Superannuation forecasts

Response to ASIC consultation paper 351

28 January 2022

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1. Introduction

Challenger operates three core businesses dedicated to providing our customers with financial security for a better retirement. We are the country's leading and most recognised provider of retirement income to Australian retirees. Challenger's leading market position comes from our guaranteed income products (annuities), our retirement focused retail bank, and our funds management business, which is a leader in actively managed income and growth strategies.

We have put more detailed comments in an Appendix.

2. Principal points

1. Retirement estimates should take into account the risk management aspects of the Retirement Income Covenant (RIC), and estimates that meet ASIC's requirements should be included in periodic statements sent to all members of all APRA-regulated funds once a member reaches 55 years of age.

2. 'Deterministic' projections of a single financial outcome should not be permitted. Instead, such projections could be improved in the following ways:

    a. Trustees should be required to provide members with a range of projected outcomes based on, at a minimum, the fund achieving below, equivalent, and above benchmark returns. This is an important message to convey to consumers: that long term investing does not mitigate the risk of worse than expected outcomes.
    b. The planning horizon for the projection should not be based on average life expectancy. A single age provides a simple method, but this needs to include a sufficient buffer to reflect a clear majority of the population. Ideally, a range of outcomes would be considered, but if using a single age, increasing it to 95 (ie a 28-year period in all cases) would be better suited than age 92.

3. Retirement calculators should also present an appropriate range of outcomes in a way that is meaningful to users.

3. RIC and periodic statements

It is critical that retirement income estimates provided to members are consistent across the industry and take into account the risk management aspects under the proposed retirement income covenant. The most appropriate way to achieve this is through tailored and consistent requirements for the content of periodic statements. Section 1017D(5)(g) of the *Corporations Act* provides for additional content to be specified in Regulations. In our view, the best approach would be for the Government to make Regulations that require all trustees to include certain prescribed information in periodic statements that are sent to members when, for example, they reach a specified age.

For simplicity's sake, we have suggested age 55. The information should also be in a form that is easy to understand, but does not brush over or downplay the unique risks that members will face in retirement.

4. Range of Financial Outcomes

Retirement estimates are intended to be a general engagement tool, not a representation about a specific product. There are potential problems in allowing trustees and other providers to set their own assumptions about investment earnings, fees and costs. These are that:

a. It will be very difficult to prevent retirement estimates from becoming a 'race to the bottom' where outcomes are inflated by overly optimistic assumptions; and

b. There is a risk that the purpose of retirement estimates will be compromised. Estimates that are directly linked to specific products will convey (incorrectly) the impression that they are a reliable indicator of financial outcomes many decades into the future. If this occurs, the original purpose of retirement estimates, as a 'ballpark estimate' engagement tool will be lost.[1]

'Deterministic' projections of a single financial outcome should not be permitted. Allowing deterministic forecasts masks the potential for a range of outcomes and is inherently misleading. It also significantly underplays the risk that a member might not achieve the expected outcome. This cannot be adequately ameliorated by written disclosures either.

Best practice is the use of stochastic modelling in all cases. However, this is unlikely to be suitable for regulatory relief. ASIC should require three data points for each estimate: first, second and third quartiles. Language like 'below average', 'average' and 'above average', would be appropriate. This should be based on a range of outcomes, ideally at the 25th, 50th and 75th percentiles.

ASIC's MoneySmart asset return assumptions could be the starting point for all retirement estimates. Alternatively, for MySuper offerings, projections could be anchored to APRA's YFYS benchmark allocation for the particular product. This will ensure consistency and much greater accountability than simply requiring trustees to use 'reasonable' assumptions.

The YFYS performance measures are based on a limited number of benchmark indices. ASIC could provide a suitable expected return estimate for each benchmark. Projections will have to be based on the same allocation to the indicator as the performance test. This will enable projections to reflect the actual product.

In addition, in order to provide the range of outcomes, ASIC could specify for each benchmark a higher return and a lower return that can be used to provide the above and below average estimates. These should be set to capture the variability of each benchmark index with the potential to reflect diversification benefits, as most super funds have diversified asset classes.

It would also be appropriate for the below average case to assume a longer than expected lifespan. A planning horizon of 25 years does not provide a sufficient buffer for a retirement projection (unless longevity risks were fully hedged). A 67-year-old woman in 2022 has an average life expectancy of 24 years (based on the AGA's 25-year mortality improvements). Almost half the plans on this basis would fail. A realistic buffer might include 75% of women (and just over 80% of men). This would be to age 95, or 28 years after retirement at age 67. For people who retire before age 67, a longer period in retirement is also more likely.

[1] ASIC MR 08-172 issued on 28 July 2008 along with CP101: Superannuation forecasts <https://asic.gov.au/about-asic/news-centre/find-a-media-release/2008-releases/08-172-asic-advocates-super-snapshots-a-wake-up-call-on-super/>

Taking this approach would help consumers understand the combined impact of poor investment returns and living beyond life expectancy.

