Retirement income policy - issues & background

This paper:

- Identifies two key issues that Gyrostat believes would, if appropriately addressed, progress the development of retirement income products.
- Provides a summary of the retirement income policy development in Australia since 2010.

Key issues:

Limited disclosure of returns relative to risk and liquidity

Consideration of trade-offs between income, flexibility and risk management is required in order to select an appropriate retirement income product. However, these trade-offs are rarely made explicit in product disclosure documents. Few PDSs for retirement products include information about levels of expected income or cash flow in dollar terms, the likelihood of money running out under certain withdrawal or drawdown strategies or the likelihood that income would be lower than expected.

This issue is being progressed through Treasury which issued a "Retirement Income Disclosure Consultation Paper" in December 2018. However, this issue requires greater attention and focus.

Inadequate and inconsistent classifications of financial assets

Investment options are made up of different combinations of asset classes. There are two broad asset classes – growth and defensive. Ideally, these asset classes would assist understanding of risk, return and liquidity in a portfolio. In practice:

- Different funds may treat similar assets, such as unlisted property, differently
- Non-traditional financial assets, which may have vastly different risk return and liquidity characteristics are often lumped together as "alternatives" or "hedge" assets.

Gyrostat believes that a more consistent and granular definition of asset classes would improve consumers ability to understand retirement products. Guidelines need to be developed with more asset classes, including 'alternative defensive' which is particularly relevant for retirees in a 'late cycle' historically low interest rate environment.

Background

Public policy timeline

- 2019: Retirement Income Review – consultation paper due November 2019, final report June 2020
- 2019: Productivity Commission: Superannuation – Assessing efficiency and competitiveness January 2019
- 2018: Treasury "Retirement Income Disclosure Consultation Paper" December 2018
- 2018: Australian Treasury Retirement Income Covenant Position Paper" May 2018.
- 2014: Financial System Inquiry final report December 2014 (Murray Review)
- 2010: Super system review final report June 2010 (Cooper Review)

2019 Retirement Income Review

The recently announced Retirement Income Review terms of reference detail the three pillars on which Australia's retirement income system is based – the age pensions, compulsory superannuation and voluntary savings.

The Retirement Income Review will identify:

- how the retirement income system supports Australians in retirement;
- the role of each pillar in supporting Australians through retirement;
- distributional impacts across the population and over time; and
- the impact of current policy settings on public finances.

A public consultation paper will be released in November 2019 and the Panel will provide its final report to the Government by June 2020.

https://treasury.gov.au/review/retirement-income-review

2019 Productivity Commission: Superannuation- Assessing efficiency and competiveness

This Productivity Commission Report was handed to the Australian Government on 21 December 2018 and publicly released on 10 January 2019. The report assessed the efficiency and competitiveness of Australia's superannuation system and whether better ways to allocate defaults are needed.

The Commission concluded:

- Australia's super system needs to adapt to better meet the needs of a modern workforce and a growing pool of retirees. Structural flaws — unintended multiple accounts and entrenched underperformers — are harming millions of members, and regressively so.
- Our unique assessment of the super system reveals mixed performance.
    - While some funds consistently achieve high net returns, a significant number of products underperform, even after adjusting for differences in investment strategy. Underperformers span both default and choice, and most (but not all) affected members are in retail funds.
    - Evidence abounds of excessive and unwarranted fees in the super system. Reported fees have trended down but a tail of high-fee products remains entrenched, mostly in retail funds. –
    - Compelling cost savings from realised scale have not been systematically passed on to members as lower fees or higher returns. Much scale remains elusive with too few mergers. –
    - A third of accounts (about 10 million) are unintended multiple accounts. These erode members' balances by $2.6 billion a year in unnecessary fees and insurance.
    - The system offers products that meet most members' needs, but members lack simple and salient information and impartial advice to help them find the best products.
    - Not all members get value out of insurance in super. Many see their retirement balances eroded — often by over $50 000 — by duplicate or unsuitable (even 'zombie') policies.
- Inadequate competition, governance and regulation have led to these outcomes.
    - Rivalry between funds in the default segment is superficial, and there are signs of unhealthy competition in the choice segment (including product proliferation). Many funds lack scale, with 93 APRA-regulated funds — half the total — having assets under $1 billion.
    - The default segment outperforms the system on average, but the way members are allocated to default products has meant many (at least 1.6 million member accounts) have ended up in an underperforming product, eroding nearly half their balance by retirement.
    - Regulations (and regulators) focus too much on the interests of funds and not members. Subpar data and disclosure inhibit accountability to members and government.
- Policy initiatives have chipped away at some problems, but architectural change is needed.
    - Default should be the system exemplar. Members should only be defaulted once, and move to a new fund only when they choose. Members should also be empowered to choose their own super product from a 'best in show' shortlist, set by a competitive and independent process. This will bring benefits above and beyond simply removing underperformers.
    - All MySuper and choice products should have to earn the 'right to remain' in the system under elevated outcomes tests. Weeding out persistent underperformers will make choosing a product safer for members.

