



Response to Treasury: Review of retirement income stream regulation

5 September 2014

AIST Submission

AIST

The Australian Institute of Superannuation Trustees is a national not-for-profit organisation whose membership consists of the trustee directors and staff of industry, corporate and public-sector funds.

As the principal advocate and peak representative body for the \$600 billion not-for-profit superannuation sector, AIST plays a key role in policy development and is a leading provider of research.

AIST provides professional training, consulting services and support for trustees and fund staff to help them meet the challenges of managing superannuation funds and advancing the interests of their fund members. Each year, AIST hosts the Conference of Major Superannuation Funds (CMSF), in addition to numerous other industry conferences and events.

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1 Executive summary

AIST supports a thorough review of retirement incomes and welcomes the opportunity to respond to this discussion paper ('paper').

However, we note that there are many factors outside the scope of this paper that have not been addressed. Consequently, we take the opportunity to recommend a broader review of retirement incomes where the interplay between tax, tax environments and social security are included within the scope of the review. In addition, we re-iterate that this review will work best, having considered global best practice and applying findings to adequacy, sustainability and longevity.

We have made a number of recommendations throughout this submission. In brief, AIST strongly believes that there is no single best income strategy for retirees. Consequently, trustees should be required to develop a retirement incomes strategic framework which conveys a trustee's approach to retirement incomes.

Throughout this submission, AIST has made recommendations with respect to various retirement income products and strategies. We consider that these have the following in common:

- Investment risks are not homogeneous and these must be considered in turn;
- Investment risks must all be considered along with longevity risk, mortality risk and the disadvantages associated with retirement income products. Individual financial risks, including longevity risk should not be considered in isolation;
- Transparency, consumer protection and a competitive market should form the basis of product development, instead of prescriptive rule-making; and
- Tax, social security and other environmental factors must be considered prior to implementing change.

2 Introduction

While this paper raises specific questions regarding income streams, AIST submits that there are four main structural issues which must underpin any review of retirement income streams:

- That **there must be** a clear set of objectives for retirement incomes against which the specific issues raised in this paper are measured against. AIST believes that these objectives include:
 - Support for the three pillars of retirement income saving.
 - Support for community support, aged and health care.
 - Broad and adequate retirement income system.
 - Robust retirement income system, appropriately dealing with investment risks, longevity risk, and inflation.
 - Equity between generations.
 - Sustainability.
 - Consumers are adequately protected through disclosure, regulatory prescription, and that products are easy to understand.
- That the best interests of members must be taken into account when a fund determines its retirement income stream products and services. In this regard, **AIST recommends** that the concept of funds developing a strategic framework for retirement income products and services – similar to the prudential requirements for MySuper insurance and investment policies – should be adopted. This approach would assist with ensuring that funds provide products and services which meet the particular member demographics of that fund, rather than having prescription regarding which products and services are to be provided.
- Members in their retirement phase **should be provided** with disclosure which ensures that all matters fundamental to them understanding the product are disclosed. This is in line with OECD Consumer Protection Principles.
- AIST notes the impact of increasing longevity on the Australian superannuation system and draws attention to the release of a Longevity Index by The Hon Wayne Swan in 2009. The Longevity Index assists with understanding the changing costs for those who wish to fund their retirements and, in particular, examines changing interest rates, inflation and longevity risks and assists with building markets to help manage longevity risks. **AIST recommends** that the Longevity Index be reviewed and promoted to assist members.

We note that the scope of this discussion paper is restricted to products and their features and rules. We believe that this is short-sighted and **recommend** a broader review be undertaken. At an absolute minimum, this broader review must examine the following:

- The sustainability of taxation arrangements in retirement income streams and whether there is any real advantage of these products over amounts invested in competing non-superannuation investments;

- The sustainability of superannuation restrictions and whether these form a barrier to retirement savings;
- The adequacy of social security arrangements, and what is accomplished by means testing parity between non-superannuation and superannuation products; and
- The issues associated with longevity risk as part of a larger basket of financial risks which include greater exploration of investment risks, as well as mortality risk.

AIST attaches as Appendix D issues which AIST believes should form part of such a broader review. AIST also notes the forthcoming Taxation Review, and firmly believes that any review of retirement incomes legislation or policy consultation on the matters contained in the Treasury paper should be deferred.

Although our comments throughout this submission primarily refer to superannuation fund trustees, we support equivalent consumer protections being mandated for customers of life companies wherever possible in the interests of competition and consumers. Our comments should be read with this aim in mind.

3 The regulatory arrangements for superannuation income streams

3.1 Question1: What types of income stream products would enable retirees to better manage risk in the retirement phase (in particular longevity risk and investment risk)?

Firstly, AIST contends that there is no single answer to which type of income stream product would enable retirees to better manage risks in the retirement phase. AIST makes this comment based on its fundamental recommendation that funds should develop a strategic framework for retirement incomes – and which therefore takes into account a fund’s member demographics. Second, we are concerned that the discussion of investment risk in this paper is somewhat simplistic.

We are aware that adequacy risk – the risk that retirees will have insufficient retirement savings – is well outside the scope of this paper, and is a subject that is more readily addressed by the age pension, as well as the Superannuation Guarantee (SG).

AIST supports measures that enable retirees to better manage risk in the retirement phase, investment-related and otherwise. Coupled with this is the ‘balancing act’ of how these consumer risks are weighted against public interest risks arising from the retirement system (impact on age pension, encouragement to stay at work longer, etc.).

Although not necessarily a subset of investment risk, longevity risk is considered to be important. In addition, investment risk refers to a variety of different risks which behave in different ways. However, paragraph 6 of the paper conflates these, concluding erroneously that¹:

...a defining feature of account-based products is that the holder bears the full extent of the risks—in particular, investment and longevity risks—associated with the product...

This is a conclusion upon which most of the discussion in this paper rests. In Appendix A to this document, we have attached a brief discussion of how various investment risks impact investors in retirement income streams. It can be seen that other risks affect investors in different ways in retirement income streams.

The conclusion that an investor in an account-based retirement income stream bears the full extent of risks is erroneous, as can be seen in Appendix A. The assumption, above, that there is a magic product that addresses both longevity risk and the many competing investment risks is fanciful.

¹ Treasury, The. (2014). *Review of retirement income stream regulation*. [discussion paper] Canberra: The Treasury, para.6. Available at: <http://tinyurl.com/kf8u3eg> [Accessed 5 Sep. 2014].

We accordingly **recommend** that the next iteration of this paper should better address investment risks, as well as mortality risk, which we note is completely absent from the paper.

We contend that the different types of financial risk that affect investors should be considered together. We point out that solutions that are appropriate for addressing, for example, longevity risk, may not necessarily be as appropriate to address, for example, mortality risk.

The ability of an income stream product to manage financial risks is going to depend on what is considered to be the most appropriate risks to respond to, given a group of retirees within a particular superannuation fund. A longevity-focussed product, for example, is not necessarily going to be appropriate for a group of members who have a shorter life expectancy.

AIST proposed in our submission to the Financial System Inquiry² that the most appropriate entities to make decisions about what is in the best interests of their members are trustees:

***AIST recommends** that superannuation funds be required to develop a strategic framework that examines how they address retirement incomes for their members. Such a framework would consider:*

- *Rules, fund features, retirement income strategies, reversionary arrangements and tax;*
- *Whether a default transition from accumulation to drawdown phase is appropriate to members of a superannuation fund; and*
- *Trustees opting to provide alternative retirement income strategies (including additional investment options) upon request for members who do not prefer default arrangements.*

Although our recommendations for a retirement income strategic framework extend to superannuation trustees, we would welcome equivalent measures for life companies who offer retirement income streams to their customers. We believe that it is in the interests of both competition and consumers that the best possible retirement income policies are available for all, whether an investor is part of a superannuation fund membership, or a life company's customer base.