There is an over-reliance on disclosure in CP351. Rather than relying on disclaimers and fine print, the policy should drive better design of calculators and the bases on which forecasts are made.

5. Superannuation calculators

Most calculators and tools use long-term average investment returns as a constant compounding factor. That is, they assume that the long-term average happens each and every year when we all know it does not. This is called a 'deterministic' approach. You key in a fixed investment return (say 6%) and that determines what you end up with. There are often warnings in the instructions or in a footnote that things might not go to plan, but that doesn't change the fact that these calculators sugar-coat what really happens.

In 2015, superannuation researchers, Chant West, tested seven major super fund retirement calculators, including ASIC's then MoneySmart superannuation calculator.[2] Chant West assumed a 35-year old male earning $60,000 a year with super of $50,000, making only compulsory contributions, and tested what lump sums were projected at age 65. The results ranged from $235,064 (ASIC) to $376,809 (unknown super fund) which is more than 60% above the ASIC figure. Such a wide range would suggest that something is wrong; possibly funds using overly optimistic investment return assumptions.

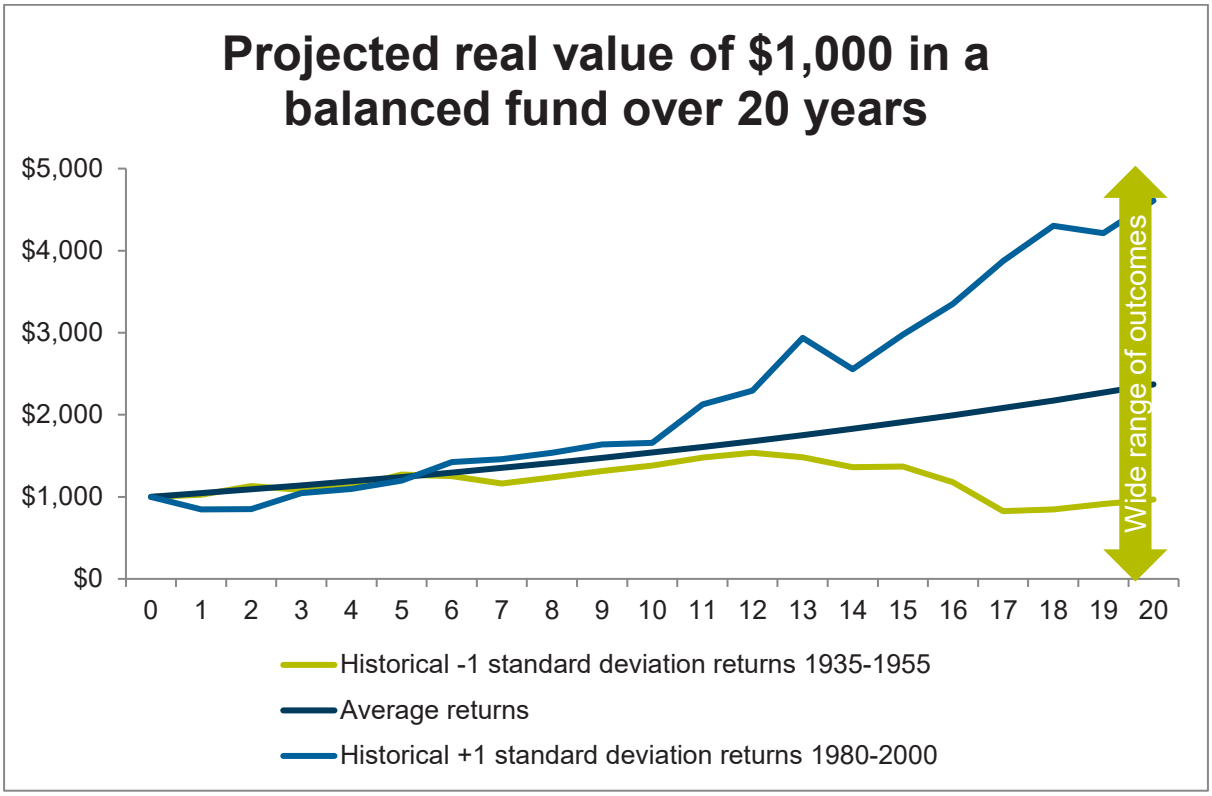
The current ASIC MoneySmart superannuation calculator[3] uses a default annual investment return of 7.5% per annum. Users are also able to select their own investment return of up to 20% per annum (which seems unnecessarily high) and can also extend their assumed saving period to age 75. MoneySmart warns about the uncertainty of the superannuation benefit the calculator predicts. Nonetheless, at the command of the user, the calculator delivers either 7.5% pa, or the selected percentage compound return, year in and year out as if it were guaranteed (a disclaimer says it is not).[4] In reality, an investor will not get an investment return of 7.5% (or their alternative selection) every year and might never get exactly 7.5% pa nor their selected return.