   - All trustee boards need to steadfastly appoint skilled board members, better manage unavoidable conflicts of interest, and promote member outcomes without fear or favour.
   - Regulators need clearer roles, accountability and powers to confidently monitor trustee conduct and enforce the law when it is transgressed. A strong member voice is also needed.
- Implementation can start now, carefully phased to protect member (not fund) interests.

https://www.pc.gov.au/inquiries/completed/superannuation

2018 Treasury Retirement Income covenant position and risk disclosure framework

In May 2018 the Australian Government Treasury (**Treasury**) issued a Position Paper on introduction of a retirement income covenant in the Superannuation Industry (Supervision) Act 1993, which will require trustees to develop a retirement income strategy for their members. The covenant will codify the requirements and obligations for superannuation trustees to consider the retirement income needs of their members, expanding individuals' choice of retirement income products and improving standards of living in retirement.

The Position Paper outlines the principles the Government proposes to implement in the covenant and supporting regulatory structures.

In December 2018 Treasury issued a Consultation Paper seeking views on a disclosure fact sheet for retirement income products. The paper proposes a standardised, simplified document that outlines key metrics and features to help consumers compare different retirement income products.

These papers on retirement income highlight the increasing focus on a more comprehensive risk assessment of retirement income products.

- A key feature of the retirement income framework is Comprehensive Income Products for Retirement (CIPRs). A CIPR would provide a complete solution that balances a number of competing objectives in retirement. The three key objectives are to maximise income, ensure income is provided for life and provide flexibility to access capital[1].
- The risk assessment considers the following factors[2]:
   - • the amount of periodic income the product would be expected to provide;
   - • the likelihood that income may fall short of that expectation in a given period;
   - • the degree of protection the product provides against the risk of running out of money; and
   - • the level of access to the underlying capital or for lump sum withdrawals.

[1] Treasury "Retirement Income Covenant Position Paper" May 2018 p6
https://treasury.gov.au/consultation/c2018-t285219
[2] Treasury "Retirement Income Disclosure Consultation Paper" December 2018 p3
https://treasury.gov.au/consultation/c2018-t347107

- For a product to perform well, judged by these factors, it will need to address both market risk, sequencing risk, and liquidity. Products with risk mitigation strategies, protection factors, or conservative investment categories, create fewer downside variations and therefore will have lower risk scores.

The Treasury Framework – income variation risk score

The detailed factors to be considered when designing retirement income strategies are detailed on page 4 of the "Retirement Income Covenant Position Paper" issued May 2018.

> "The factors specifically require trustees to focus on considering and optimising the competing objectives in retirement of delivering high **income**, **risk management** and **flexibility**, taking into account collective member preferences. The optimal strategy may involve trustees offering **products** managed or **provided by third parties if this is the most cost-effective approach."**

The Australian Government Actuary Paper "Retirement Income Risk Measure[3]", an appendix to the Treasury Retirement Income Disclosure Consultation Paper, discusses a range of standard metrics to help consumers make decisions about the most appropriate retirement income product for their own circumstances. One of those standard metrics is a measure of income variation. Income variation is defined and a methodology for measuring the relative income variation associated with alternative retirement income products is set out at page 4.