Our recommendations with regards to a strategic framework for trustees can be summarised below.

3.1.1 Scope of retirement incomes framework

AIST is of the firm view that the objective of a superannuation fund's retirement income strategy needs to be clearly defined and this includes recognition that the retirement income settings are designed to deliver equity, adequacy and sustainability to a fund's members and beneficiaries. Considerable attention has been given to setting such goals for accumulation members through MySuper requirements for funds to

² AIST, (2014). *Response to Financial System Inquiry Interim Report*. [pdf] Melbourne: Australian Institute of Superannuation Trustees, pp.39-43. Available at: <http://tinyurl.com/n4ozc4l> [Accessed 2 Sep. 2014].

deliver, implement and report upon investment and insurance strategies. A similar approach should be adopted for retirees, given that a growing pool of superannuation monies is transitioning from accumulation to retirement phase. A long-term, member-focussed objective will make it easier to make significant changes with reasonable transition periods.

AIST recommends that a retirement incomes strategic framework be formulated by trustees to address retirement incomes and investments for their members:

- The strategic framework should contain a statement of intent by the fund with regards to retirement incomes. Such a statement would convey the type of benefit to be provided and how the benefit meets the fund's long-term objective of the fund's retirement incomes framework;
- A statement of intent should be harmonious with the design of benefits in the accumulation phase: We realise that the accumulation phase is outside the scope of this paper; however we are mindful of the need for expectations around retirement incomes to be managed appropriately. For example, if a fund was providing a default retirement income strategy where the benefit was expressed primarily in terms of an income amount, we might see mixed messages if trustees were primarily conveying benefits contained in account statements in the form of an account balance;
- The strategic framework should consider the demographics of the fund's membership;
- The scope of the framework would cover off on the rules of retirement income strategies offered by the fund, as well as product features. These rules would set out such things as calculation of benefits, minimum thresholds and availability of variations, commutations (if appropriate) and arrangements for portability;
- The framework would also contain details on how beneficiary arrangements would work, including reversionary arrangements;
- The framework should include a tax strategy. The tax strategy would need to consider the treatment of assets, and whether it is in the interests of members for an orderly migration of assets from the accumulation phase to the drawdown phase. This would need to consider custodial arrangements, tax liabilities, both realised and unrealised and the structure of how assets are held – whether assets are housed in formally defined divisions, or calculated as part of an actuarial assessment; and
- Consideration must be given to whether the fund implements a default transition in the absence of other instruction from a fund member to a trustee. The design of an appropriate default transition is discussed below.

We consider that the strategic framework must, above all, be conducted in the best interests of fund members.

3.1.2 Default transition

AIST supports the ability for funds to develop a default pension option – or default transition - where this is in the interests of a fund's membership base. We have defined the term 'default transition' to mean a

situation where, in the absence of other instructions to the trustee, a member's account transitions from the accumulation phase to the drawdown phase.

We accept that for some funds, an appropriate default transition strategy may not be possible, or desirable. We consider that inclusion of a default transition in a fund's post-retirement strategic framework will depend on whether trustees establish that this is in their particular members' best interests.

How a fund might structure its default transition is subject to one main consideration: When is it in members' best interests for assets to transition in consideration of the taxation differential between accumulation and drawdown phases. This reinforces how critical tax policy is when designing or re-designing Australia's retirement income system.

The following criteria, at a minimum, would need to be considered to allow default transitions to occur:

1. Trigger events

A fund would need to set a trigger event, such as an age, as to when this event takes place. A fund may, for example, consider the unrestricted age (65) to be appropriate, where another fund may opt for the Age Pension age. Yet another fund might opt for the age where personal contributions may no longer be made (75). These considerations should be appropriate to the fund's particular membership.

Consideration of criteria other than an age may also be appropriate. The trigger event may also be contingent upon other events, or lack thereof. One example of this might be cessation of contributions for the previous six months.

2. Default payment processes

A fund would need to develop a default payment process for income payments. If this is to be via direct credit of the member's bank account, details such as BSB and account number would need to be collected, in addition to a fund's existing information set.

3. Which members?

Consideration would need to be given as to whether default transitions should only extend to MySuper members, or whether all members automatically have a default transition profile assigned to them.

4. Structure of income payments

Rules relating to income payments and income stream strategies should be appropriate to the fund's particular members. A fund that caters to a predominantly blue-collar member base that may have lower life expectancies, for example, would find it very difficult to justify developing a longevity-based retirement income strategy as a default solution.

5. Default investments

A default investment option should be chosen, if an account-based income strategy or similar is chosen by the fund. This could be a single investment option, or could be part of a staged lifecycle approach. The investment strategy should consider what is appropriate to a fund's particular membership.

6. New contributions

Consideration of a fund's rules may need to allow for separate member accounts to be set up for a fund to continue to receive contributions in the accumulation phase whilst paying income in the drawdown phase. Consideration should be given by policy and lawmakers as to whether there is a feasible way for a member to make contributions to an account in the pension phase.

Further consideration of this aspect may require rolling both accounts back into the accumulation phase once a year and recommencing an income stream on an assigned date, for example, 1 July annually. Such a process could be automated, if rules were unable to be changed to allow pension top-ups.

7. Ability to opt-out

AIST supports the ability to opt-out of a default transition by members. This would be in the form of a member providing alternative instructions to trustees.

Such alternative instructions may include alternative retirement income strategies to those chosen by trustees as their default strategy. For example, a trustee may operate an account-based income stream as a default, but may also make a non-account-based income stream available upon request.

In the interest of choice, AIST also supports a variety of solutions for members. We acknowledge that a default retirement income policy is not going to be preferred by all members, in the same way that default investment options are not appropriate to all members.

8. Preservation of the right to lump sums

AIST supports the right of members to lump sums; however as member retirement balances grow there may be the need to introduce a cap on the lump sum withdrawal amount.

3.2 Question 2: Do the annuity and pension rules constitute an impediment to the development of new products and if so, what features of the rules are of most concern from a product innovation perspective?

Our discussion in response to this question is limited to the use of annuity and pension products as vehicles for superannuation monies. Whilst we understand that annuities may also be used as a non-superannuation investment vehicle, we have no comment on these other than in passing.

We also note that the term “annuity” is commonly applied to a variety of income products that are used in addition to lifetime and life expectancy income streams, such as fixed long and short term income streams. We note that fixed long and short term income products (notwithstanding paragraph 10) appear beyond the scope of this paper. In addition, we would also make the point that the context of this paper makes a very good case that sound arguments for long and short term income products as appropriate vehicles for retirement savings appear limited and therefore would recommend that these products be renamed.

AIST believes that the definitions of “annuity” and “pension” at regulations 1.05 and 1.06 of the *Superannuation Industry (Supervision) Regulations 1993* are outdated and need revision.

We note that the rules as they are currently worded have historical relevance, particularly with regards to certain complying income streams that are in place for Australians which commenced prior to the removal of social security and other concessions. AIST believes that these income streams can be easily grandfathered, and a new common set of rules created that are more relevant to income streams that are in place at the moment. Furthermore, the differences between the products appear arbitrary: We are uncertain why there needs to be different rules for superannuation trustees compared to life insurers, unless these differences assist in providing greater consistency or consumer protection.

Of most concern is the notion that income streams may not be contributed to after their commencement. Whilst we understand that the reason for this is to ensure that contributing members are utilising an account in the accumulation phase and pension members are utilising an account in the drawdown phase, we believe that this situation does not encompass the grey area of Australians who are genuinely transitioning to retirement, or Australians who legally supplement their retirement incomes with additional employment.

