal submission to the Retirement Income Policy Division on a Framework for Comprehensive Insurance Products for Retirement (Retirement Income Products).

The views expressed in this document are mine alone and do not necessarily reflect the views or opinions of any organisation I am associated with in the past or present.

Need for better Retirement Income Products

Australia has a world class and well-developed superannuation savings system that unfortunately falls short on what many consider to be the fundamental purpose of these savings - to provide individuals with resources and risk management in retirement. The risks in retirement are one off, extremely complex and even a sophisticated financial expert will struggle with determining the "right" answer.

The superannuation system falls short because it does not have a well-developed post-retirement income stream solution that manages an individual's income needs and associated risks in retirement. These risks are left to the individual to manage with very few effective and efficient market solutions. Ultimately these risks fall back on government through various safety net programs and ultimately on society as a whole. It is therefore in everyone's interest that this deficiency is addressed as the number of retirees with significant superannuation balances increases over the next 20 years. It's imperative that we establish the rules early before it becomes too hard to change expectations – both of retirees and tax payers.

Australian Bureau Statistics (ABS) data suggest that in the March quarter 2017 55% of super payments were in lump sums and 45% in a pension. And of these pension payments 70% were allocated pensions and only 20% guaranteed pensions. Retirees that take allocated pensions absorb all liquidity, market, longevity and inflation risk. In all likelihood many of these retirees are broadly aware of these risks but ill-equipped to deal with them. And for those that take guaranteed pensions it is unclear what the nature of these guarantees were, many will merely be income guarantees for a period of time, and not lifetime or deferred annuity products that genuinely absorbe significant retiree risks.

What is also worrying about these numbers is for the 55% of people that are receiving lump sums a significant number are using these superannuation lump sums to pay down debt. This seems an inefficient use of the system as the individual would probably have been better off directly paying down the debt while working and not paying tax on either the contribution or the income within super and in many cases receiving a much lower risk and higher post-tax return than within the super system. Given the price of housing in Australia increasing over the last five years and the delayed lifetime purchase of housing this use of superannuation to pay down debt is likely to increase.

In addition over the last 10 years there has been no discernible reduction in individuals over 65 receiving more than 50% of their income from government. Whilst I recognise that the superannuation system has not reach full maturity and average balances will continue to grow this is nevertheless concerning given one of the major benefits of superannuation should be to increase individual responsibility for, and ability to, support themselves in retirement. I would have expected some progress on this to date.

These issues suggest that we have a retirement income issue that urgently needs to be addressed.

Objectives and focus

Based on my definition of the purpose of superannuation I argue the objective of retirement income products is to help superannuation achieve its core purpose by providing individuals with a means by which they can efficiently, effectively and simply manage their income and expense risks in retirement: giving greater peace of mind and reducing the degree of reliance on government for post-retirement support.

This objective will become increasingly important not just in relation to pensions but more importantly for aged care and healthcare as the baby boomer population ages increasing the proportion of individuals in the post-retirement stage.

A proposed retirement income product solution needs to focus on the:

- Middle net worth individuals, representing circa 80% of the population, who have the most to gain from retirement income products and are most at risk of falling back on the social security system if they fail to manage their risk in retirement[1].
- Reasons why the market is not providing adequate post-retirement income stream solutions today i.e. we seem to have a market failure that likely requires some form of government intervention.
- Cognitive capacity of individuals and their information requirements to make informed decisions including product disclosures, adequacy of financial advice, and individual's cognitive capacity as they age.

Retirement income products cannot resolve but must have regard to the impact of the:

- Adequacy of retirement savings, and
- Uncertainty about the government's ability and fundamentally the extent of society's willingness to fund individuals in retirement.

Specific objectives considered by Treasury are considered below.

Increased Standard of Living

I'm not convinced retirement income products should focus on 'increased standard of living through risk pooling' - Providing security yes but only maybe providing higher income in retirement. This higher income will potentially flow from the increased drawdowns by individuals if the retirement income solution enables them to reduce their monetary buffer for uncertainty[2]. However individuals may still wish to retain a buffer, for say major capital expenditures, mitigating some of this benefit. Offsetting this retirement income products will have to absorb risk and this has a cost which must be passed on to the individual or subsidised by the government. Whilst idiosyncratic risks can theoretically be diversified away across the population, it may not be fully possible, and systemic risks and other expenses need to be covered.