> "In order to define a measure of income risk for a retirement income product, it is necessary to define what this risk is. This provides a focus for what is to be measured. Having measured the risk, we can then consider how to express the result in a meaningful manner. **Industry uses terms like longevity risk, market risk, sequencing risk and inflation risk**. All these are relevant to the outcome experienced by members in a retirement income product. However, these terms do not easily translate into use by a lay person and it is difficult to see that presenting a measure of each of these risks would be meaningful to the individual. Nevertheless it is important that the risk measure captures these key risks."
>
> "Adoption of this definition of the benchmark payment will result in higher risk scores for products that do not provide protection against longevity, inflation or market risks."
>
> "Traditional measures of variance (standard deviation) focus on both upside and downside variation. However, behavioural economists commonly point out that individuals are more averse to downside variation than upside variation. Intuitively this would apply to retirement incomes. For this reason, I have chosen to focus on quantifying downside risk and using that to measure the relative 'income risk' of various products."

Following the Australian Government Actuary's advice the Retirement Income Disclosure Consultation Paper suggests at page 6:-

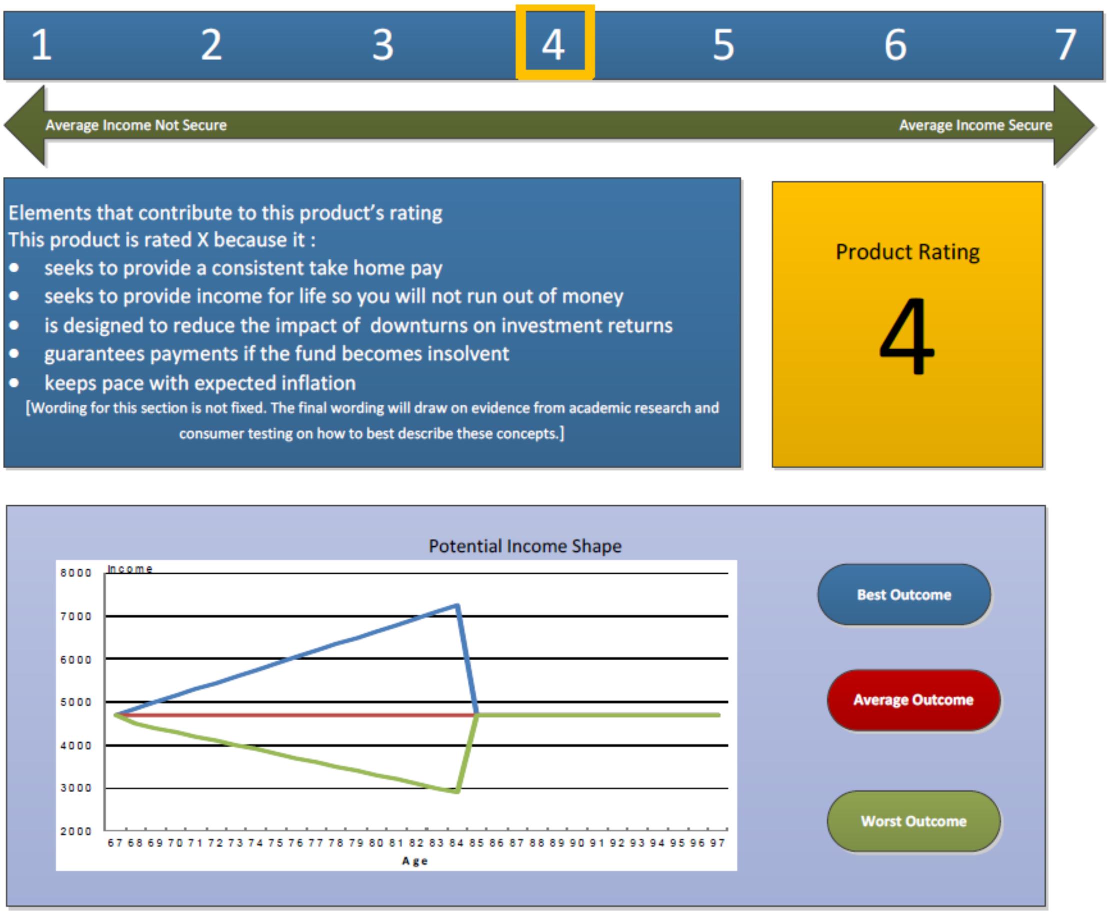
> "The proposed presentation for the fact sheet is a scale of one to seven referencing 'income security'. A high number on the scale would indicate expected income is

[3] https://treasury.gov.au/consultation/c2018-t347107

stable and reliable, higher risk products would equate to a low level of security, so a lower number on the scale.