We support the notion that minimum standards must be in place to allow investors to utilise the tax exemption that applies to assets invested to support retirement income streams. We agree that there must be some restrictions in place, such as a minimum drawdown set up so that the tax exemption is not abused. We also understand that the minimum drawdown requirement is so that these products satisfy the present aim (as succinctly stated at paragraph 20 of the discussion paper) to provide a regular source of income in retirement rather than accumulating or preserving wealth.

However, we must point to the current tax free threshold of \$18,200 on income outside of superannuation. To better explain the impact of this, we note that the current Cash Rate posted by the Reserve Bank of Australia (RBA) is presently 2.50%³. For an investment at the cash rate to be returning annual interest of \$18,200, a little over \$700,000 must be invested.

³ RBA, (2014). *Reserve Bank of Australia*. [online] rba.com.au. Available at: <http://tinyurl.com/d82hjk> [Accessed 2 Sep. 2014].

In addition, current social security means testing ensures that superannuation and non-superannuation savings are identically treated for the purpose of Age Pension calculations. This has several consequences:

- A significant disincentive to keep one's money in the superannuation system and whilst we know that interest rates will not continue to remain this low, the reality is that imposition of a drawdown to keep a "tax exemption" that investors can enjoy "for free" outside of superannuation without a drawdown requirement will be seen as unjust.
- Consumer unfriendly features such as the inability for lifetime and life expectancy income streams to provide commutations or change provider stand out in stark relief. Whilst we support the provisions of retirement income streams to provide retirement income, we would question whether in this tax environment it is still appropriate that this comes at the expense of accumulation or preservation of wealth? We certainly do not support the provision of retirement income at the expense of consumer inflexibility.

3.3 Question 3: What changes could be made to the annuity and pension rules to accommodate a wider range of income stream products while having regard to the need to protect against abuse of the earnings tax exemption and to promote appropriate and prudent retirement income objectives?

AIST supports the notion that an account-based income stream is the easiest for members to understand. Account-based pensions are offered by most superannuation funds, and largely resemble superannuation accounts in the accumulation phase, in some cases right down to the investment options available to members.

Other attractions of account-based income streams in addition to their relative simplicity include the following benefits:

- Income amounts are able to be varied quickly and easily (subject to income minimums);
- Commutations are available in the form of lump sum withdrawals and rollovers;
- Ability to rollover includes the ability to change provider, if a member is unhappy with their present provider; and
- A great deal of information is available regarding underlying investments, including asset allocations, investment manager styles, currency hedging etc.

We believe that when constructing a retirement income strategic framework, superannuation fund trustees would find it difficult to justify a default strategy which did not allow for commutations.

There are significantly more restrictions in place for non-account-based income streams. Most notably, the restrictions on the size of payments, as well as the rules on commutations conspire to make these products less attractive to consumers. However, it is important to note that products that address longevity, such as

annuities, are not new products. The reasons that longevity products have not been adopted by investors have more to do with lack of demand from consumers than with product design. Barriers to the take-up of these products include:

- Financial incentives to invest in annuities provided through tax or social security concessions have long been abandoned. This has, understandably, reduced the attractiveness of these products.
- Concerns about lack of diversification: When viewed through the lens of portfolio theory, an annuity in a portfolio is equivalent to a single fixed interest investment. This means that such an investment will only be appropriate to niche investors who are either ultra-defensive yet uninterested in the benefits of diversification, or where the investment forms part of a diversified portfolio of fixed interest investments.
- Legacy Issues: There is a stigma attached to longevity products from times past that they are expensive, inflexible and designed with the benefit of the provider as opposed to the consumer.

With that in mind, the following is a short discussion of some specific product rules that relate to income streams which we believe could be improved.

3.3.1 Annual pension payment requirement

Although we have previously explained that current rules put retirement income streams at a disadvantage to non-superannuation investments, it would be difficult to describe a product as a retirement income stream without a requirement to make a minimum annual payment.

AIST recommends that the finer detail of pension payments be reviewed as part of a broader review.

3.3.2 Pension minimum drawdown requirements

As previously identified, the current tax environment has resulted in minimum drawdown requirements becoming, effectively, red tape, when the following is considered:

- The tax-free threshold for non-super assets, compared to income from superannuation assets below a certain threshold; and
- Centrelink deeming now applies to all income streams (except for certain grandfathered complying income streams) as well as all financial assets outside of superannuation.

Whilst we accept that an income stream must pay some income, given the above, we are **unable to support** a requirement for pension incomes being as high as what is required. However, AIST would support a threshold below which minimum pension income requirements were reduced. We believe that this would act to improve longevity. In addition, applying normal drawdown requirements for higher balances would act to reduce income streams being treated as wealth accumulation or preservation vehicles.

3.3.3 Commutation limitations

Limitations on commutations exist to assist with the design of products. Lifetime income streams provide an investor with an undertaking from a provider to pay an amount of income, as opposed to a balance which an income is paid out of, which is the case for account-based income streams.

Although these may be necessary for product integrity, these limitations may create a set of circumstances which could be regarded as anti-competitive or anti-consumer. Certainly, as explained in the paper, limitations on commutations reduce the attractiveness of these products. But in addition, the inability to commute means that investors may not change provider. This can be referred to as vendor lock-in. Although legal, the ethics of vendor lock-in are hotly debated. AIST supports the removal of barriers that stifle competition or consumer rights and sees vendor lock-in as such a barrier.

In addition, we question whether the current situation is appropriate for ensuring that providers are able to meet their obligations to members with respect to compliance issues such as excess contributions or Division 293 tax liabilities.

Lastly, we would **recommend** that the withdrawal of rights such as commutations should come with some kind of incentive or compensation for investors, or possibly a limit. We would propose that consideration be given to the re-introduction of social security concessions as an example of an incentive that potential investors in these products might be receptive to.

AIST recommends that commutation rules be reviewed and simplified. In addition, **we recommend** that mechanisms to allow investors to change providers (regardless of commutation rules) be put in place.

3.3.4 Residual capital value requirements

The rules regarding residual capital values were designed to satisfy various tax and social security concessions that existed for complying income streams. As previously mentioned, however, these have long since been abandoned, leaving these serving no clear purpose.

AIST recommends that requirements regarding residual capital values be removed.

3.3.5 Pension payment maximums

As part of the Better Super reforms of 2007, account-based income streams were created to replace allocated income streams. The major difference was that account-based income streams do not have payment maximums, where allocated income streams did.

AIST believes that in order to take the problem of longevity risk seriously, payment maxima should be re-introduced. . This would impose an 'outer rail' to act as a barrier to retirees drawing their retirement savings too quickly.

3.3.6 Consumer friendly enhancements

AIST proposes additional consumer-friendly enhancements with respect to non-account based income streams.

We note that information related to the investments contained within annuity pools are subject to a large degree of opacity. We point out in Appendix A to this submission that this is critical in assessing the degree to which an investor is subject to counterparty risk. **We recommend** that absolute transparency be mandated with regards to investment pools that support guaranteed income streams.

Related to this are issues including related party payments. AIST supports full disclosure of related party payments, including gross interest margins. AIST supports greater transparency in all retirement savings products.

3.4 Question 4: Would such changes lead to new products being brought onto the market?

AIST believes that the existing product rules are too restrictive. More flexibility would allow trustees to service their members better with respect to their specific retirement income needs.

4 Deferred lifetime annuities

Although section 2 of the paper refers to Deferred Lifetime Annuities (DLAs), AIST supports the ability for superannuation funds to offer equivalent Deferred Lifetime Pensions (DLPs), notwithstanding our response to question 2, above. Although a more accurate term in the interim would be 'Deferred Lifetime Income Stream' (DLIS), we have used DLA throughout this section in line with the discussion paper.