Increasing availability and choice

Increasing availability of post-retirement products is absolutely fundamental and choice of products is necessary with the caveat that more is not necessarily better, the art of genius is in simplicity and the answer to complexity is not more complexity. In addition the retirement income solution must also have regard to the market impediments that are currently preventing products being offered. It's fundamental that we understand what is driving the market failure and ensuring that any solution has regard to these issues and addresses as many as is possible.

[1] Superannuation is going to provide limited support for low net worth individuals given low balances. And high net worth individuals with substantial retirement resource are arguably of less social concern and risk.

[2] In understanding the need for this buffer caution needs to be made about assuming that individuals are planning for some form of bequest from this pool. Evidence and research by Prof. Hazel Bateman and others suggests this is not the case.

My high level summary views on market impediments on both the supply and demand side, and possible solutions are set out in the table below[3]:

No.	Issue	Solution
1.	High capital requirements of retirement income products and the high risk involved and low return expectations i.e. products not attractive.	Review Prudential capital requirements. Design products that minimise capital e.g. combined allocated pension and deferred annuity post 85 years old. Develop reinsurance and derivative solutions to diversify the risk (see points two and three below)
2.	Inability to obtain adequate reinsurance protection and to diversify idiosyncratic longevity risk	Establish a government backed/facilitated longevity pool. Support the development of reinsurance or derivatives based longevity protection market.
3.	High cost of systemic longevity risk.	Government facilitated systemic risk stoploss cover.
4.	Lack of suitable assets to back Retirement income products	Support a market of suitable assets e.g. long dated Treasury, infrastructure, inflation indexed and longevity bonds.
5.	Perceived high cost of annuities, particularly immediate life time annuities	Provide tax and social security incentives for individuals to take up retirement income products Efficient product design e.g. using deferred rather than immediate annuities.
6.	Lack of retirees interest	• Awareness program targeted to those approaching retirement • Super disclosure requirements to create awareness from commencement of work on the need for building resources for retirement, and for individuals to take responsibility for managing their lifetime income. • Develop skills of all Financial Advisors in the need for and benefits of retirement income products.
7.	Possible inequality from risk pooling	Differential pools to prevent disadvantaging poorer individuals who have lower life expectancy and savings.

Increasing efficiency of superannuation
Increasing efficiency of superannuation to meet its objectives is clearly a good thing but not sufficient. I would add effectiveness and simplicity (avoidance of complexity).

Empowering trustees
Empowering trustees to provide an easier solution is appropriate in so far as is refers to providing a defined 'default' on retirement suitable for retirees which enables trustees to satisfy their the fiduciary obligations. However I am concerned that not all trustees are presently equipped or skilled to determine, on behalf of their members, the best retirement income solution. Nor do I believe it is reasonable that they should be.

Making trustees responsible for the designing of post-retirement income stream products could to lead to a proliferation of products, creating further complexity and cost, and mitigating the benefit of any system.

[3] The issues are complex as are the solutions and I have necessarily kept it simple to demonstrate the point.

Product proposition

In relation to the proposed retirement income products proposition I note the following:

- 'Mass customised' retirement income product solutions are desirable and possible at a reasonable cost by leveraging new technologies with simple product design. Excessive choice will make retirement income products more costly to produce, the decision harder to make and advise on, and is likely to increase the retirees' decision risk[4]. The MySuper product, whilst not perfect, is a good example of how this can work.
- The proposed 'balanced product' that provides higher income, peace of mind (risk reduction), and flexibility is desirable for the consumer and government. However I question whether they are all possible without government support.
    - Of these flexibility and risk minimisation are critical to provide retirees with the ability to manage uncertain and variable future expenses.
    - I'm not sure it's possible retirement income products will necessarily be able to provide a higher income, although they should be efficient in risk absorption, with appropriate product design and margins[5].
- Finally, the idea of the product providing an "anchor for retirees' to help individuals with their retirement decision without compulsion is desirable from a political perspective. However I question whether there should be individual consequences of choice i.e. given the high level of government support for superannuation surely it's not unreasonable to expect individuals to make rational choices about protecting themselves in retirement.