Different products would have different income shapes depending on the product design. It is proposed that the fact sheet also include a graph which shows simulated real income between the 5th and 95th percentile over the life of the product. This should provide consumers with an indication of payments outcomes over the life of the product.

The income security measure takes account of inflation, longevity and market risk. For consumers these risks may be of different values. For example, a consumer who is concerned about whether their income varies due to market forces may want to know whether the product protects them from this particular risk."



Treasury "Retirement Income Covenant Position Paper" May 2018
https://treasury.gov.au/consultation/c2018-t285219

Treasury "Retirement Income Disclosure Consultation Paper" December 2018
https://treasury.gov.au/consultation/c2018-t347107

2014 Financial System Inquiry final report (Murray Review)

The Financial System Inquiry Final Report was released on Sunday 7 December 2014. The Inquiry made 44 recommendations relating to the Australian financial system. The Inquiry made recommendations on five specific themes:

- Strengthen the economy by making the financial system more resilient.
- Lift the value of the superannuation system and retirement incomes.
- Drive economic growth and productivity through settings that promote innovation.
- Enhance confidence and trust by creating an environment in which financial firms treat customers fairly.
- Enhance regulator independence and accountability, and minimise the need for future regulation.

The recommendations sought to improve efficiency, resilience and fair treatment in the Australian financial system, allowing it to achieve its potential in supporting economic growth and enhancing standards of living for current and future generations.

The Government's response on 20 October 2015 set out an agenda for improving the financial system. This agenda was to:

- strengthen the resilience of the financial system;
- improve the efficiency of the superannuation system;
- stimulate innovation in the financial system;
- support consumers of financial products being treated fairly; and • strengthen regulator capabilities and accountability.

http://fsi.gov.au/publications/final-report/

https://treasury.gov.au/publication/government-response-to-the-financial-system-inquiry

2010 Super system review final report (Cooper Review)

The Super System Review, chaired by Jeremy Cooper, presented its final report on 30 June 2010.

The Review highlights were:

"1.1 Engagement
Australians have contributions made to their super funds whether they like it or not. Members should not have to be interested, financially literate, or investment experts to get the most out of their super. If members want to engage and make choices, then the system ought to encourage and facilitate them doing so. If members are not interested, then the system should still work to provide optimal outcomes for them. The super system should work for its members, not vice versa. This is the basis of the Panel's new 'choice architecture'.

1.2 MySuper

MySuper is a simple, well-designed product suitable for the majority of members. The MySuper concept is aimed at lowering overall costs while maintaining a competitive market-based, private sector infrastructure for super. The concept draws on and enhances an existing and well-known product (the default investment option). MySuper takes this product, simplifies it, adds scale, transparency and comparability, all aimed at achieving better member outcomes.

1.3 SuperStream

SuperStream is a package of measures designed to bring the back-office of superannuation into the 21st century. Its key components are the increased use of technology, uniform data standards, use of the tax file number as a key identifier and the straight-through processing of superannuation transactions.

1.4 Regulating for efficiency

APRA would have an increased mandate to oversee and promote the overall efficiency and transparency of the superannuation system. To this end, APRA would be given a standards-making power in superannuation as a tool for driving transparency and comparability of member outcomes.

1.5 SMSFs

The SMSF sector is largely successful and well-functioning. Significant changes are not required, but measures relating to service providers, auditors and the regulatory framework are recommended.

1.6 Scale matters

There are substantial benefits for members arising out of increased scale in the superannuation industry. MySuper providers would be exposed to scrutiny and pressure on this issue and would be required to consider each year whether they had sufficient scale to optimise outcomes for members.

1.7 Governance

Nearly all the issues looked at in the Review link back to trustee governance in some way or other. Improving governance practices and structures is key to improving member outcomes. A Code of Trustee Governance is proposed.

1.8 Helping members compare

In order to make meaningful choices (or to understand their personal situation) members need to be able to make 'like with like' comparisons between competing superannuation products. Standard product 'dashboards' and standardised investment performance reporting would lift the fog that has clouded this area so far.

1.9 Insurance in super

Commissions should be banned on all insurance products in super, including group risk and personal insurance. Trustees will continue to be able to offer life, TPD and income protection insurance in MySuper and choice investment options.