4.1 Question 5: Should people only be able to purchase a DLA with superannuation money?

AIST supports the availability of DLAs for purchasers using either superannuation money, or non-superannuation money, provided that product pools are appropriately separated and that the appropriate tax rules that relate to superannuation or non-superannuation monies are properly observed. Alternatively, that non-super monies being used to start DLAs are treated as contributions into super prior to commencement.

We note that retirees have limited scope to contribute to superannuation once they reach certain ages, subject to work test requirements. The ability to accept an unlimited quantity of non-superannuation monies provides an artificial commercial advantage to life offices, compared to superannuation funds. AIST has long supported the removal of age-based restrictions on contributions into superannuation and recommends that the extent to which investors can contribute non-superannuation monies to DLAs be restricted in line with present superannuation contribution restrictions, with respect to both ages and amounts.

We have discussed amounts that can be contributed to income streams in more detail in question 7.

4.2 Question 6: Should people only be able to purchase a DLA for an up front premium or should other purchase options also be allowed? If an annual premium approach is allowed, what should be the consequences if the premium payments cease?

We have interpreted this question as whether a DLA could be purchased with a series of payments, including via regular superannuation contributions throughout one's working life. Essentially, such arrangements would allow for quasi-defined benefit pensions to be purchased over time, for example, a unitised arrangement where each unit corresponds to an annual guaranteed pension payment amount that may be indexed.

Cessation of payments under such a scheme would mean that income amounts are smaller, in line with the number of units purchased to date. To better illustrate retirement benefits, statements showing a balance in retirement income units as opposed to a dollar balance would better manage the expectations of

members of such schemes. The rules regarding superannuation statements may have to be amended to allow for this.

AIST would support the availability of such arrangements, subject to a number of safeguards. One of these would be to ensure that vendor lock-in is minimised.

We would also welcome a review on the rules where these relate to the acceptance of contributions into an income stream product.

4.3 Question 7: Should there be an upper limit on the amount that can be invested in a deferred lifetime annuity?

AIST supports an upper limit on amounts that can be contributed to superannuation. We are aware that superannuation is a concessionally taxed environment and that measures are needed to safeguard the abuse of this environment.

We explained in our answer to question 5, that, in addition, we would support restrictions on investors contributing non-super monies to DLAs in line with limits on contributions to superannuation monies. As discussed in question 2, the tax-free threshold is presently \$18,200, meaning that superannuation-like benefits can be enjoyed utilising non-super investments with no real tax or social security disincentives. However, we do not have any objectives in principle to how much may be paid for longevity insurance.

We believe that a review of contribution limits should form part of the government's upcoming tax review, and that consideration of longevity insurance be undertaken as part of this review.

4.4 Question 8: Should there be a minimum deferral period for a DLA? If so, what would determine the period?

No. Deferral periods should be left to individuals in the same way that individuals determine the waiting period on income protection policies. We support transparency that ensures that policy holders are fully aware of how much the deferral period costs them, relative to other choices that may be present.

4.5 Question 9: Should there be a maximum deferral age or period? If so, what should it be?

No. As we remarked in our answer to the previous question, deferral periods should be left to individuals in the same way that individuals determine the waiting period on income protection policies.

AIST is concerned that presently available annuity-based hybrid income streams are not fully transparent with regards to when guaranteed income commences. Recent conservative modelling of one of these products revealed that a 65 year old investor in one of these products, even after quite benign usage and no drawdowns would not see the benefit of any guaranteed income until after age 109. Our assumptions and modelling can be seen in greater detail in Appendix B.

AIST recommends full transparency to ensure that investors in these products are better aware of when guaranteed income commences.

4.6 Question 10: Do the payment features described in paragraphs 51 and 52 strike the right balance in allowing people to insure against longevity risk while avoiding unnecessary restrictions on product development?

AIST supports features like the non-commutability of these products to be set by trustees in accordance with what they believe is best for their members. If such commutability was warranted, and could be enabled in a way that did not present the issue of avoiding drawing down on one's superannuation, then we would see a blanket prohibition as stifling product development.

AIST does not support non-commutability as a reason why an investor cannot change providers if they so wish.

4.7 Question 11: Should providers of DLAs be able to offer a death benefit? If so, should there be restrictions on the size of the death benefit that could be offered? If so, what restrictions?

We are mindful that the intention of superannuation is to provide benefits for members in retirement. Similarly, AIST agrees with the notion that superannuation should not necessarily be a vehicle for wealth accumulation or generational wealth transfer.

However, we point to continuing equity issues associated with superannuation, noting that women routinely have smaller superannuation balances to men, and live longer. Restrictions on death benefits in this instance have the potential to disadvantage women.

5 The minimum payment amounts for account-based income streams

5.1 Question 12: Are the current minimum payment amounts for account based products appropriate to achieve the objectives outlined above, given financial conditions can change?

We note that payment amounts haven't moved since Better Super was implemented in 2007. Paragraph 66 refers to the fact that minimum payment factors have been set with regards to average investment returns and average life expectancies, and paragraph 64 sets out the rationale for an income drawdown.

5.1.1 The perception that income streams are advantaged environments

There is an underlying assumption that is unstated: The advantage of the superannuation system is assumed to be the relevant tax rate on earnings from assets when considered relative to the average rate of taxation on assets held outside of superannuation. It is this perceived advantage upon which the requirement for a drawdown is built.

However, tax rates have changed, as we noted in our response to question 2, with the tax free threshold tripling to \$18,200. The advantage is no longer there, meaning that the rationale for continuing to be invested in the superannuation system must come from elsewhere. This is an important observation. In a report released in 2013⁴, an analysis of three medium to large industry funds revealed that average balances being rolled over or withdrawn at retirement are in the low hundreds of thousand – well below the amounts required to generate any tax liabilities if invested in non-super investments in retirement.

In addition, there have been changes to social security means testing. From 1 January 2015, changes to means testing bring retirement income streams to parity with non-super financial investments, for the purposes of assessing eligibility for the age pension. What this means is that there are no differences between non-super and super investments (including income streams) for the purposes of means testing.

It could even be argued that, given the separate treatment of superannuation benefits for the purposes of estate planning, the only benefit that superannuation offers (over non-super benefits in retirement) is the ability to outsource a limited amount of estate administration to a superannuation fund trustee. These limitations might be considered by some to be a reduction in the scope of available estate planning options, with trustees unlikely to pay benefits to entities such as charities, neighbours except via an estate. Any need to interpose an estate obviously nullifies the use of a trustee in filling this role.

Thus the assumption that these vehicles are advantaged in some way is only valid for smaller account balances. We note that the objective in addressing longevity risk is to ensure that retirement income

⁴ Webb, R. (2012). *How attractive are lump sums, really.* [pdf] (limited release). Melbourne: Australian Institute of Superannuation Trustees.

benefits are able to last longer, and thus suggest that, once retirement benefits fall below a set threshold, the minimum drawdown rates are reduced.

5.1.2 The effects of sequencing risk

Finally, we point to sequencing risk. Paragraphs 67 through 71 of the paper examine the effect that volatility has on account-based income streams. The recent global financial crisis has meant that we now have concrete examples of how adverse market movements accentuate a phenomenon known as ‘reverse dollar cost averaging’, which is alluded to in the paper.

Reverse dollar cost averaging refers to the situation where assets must be sold gradually over time to fund a liquid income stream. Relative to assets sold and assuming growth in the capital value of assets in a portfolio, as available cash is used up; fewer assets per dollar of income will normally be sold in the future, compared to near the start of an income stream.