Combined allocated pension deferred annuity product

The experience of other countries and academic research strongly supports the use of an allocated pension product through to the age 80 or 85 as this allows the individual to smooth their income and absorb capital fluctuations without the necessity for insurance and its associated capital and administrative costs, and provides great flexibility. The period of greatest risk from 80 to 85 onwards where longevity becomes uncertain can be protected at retirement through the purchase of a deferred annuity. This enables an individual to know with a high degree of certainty what income they can expect to receive not only to the mid-80's but beyond regardless of their longevity.

The deferred annuity can be reasonably priced as the survivors benefit from mortality bonus from those that don't reach that point, and as the premium is collected ~20 years ahead of any payment allowing discounting for future earnings to reduce the purchase price to a reasonable percentage of an individual's retirement savings in the order of 15% depending on the level of cover taken.

The market impediments referred to previously prevent many insurers from offering this product potentially the largest of which being the risk of a systemic shift in longevity caused by, say, a 'wonder drug' or a medical treatment that causes people to live for much longer than currently anticipated. It would be unreasonable to expect insurers to price such an outcome into their product and it may be in the best interests of society that the government provide this deferred product or provides some form of stop loss to insurers in the event of a systemic shift in longevity. In any event this risk is carried by the government today as people living longer will more than likely draw on the government for financial support when their money runs out.

[4] For example, the car industry manufacturers' typically offer 3-4 models in a range which provides appropriate choice, minimises production costs, and simplifies supply chain management and the sale process e.g. cheap & cheerful, sporty and luxury.

[5] It's important that risks that the individual can assume more efficiently than an insurer are not included within a product as this will increase its cost and offer no long-term benefit to the individual.

Behavioural considerations

I fully support the Treasury focus on behavioural economics and ensuring disclosures and presentation of information optimises individual decisions about suitable retirement income products. But I will leave this to others to comment on. Again I emphasise the simpler the product and the more carefully it is designed to be appropriate increases the chance of the 'right' decision being made by individuals and may be far more effective than any disclosure enhancement. This is particularly the case in relation to retirement income products given the enormous complexity, individual variability and long timeframes involved overlayed with varying degrees of cognitive decline.

Certification test

The proposed certification test formula is highly dependent on the assumed discount rate, life expectancy of the individual and inherent risk in the product's investment strategy. I won't go into it here but there are other models that maybe more appropriate for assessing the efficiency of the product. I suggest you talk to Prof Mike Sherris or review some of his papers in this regard. There are two principal factors at play in these products one is income and the other risk, and unless there is a measure that enables an individual to compare both the risk absorption and income from the product it's difficult to make sensible comparison.

As an alternative to a certification process, there could be a few defined 'MyRetirement' products that are well understood and which enable providers to compete on price and service without the added confusion created by product differences and complexity.

Consultation process

The three significant issues from the consulting process resonate with my comments and need to be explored further including: the number of retirement income (CIPR) options, who should be offered Retirement income products and ensuring adequate take-up of the product.

CEPAR Submissions to the Financial System's Enquiry

Finally, I implore the Treasury Retirement Income Policy Division if they haven't done so already to review the three submissions made by CEPAR to the Financial System's Inquiry (FSI) dealing with post-retirement income stream products dated 31 March 2014, 12 June 2014 and 23 August 2014. These submissions were highly influential in the final FSI report, canvas many of the relevant issues and remain as valid today as they were at the time of writing.

If you have any queries in relation to above please do not hesitate to contact me on 0407 922 058 or marc_de_cure@bigpond.com.

Marc J de Cure BCom (Hons) *UNSW*, MWineQual *WSU*, FCA

Adjunct Professor, UNSW Business School
Chair, Advisory Board, ARC Centre of Excellence in Population Ageing Research
Independent Non Executive Company Director