1.10 Systemic transparency
Each fund would be required to provide free of charge on its website, detailed financial and operational information about the fund (including its portfolio holdings) and about the fund's management to greatly increase accountability and availability of information to those who are interested.

1.11 Whole of life focus
The super system exists to enhance retirement incomes for working Australians, not simply to accumulate assets. MySuper should be a whole of life product and include a single type of retirement income stream product chosen by the trustee and not just cater for members in the pre-retirement phase. Trustees would have a duty to address longevity, inflation and investment risks for retirement phase members in developing their strategies.

1.12 Data
Improving the quality and availability of data and research on the superannuation industry facilitates decision-making, ensures participants in the industry are held to account by members, regulators and peers and gives confidence in the integrity of the system. The importance of this issue justifies regulatory intervention so APRA would have an increased role in this area.

1.13 Dollar savings for the system
Treasury estimates short-term annual system savings of about $1.55B and long term annual system savings of around $2.7B as a result of MySuper and SuperStream.

1.14 Dollar savings for members
Treasury estimates that the MySuper and SuperStream proposals would, in the long-run, see a cut of around 40 per cent in fees for the average member. This would lift their final superannuation balance by around $40,000 or 7 per cent after 37 years in the work force."

https://treasury.gov.au/sites/default/files/2019-03/R2009-001_Final_Report_Part_1_Consolidated.pdf

Gyrostat articles on retiree income with protection products

Gyrostat has been publishing articles since 2015 on the risk managed equity investing developments, in particular to meet the equity income needs of retirees and defend against losses in declining markets.

Gyrostat Capital Management Recent Articles – Retirement Income Review

18 September 2019:
Comprehensive Income Products for Retirement – Treasury Framework
https://www.gyrostat.com.au/news/feature-article-3/

19 October 2019:
Positive developments likely from the retirement income review
https://www.gyrostat.com.au/news/feature-article-positive-developments-likely-from-the/

31 October 2019:
Three key outcomes needed from the retirement income review
https://www.gyrostat.com.au/news/firstlinks/

19 August 2019:
Sequencing risk for retirees – the consequences of loss 'late cycle'
https://www.gyrostat.com.au/news/feature-article-2/

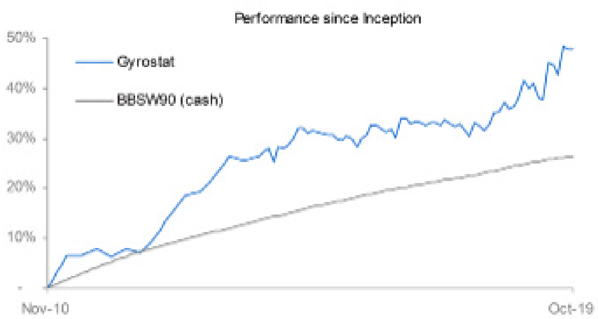
12 August 2019:
Equity income in retirement products
https://www.gyrostat.com.au/news/feature-article-equity-income-in-retirement-2/

22 March 2016:
Submission to Treasury. Developments in technology and deregulation enable cost effective protection to always be in place.
https://treasury.gov.au/sites/default/files/2019-03/C2016-010_Gyrostat_Capital_Management.pdf

29 December 2015:
Where are the retiree solutions for income and protecting nest egg?
https://www.gyrostat.com.au/news/where-are-the-retiree-solutions-for-income-and-protecting-nest-egg/

About Gyrostat

Gyrostat has for 35 consecutive quarters operated at all times within a 'hard' defined risk parameter (no more than 3% capital at risk with our maximum draw-down 2.2% in any circumstances), delivered regular income by passing through ASX-20 dividends, and met returns guidance based upon market conditions (demonstrating increasing returns with market volatility). The Fund buys and holds ASX-20 shares with lowest cost protection always in place with upside. It is an 'alternative - defensive' conservative asset allocation.



Returns: 8.4 % pa (12M); cumulative 51% (>8 years)

Income: Minimum 4.2% pa (BBWS90 + 3%)

Protection: No quarterly draw-downs exceed 3%

Also includes 'tail hedge' for gains on large market falls

https://www.gyrostat.com.au/news/presentation-gyrostat-absolute-return-income-equity-fund/

Gyrostat **complement existing growth' asset allocations** with a track record of our returns increasing with volatility (tail hedge always in place for gains on large market falls. Ie: addresses sequencing risk).