However, it is near the start of an income stream where this effect is most pronounced, as the asset sold to dollar realised ratio is at its highest. Adverse market movements near the start of an income stream (or even towards the end of the accumulation phase) result in a situation where more assets are being sold down to fund an income stream, resulting in larger capital reductions.

The extent to which sequencing risk becomes a major risk is best illustrated in defined contribution schemes which include account-based income streams. Basu, Doran and Drew (2012)⁵ found that the sequence of returns largely determines the sustainability of members’ retirement income.

5.1.3 AIST’s recommendations

AIST would recommend that drawdown amounts are permanently reduced once account balances drop below a set threshold. Such a threshold would be arrived at through consideration of tax relativities between income streams and non-super investments.

AIST would also support measures to combat avoidance (e.g. multiple pension accounts) such as an order from the tax office to providers to pay one-off amounts to affected members. We acknowledge that many members have needs to segregate amounts in different pension accounts and do not support mandatory consolidation.

AIST considers that sequencing risk is a key risk and recommends that pension drawdown minimums be reduced in order to ensure that the impact of volatility is minimised.

Finally, **AIST recommends** that maximum drawdown amounts be re-considered as a measure to prevent retirement income streams being depleted earlier than optimal.

⁵ Basu, A., B. Doran and M. Drew, 2012, *Sequencing Risk: A Key Challenge to Sustainable Retirement Incomes*, Finsia (Financial Services Institute of Australasia), Sydney

5.2 Question 13: Should there be an automatic mechanism for adjusting the minimum drawdown amounts in response to significant adverse investment market performance? If so, what should that mechanism be? How would this also satisfy the rationale for setting minimum payment amounts?

AIST is not opposed to an automated solution, such as a market performance measure, to adjust minimum drawdown amounts. Such a measure may consider a basket of market indices and/or economic indicators and be reduced to reflect these events. For simplicity, we would recommend that this take place no more than once per financial year, and be communicated to superannuation funds well ahead of the start of a new financial year.

However, we note that ministerial discretion worked well during the global financial crisis. We would therefore recommend that this remain our first preference for the adjustment of minimum payments.

5.3 Question 14: Should the minimum drawdown amounts also increase in response to very strong market performance? Would the mechanism be similar to that for decreases? Would this satisfy the rationale for setting minimum payment amounts?

No. We would not support an increase in payment amounts beyond their current levels. We believe that payments are already too high for a variety of members, and if longevity risk is to be taken seriously, the notion that drawdown minimums should potentially be increased requires questioning.

5.4 Question 15: For how long should the change remain in place? Should it be left in place only for the year in which the shock occurs, or until balances have ‘recovered’ by a particular extent?

In our response to question 13, we indicated that our preference was for ministerial discretion with regards to reductions in minimum drawdown amounts. We consider that this worked well in the aftermath of the global financial crisis. However, we would not also be opposed to an automated solution, such as the one we discussed in our response to question 13.

5.5 Question 16: What other issues need to be considered if the minimum drawdown amounts should fluctuate?

AIST offers no additional comments in response to this question.

6 Appendix A: Financial risks and disadvantages in retirement income products

As mentioned earlier on in this submission, conclusions drawn with regards to other areas of investment risk with regards to retirement income products has been somewhat crude and/or simplistic. Although longevity risk is addressed as a core focus of the discussion paper, other risks that have been referred to under the broad umbrella of “investment risk” have not.

The following is discussion of some of these. This list is not exhaustive, and also includes discussion of mortality risk. Longevity risk has already been addressed at length as part of the discussion paper.

6.1 Investment risk

6.1.1 Concentration risk, or asset-based risk

Concentration risk is the risk of overinvesting in one area. “Area” for the purposes of concentration risk, may be asset classes, location of assets, capital markets or even different assets themselves.

In most APRA-regulated retirement income streams, this risk is minimised by investing in diversified portfolios of assets. Market risk that is left over is generally not capable of being diversified.

It may also be the case that a portfolio of assets that funds an annuity pool for an insurer is similarly diversified. However, because an annuity reflects a single obligation from a product offeror to an investor, such a portfolio of assets becomes less relevant to investors for the purposes of assessing concentration risk.

An annuity is essentially equivalent to one single fixed interest investment: There is a principle (the purchase price), there is a borrower (the insurer), a coupon-like rate of return (which can either be implied or expressly stated) and there are repayments (the income payments). The risks to investors of ‘putting all one’s eggs in one basket’ are well documented, and in the case of annuities, not only would such an investment represent a large amount in one asset class, but would represent a large amount in a single asset at the same time.

6.1.2 Market risk

Market risk is the risk that adverse investment market movements will impact the value of an asset. Market risk is also the risk that is most commonly referred to as an example of investment risk.

Market risk is also an example of speculative risk. Speculative risk refers to a type of risk where in addition to the risk of a loss, there may be the corresponding possibility of a gain. Most notably, the impact of market risk is seen in variations in the capital value of account-based income streams. Although a significant amount of market risk is non-diversifiable, most APRA-regulated superannuation funds offer diversified investment pools to their members as part of their account-based income streams.

Non-account-based income streams such as traditional annuity products can insulate investors from both the risk of losses, as well as the possibility of a gain that is reflected in market risk. However, the impact of market risk on newer annuity-based hybrid products is more difficult to quantify.

6.1.2.1 *The impact of market risk on hybrid products*

It is necessary to explain that annuity-derived hybrid products require further explanation with regards to market risk. The volatility of one's investment may, on the surface, not be immediately relevant to one's guaranteed income, except insofar as upwards capital movements are 'locked in'. However there are a number of less obvious impacts that warrant further explanation.

The first point relates to the number of growth assets in the portfolio. Although promoters of hybrid products are happy to promote increases in guaranteed income that relate to upwards capital movements as a product feature, the reality is subject to some considerable fine print: It is often unknown how much of the investor's portfolio is comprised of growth assets, implying that any growth may actually be considerably minor.

On the down side, there is the possibility of commuting hybrid products before longevity benefits are paid. In the meantime, the inability to gauge an investor's exposure to growth assets means that the market risk of the portfolio is unable to be objectively verified. In addition, it also means that recommended minimum investment time horizons (if any) are impossible to scrutinise.

6.1.2.2 *Pricing/valuation risk and the risk of downward valuations*

Many portfolios hold assets which are thinly traded, or have rare or unique characteristics which make obtaining market valuations difficult. An example of such assets may be unlisted property, or infrastructure.

These assets are often subject to valuation which is not made with reference to an investment market. However, such valuations are generally considered to be approximations, and may differ from the actual proceeds when such assets are realised.

The probability that a loss occurs relative to asset valuations as a result of the market sale of assets is often referred to as 'pricing/valuation risk'. It is considered to be a subset of market risk.

The risk that asset valuations can be revised downwards is also generally considered to be a subset of market risk. Non-account-based income streams generally insulate investors from this kind of risk, as well as pricing/valuation risk.

6.1.3 Counterparty risk

Superannuation fund investors are most familiar with credit risk, which is basically a synonym for counterparty risk. Counterparty risk is the risk that someone who accepts investors' money will default on their financial commitments to investors.

Due to their pooled nature, account-based income streams are not generally subject to counterparty risk, although they may hold individual debt-based assets such as fixed interest that are subject to credit risk. In the case of account based-income streams, this is a diversifiable risk and can be greatly minimised in larger portfolios.

Counterparty risk requires a guarantee or a future obligation, which is normally provided as part of any non-account based income stream in the form of an ongoing liability. The counterparty risk inherent in an annuity is not generally diversifiable, except where portfolios of different annuities are chosen. We are not aware that such a practice is widely used by investors.

6.1.3.1 *The relationship of market risk to counterparty risk*

It is interesting to note that a secondary risk that is capable of being controlled for with the use of annuity products is that of sequencing risk. Sequencing risk is a specific type of market risk that applies to market-linked retirement income streams whereby adverse market movements early in retirement can have a profound ripple effect on later retirement income drawings, reducing them substantially. These adverse market movements can act to increase the adverse effects of what is referred to as 'reverse dollar cost averaging'.

Annuity products are generally able to quarantine investors from this risk, if the market event happens after the income stream has commenced.

However adverse market movements can still affect assets that underpin the investment, such as the assets in an insurer's statutory pool. Given enough of a downturn in financial markets, or other event effecting investment returns, this has the partial flow-on effect of increasing counterparty risk. All other things remaining constant, the part of adverse investment market movements that doesn't contribute to increasing counterparty risk is instead factored into reduced rates of return, meaning that over the long term, investors aren't fully insulated from this kind of market risk.

6.1.4 Interest rate risk

Interest rate risk is the risk that adverse movements in interest rates leave an investor exposed to capital movements. Normally, this manifests itself in portfolios of fixed interest securities, where a rise in interest rates (or sometimes and anticipated rise) has the effect of reducing the market value of the portfolio.

In the case of an annuity, an increase in interest rates has the effect of reducing the capital value of an annuity. Some have argued that, without a secondary market, there is little point in focusing on the capital value of an annuity as the product is unable to be traded, or realised for cash.

Such an attitude about the capital value of one's investment runs contrary to the generally positive view of transparency that the industry is beginning to embrace. Most would consider that, for many countering reasons including transparency, future social security targeting and other reasons, there is no single good

reason why investors shouldn't know the capital value of their investment, where one can be calculated quickly and easily.

The argument that the capital value of an annuity is not relevant can be shown to be fallacious in one instance: The risk associated with interest rate movements can be well illustrated in the case of an investor who meets his adviser the day after an unexpected fall in interest rates. Such an investor will generally not be able to buy an annuity with as high a rate of return as they would have done the previous day.

6.1.5 Fee risk

Fee risk is the risk that fees will reduce the value of one's investment faster. All investments are generally subject to fees, with the amount of fees applicable generally reflecting the level of complexity of a financial product.

6.1.5.1 The cost of premium payments and the impact of lump sum withdrawals

A consideration in newer hybrid products is the added impact of premia which is usually reflected in the fees applicable to the products, or charged as a separate premium. Whilst these might on the surface not sound like a great amount, it is worth considering that larger fees will strip the investment balance faster.

Added to this is the availability of lump sum withdrawals. Lump sum withdrawals generally reduce the benefit payable under the policy by a related amount, meaning that by the time a benefit is to be paid, it is feasible that the benefit payable will not be terribly large. In some products, a threshold balance exists, below which, if a lump sum withdrawal is made, guaranteed income is no longer payable and an account will be closed.

6.1.6 Inflation risk

The risk that guaranteed income will not keep pace with inflation is called inflation risk. Guaranteed payments are often not indexed to inflation and thus a prolonged period of receiving these payments will not assist the recipient to keep up with rising prices.

It should be noted, in the interests of perspective, that indexing one's drawings from an ordinary account-based income streams to the rate of inflation will increase the rate at which an investor's retirement savings runs out. However, such features, whilst available in ordinary account-based income streams, are not generally available with annuities or newer annuity-based hybrids.

Providers of hybrid products are often able to revise income payments down at their discretion. We note in one PDS that a product provider will revise income payments down by half a percent, in the event that their account balance drops below a set percentage of their payment base, subject to a minimum payment rate. Other contingent events are given for reductions.

Given the relative certainty of an account balance dropping below any arbitrary percentage of the payment base, it is not in the product guarantor's interest to maintain the payment rate, meaning that the income rate is certain to decrease to the minimum rate.

6.1.7 Liquidity risk

In most investments, investor capital can be accessed in a number of ways, either in the form of redemptions paid out of the product by the product provider, or from third parties in cases where an investment's ownership (and/or any rights accompanying ownership) is transferred on a secondary market in return for cash.

The risk of being unable to access capital in the form of liquid assets is known as liquidity risk. Traditional annuities are generally unable to be commuted after the first six months, leaving recipients with an income stream only. In other assets, the rights to a stream of income is considered to be valuable and capable of resale, however there is no present secondary market for traditional annuities.

Commutation can be viewed a number of different ways. One perspective that is specifically relevant is the ability to change providers, should an investor choose to do so. This ability is available for investors in account-based income streams.

Liquidity risk has been reduced somewhat in newer annuity-based hybrid products, where guaranteed income itself does not start immediately. Nevertheless, issues identified with these products remain, particularly where the guaranteed income period has commenced.

6.2 Mortality risk

The risk of being financially disadvantaged through early death is called mortality risk. Although not strictly speaking a category of investment risk, mortality risk is an opposing risk to longevity risk, and is generally low with account-based income streams. In traditional annuity products, an income stream may continue until the death of the life insured, meaning that annuitants who die after two years will potentially have nothing.

There is evidence that the problems associated with mortality risk are being addressed by product providers in newer annuity-based hybrid products. Developed in recent years, these combine a capital element with a longevity policy. To some extent, these provide a reasonable degree of surety that, should an income stream recipient die early, there will be a capital value available to dependents.

6.3 Disadvantages

There are further disadvantages to retirement income products that may not be immediately obvious. Whilst some of these are also instances where one might be financially at risk, the investment risk is, in some cases, difficult to quantify.

6.3.1 Transparency

Most account-based income streams provide an enormous amount of transparency with regards to investments.

In most cases, an annuity provider is not required to provide information about the underlying investments in the statutory pool that funds the annuity. This is, on the surface, logical, as investment risks such as market and certain other types of financial risk is generally borne by the annuity provider.

Annuities issued by Commonwealth Life (now part of Commlnsure) in the late 1990s and 2000s would routinely include information in their product disclosure documentation that explained the insurer's target asset allocation. It is possible that advisers may have been confused by this and misclassified annuities according to such information. Nevertheless, we are not aware of any recent annuity issuers who provide this information, presently.

Arguably, knowledge of the pool of assets utilised by the product provider, whilst not immediately relevant to investors for portfolio construction reasons, is still relevant to the investor for a variety of other reasons. Critical assessment of counterparty risk requires consideration of the investor's pool of assets.

Newer hybrid products such as the one profiled in Appendix B subject investors to a degree of market risk. Due to this, some would suggest that the possibility of commutations and rollovers means that the portfolio construction is crucially relevant in recommendations based on ordinary risk profiling.

Finally, the composition of a portfolio is important to some investors. Some investors, for example, are unlikely to consider a product where it is known that the portfolio invests in tobacco production, for example.

6.3.2 Consumer rights

Traditional annuity products have rarely addressed the issue of consumer flexibility. The general arrangement in traditional annuities is that an investor only has access to their capital ("commutation") in a very limited set of circumstances, including the first six months that the annuity is in operation.

This means that annuitants are generally deprived of the right to utilise a different provider if they wish. In other industries, the concept whereby consumers are restricted to the one provider is called 'vendor lock-in'. Whilst generally legal, the ethics of vendor lock-in have been vigorously debated. In the world of personal computing and consumer electronics, where such discussions are presently topical, similar terms that convey the notion that consumers are locked in such as 'walled garden' and 'platform silos' are also in use.

In newer hybrid products, there can be the ability to commute one's investment, meaning that should an investor wish, they can change providers. However, once the retiree has used their entire stock of retirement savings and begins receiving their guaranteed income, this ability to change providers ceases.

6.3.3 Related party payments

An issue that relates to disclosure is relevant in the case of annuities. Like a lot of insurance-based financial products, annuities are an obligation to provide an agreed financial benefit that is contingent on a specified event happening. In the case of annuities, it is contingent upon the life insured remaining alive.

Traditionally, the view of fees that are payable on insurance products is that premia is immediately disclosable, together with any fees that might act to reduce the benefit being paid.

However, there is evidence that fee disclosure is capable of being gamed by product providers, with related party payments being concealed beneath ordinary disclosure. Disclosure of underlying assets is immediately relevant, particularly where investments are made with related parties and indirect costs such as gross interest margins (or their equivalent) are used to game disclosure requirements.

6.3.4 Regulatory oversight

A provider of guaranteed income should be subject to the same degree of scrutiny as other financial services product manufacturers, such as banks. This is a complex question, and with complex outcomes: Should guaranteed income providers, having a similar degree of prudential regulation to banks, also have similar consumer protections in place to support their “guarantees”, including bank-like government guarantees?

7 Appendix B: Modelling a commercially-available annuity-based hybrid income stream

We modelled an annuity-based hybrid which is presently available from one provider.

The income stream resembles an account-based income stream, with the addition of a guaranteed amount of income. The guaranteed income is payable from the end point that the account balance is depleted, and is paid until such time that the investor (or an eligible reversionary beneficiary, if applicable) dies.

Fees payable include administration and investment management fees, in addition to the cost of the longevity insurance premium, which is payable for the guaranteed income. The product only has one investment option, and as at the date of submission, no publicly available information exists to explain the investment pool contents or investment style.

The guaranteed income is paid as a percentage of a guarantee base, set originally by the purchase price, and a “ratchet” is available, where if the balance of the investor’s account increases during the year that one is invested, the guarantee base will be increased to the same amount as the closing balance for the reference period.

Commutations reduce the guaranteed income amount by a mathematical formula. However, if a balance falls below a minimum threshold due to a commutation, the guarantee ends and the account is promptly closed with any capital remaining paid back to the investor.

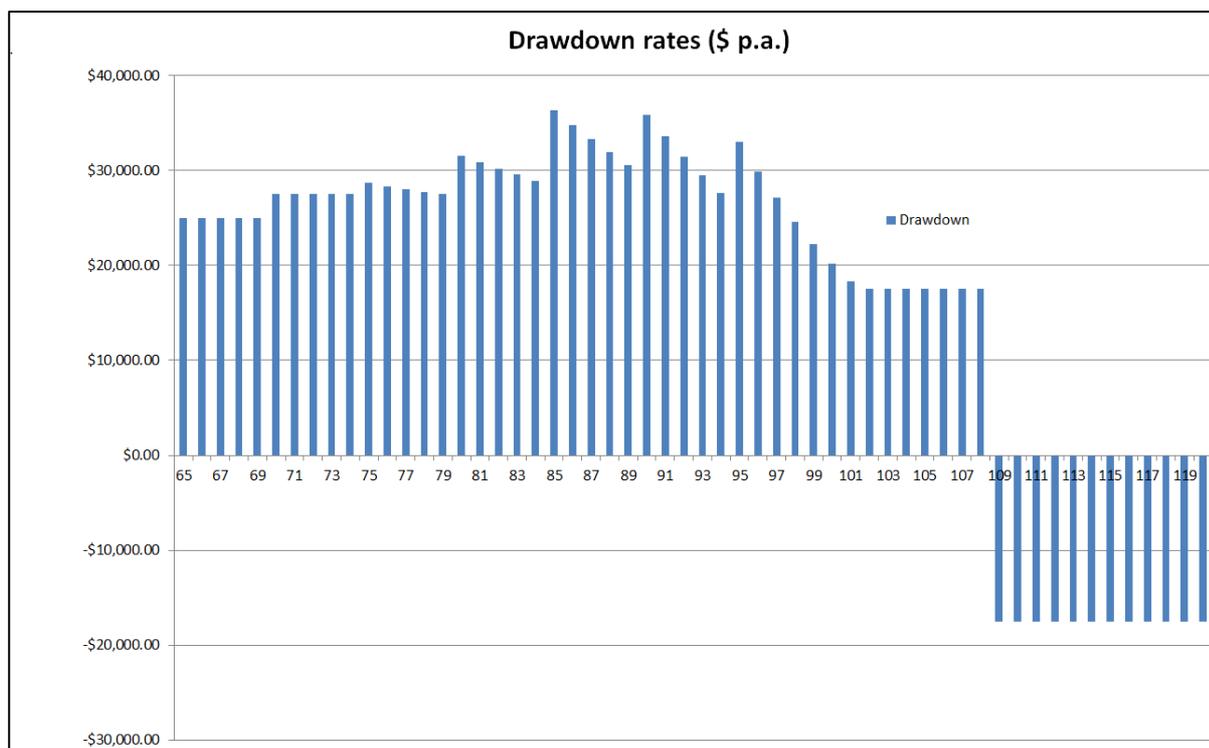
If the amount payable is less than account-based pension minimum annual requirements, a small one off pension payment amount is paid to the investor out of their account to ensure compliance. This one-off payment is not treated as a commutation for the purposes of guaranteed income calculation.

If the account balance falls below a set threshold of the account balance (which is inevitable), guaranteed income will be reduced by a set amount every year, subject to a minimum threshold which is set a minimum percentage of the initial guarantee, subject to any commutations.

We modelled an investor from age 65. We made the following assumptions:

- We assumed a constant net investment return of 5%.
- No commutations were made.
- No changes were made to the product rules, or pension minimums.
- Amounts were paid at regular intervals throughout the year. Investment returns were calculated against daily balances. For ease of calculation, we assumed that income was paid at the midpoint of the year, and that investment returns were credited on 30 June.
- Fees and premia were reflected in net returns.
- Investor’s birthday was 1 July, and commencement date of the income stream was also 1 July.

We found that the point at which the investor eventually commenced receiving the guaranteed amount payable from the policy was around age 109. This is demonstrated graphically below, where positive amounts represent amounts payable from the investor’s stock of retirement savings, and negative amounts represent amounts paid from the longevity policy:



The payments above represent minimum payments required, including both guaranteed amounts, together with one-off amounts need to meet minimum pension compliance.

Assumption of an investment rate averaging as little as 2% per annum still did not result in an investor drawing down on guaranteed income until the investor was over 98. We note that, for a 65 year old Australian male or female, 98 is still well outside current life expectancy, as issued by the Australian Government Actuary⁶.

The product does not make easily available the asset allocation of the investment pool. Although a considerable focus of marketing is on the ability of the product to ratchet up income payments in the event that account balances increase, there is no way of knowing how pronounced such movements will be.

⁶ Australian Government Actuary, (2014). *Australian Life Tables 2005-07*. [pdf] Canberra: The Treasury, pp.22-25. Available at: <http://tinyurl.com/qewffme> [Accessed 4 Sep. 2014].

Related to this, we were unable to model a realistic scenario where the product was subject to heavy reverse dollar cost averaging in early years due to adverse market movements. Although this would have no measurable effect on guaranteed income amounts, the provision for commutations or death benefits would be greatly reduced in this event. The extent to which this product is subject to sequencing risk is therefore unknown.

It follows that without knowledge of the asset allocation, it would be difficult for an investor to estimate their exposure to market risk. This is important, because up until the point at which guaranteed income commences, the investment allows commutations and death benefits.

This example also demonstrates the need for greater consumer protection in this space so that consumers understand the product they are purchasing. In its submission to the Interim Report of the Financial Services Inquiry, AIST recommended a series of 'operational principles' to assist disclosure – both of current and future products. These 'operational principles' included disclosure of calculation methodologies. They could also include using case studies to demonstrate how a product (if more complicated) works.

8 Appendix C: Income stream comparison

We modelled a number of different retirement income products with different products settings for the purposes of comparison. For ease of comparison, we tried to use the same base assumptions as what we used to model the hybrid income stream in Appendix B.

8.1 Assumptions

We modelled an investor from age 65. We made the following assumptions:

- We assumed a constant gross investment return before fees and charges of 7%. For calculation ease we used a net investment return figure after subtracting investment management and administration fees, as well as guaranteed insurance premia;
- No commutations were made from any of the income stream products. Note that for some of the income stream products modelled, commutations would not be available;
- No changes were made to the product rules, or pension minimums;
- Amounts were paid at regular intervals throughout the year. Investment returns were calculated against daily balances. For ease of calculation, we assumed that income was paid at the midpoint of the year, and that investment returns were credited on 30 June;
- Fees and premia were reflected in net returns. The following fees and premia was assumed:
 - Investment management fees and administration fees were assumed to come to a total of 1% p.a.
 - Premium payable for longevity insurance (where appropriate) was assumed at 1% p.a.
- Investor's birthday was 1 July, and commencement date of the income stream was also 1 July.

The income stream was purchased at the start of the period with an amount of \$500,000. Our comparison does not consider the addition of other sources of income, including the Age Pension.

Although nothing is known about the investment option within the hybrid income stream modelled in Appendix B, we have assumed for the purposes of this comparison that it is largely identical to similar investment options in the other income streams.

8.2 Initial modelling

We modelled a number of different products with a number of different assumptions.

In addition to presently available income stream products, we also considered a legacy product, term allocated pensions (TAPs). We considered these, as they are conceptually similar to account-based pensions, with the difference that these are non-commutable. Term allocated pensions had seven available terms:

- Life expectancy;
- Life expectancy as if the pensioner was 1, 2, 3, 4 or 5 years younger; and

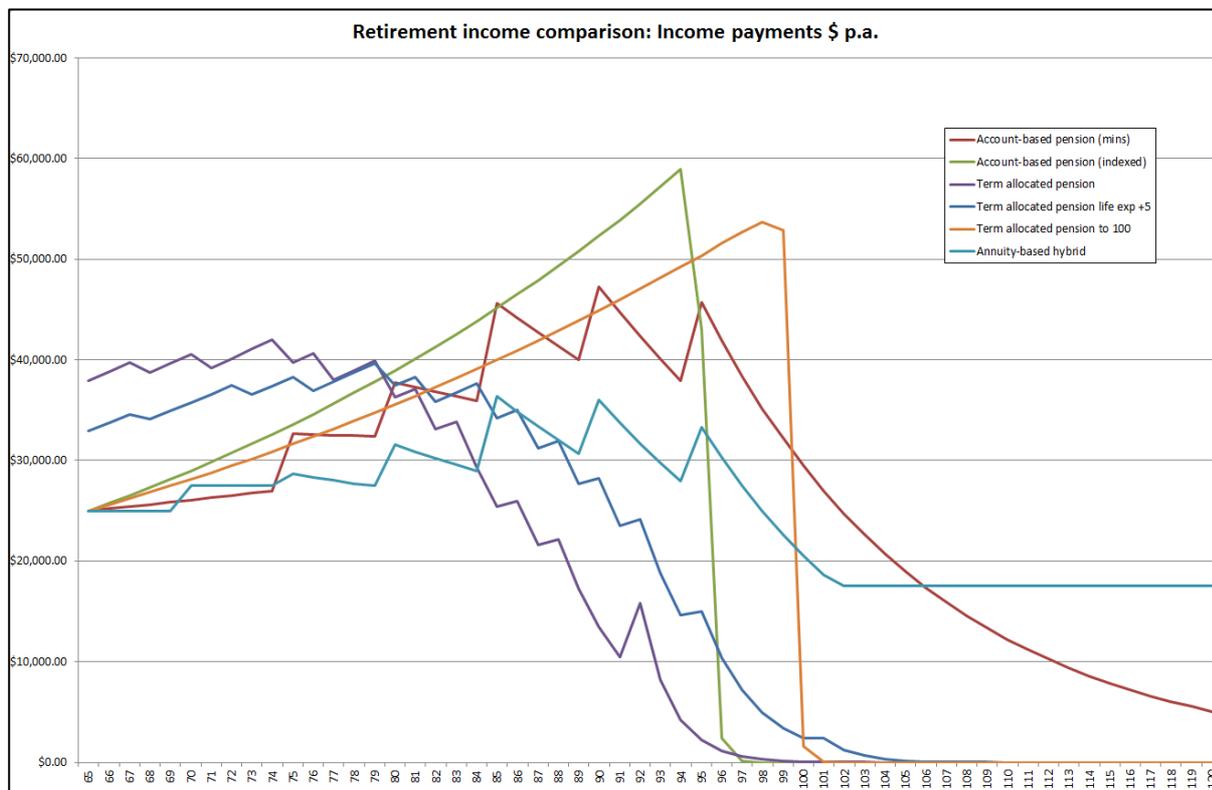
- Life expectancy as if the pensioner was expected to life to age 100.

We chose three of these to assist in our modelling.

In addition, we considered two variations on account-based pensions, as well as the hybrid income stream modelled in Appendix B. Due to complex pricing, we were unable to include traditional annuity products in this comparison:

1. Account-based pension, drawing only the normal minimum amounts each year;
2. Account-based pension, drawing the minimum amount in the first year only, then increasing in line with either a notional index figure, or pension minimum requirements. Our notional index amount was selected as 3%, a conservative estimate of potential future inflation;
3. Term allocated pension modelled on ordinary life expectancy;
4. Term allocated pension based on the life expectancy of pensioner as if they were 5 years younger (allowable under the rules);
5. Term allocated pension based on the life expectancy of a pensioner if their life expectancy was age 100 (allowable under the rules);
6. Annuity-based hybrid income stream that was modelled in Appendix B.

The resulting modelling is best demonstrated graphically below:



As can be seen above, two of the term allocated pensions commenced with payments of larger amounts, before gradually trailing off. The other TAP (to 100) showed a payment curve that was very similar to the account-based pension that had its payments indexed.

What was notable, however was that from commencement all the way to as late as age 105, the ordinary account-based pension paying the minimum amount was paying larger annual income each year than the hybrid. It goes without saying that the allocated pension making minimum payments did not actually run out.

9 Appendix D: Recommended scope of Retirement Incomes Review

At an absolute minimum, a broader review of retirement incomes must examine the following:

Part A - structural

- The objectives for the retirement incomes policy.
- How current policies are delivering the retirement incomes policy objectives – now and into the future.
- A review on the developments and trends in retirement incomes both within Australia and internationally.
- The interaction between the three pillars of retirement savings, including the respective roles that each play in Australia’s retirement incomes policy.
- The focus of the Intergenerational Reports to determine, for example, whether any additions are needed to better understand retirement incomes adequacy, longevity and sustainability issues.
- The sustainability of taxation arrangements in retirement income streams.
- An examination of taxation of superannuation and non-superannuation retirement investments.
- The interaction between retirement incomes policy and encouraging people to stay at work.

Part B – specific issues – making retirement incomes work better

- An examination of how the legislation governing various retirement incomes policies address adequacy, sustainability and longevity.
- The sustainability of superannuation restrictions and whether these form a barrier to retirement savings.
- The adequacy of social security arrangements, and what is accomplished by means testing parity between non-superannuation and superannuation products.
- An examination of retirement product options compared with spending patterns in retirement.