The solution here is for retirement calculators to present an appropriate range of outcomes in a way that is meaningful to users. Statisticians and actuaries will talk about the 'stochastic' (probability-based) model behind the calculator and the 'standard deviation' of actual outcomes.

The standard deviation is a guide to how far above and below the expected return your actual investment returns should be most of the time. For a high growth investment option, you could expect a standard deviation of 8%. In other words, roughly two-thirds of actual investment returns for a high growth investment option targeting a net investment return of 6.6% pa on average would be between minus 1.4% and plus 14.6% a year. That is a very different world from the one where it is always 6.6% each year.

[2] Chant West (2015) - Retirement Calculators – Getting Better, But Where's The Consistency: https://www.chantwest.com.au/resources/retirement-calculators-where-s-the-consistency
[3] https://moneysmart.gov.au/how-super-works/superannuation-calculator
[4] 'The amounts projected are estimates only provided by this model and are not guaranteed.'

The other problem is the false sense of comfort created by looking at annual average returns. The potential for your superannuation balance to be seriously affected by poor returns increases over time, but annual average returns make it look like this risk reduces over time.



This might sound like complex financial information that, if not presented in the right way to consumers, could do more harm than good. However, such calculators would present conclusions that illustrate the inherent uncertainty of investment outcomes.

A calculator that only illustrates an average outcome has roughly the same margin of error or chance of success as tossing a coin. In roughly half the cases, a person will actually get less to retire with than what the calculator shows and in about half the cases they will get more. We have to be able to do better than this for people trying to engage with their retirement finances.

A big improvement could be achieved if calculators provided a simple range of probable outcomes. Consider a calculator that said: '…if you get mostly good returns, your retirement income will be X; mostly average returns: Y and mostly modest/poor returns: Z'. Another way of presenting this information might be to use 'confidence intervals', so for example it might say: 'you have a 75% chance that your monthly income in retirement will be at least X'. Lastly, a calculator could say: in roughly two-thirds of cases, your retirement income will be in the range of X to Y a month. These options would require comprehensive consumer testing to see which approach resonates most with consumers. ASIC does a lot of consumer testing and could lead the way in transforming its popular MoneySmart calculators in this direction.

Challenger Limited
28 January 2022

Appendix

6. More detailed comments

a. Background – the current position

ASIC's retirement income projections in super regime (RG229 and CO 11/1227) works off relatively conservative fixed assumptions built into the ASIC class order. Any fund wanting to make a projection must apply all the assumptions without alteration so that all funds compare 'apples with apples.' The advantage of this approach is that it models 25 years of annual income streams (from age 67-92), during which all capital is smoothly consumed at the annual rate of 5.66% of the start of retirement balance. This is much the same sort of approach as adopted in 2019 for all KiwiSaver funds and follows pension finance thinking in many jurisdictions, including the Working Party on Private Pensions within the OECD.[5]

On the other hand, since 17 April 2020, the ASIC MoneySmart online retirement income and superannuation planners use fixed assumptions derived from Treasury's MARIA model. These are explained in the 2019 Treasury Research Institute paper 'Accumulation of superannuation across a lifetime'.[6] Importantly, the paper assumes a 6.5% annual investment return in the retirement phase, before fees and insurance costs. However, because MARIA also uses a 4% per annum wage deflator, the 6.5% pa is effectively only 2.5% pa.

The ASIC class order, on the other hand, assumes a net real investment return of 3% per annum (after fees and taxes, but not administration fees). There are other differences. The MoneySmart calculators now use drawdown assumptions based on the MARIA model, which just follows minimum drawdown rates, again a different approach from the ASIC class order which assumes a constant rate.

Importantly, using minimum drawdowns as a reference point runs directly contrary to the policy intent behind the retirement income covenant, which is to encourage consumers to consider whether spending at a higher rate, perhaps in the early years of retirement, would be a better strategy. Anchoring spending to minimum drawdown rates was also identified as a problem in the 2019-20 Retirement Income Review final report.

Another limitation of ASIC's approach is that projections may only be given to members who are under age 67. This seems a bit restrictive.

In summary, the net effect of this is that consumers are getting materially different information from their fund's periodic statements under ASIC [CO11/1227] (if any is provided – it not currently being mandatory for this information to be provided), compared to what they will get from MoneySmart. The need for change, beyond just renewing the ASIC class order is clear. The question is whether liberalising the retirement forecasts regime in the manner suggested in CP 351 is the right approach for consumers. The fact that funds will most likely support such a permissive regime and will want to use customised investment return assumptions, should be a less important consideration than the impact on consumers.

[5] Methodology and assumptions | Pensions at a Glance 2021: OECD and G20 Indicators | OECD iLibrary (oecd-ilibrary.org)
[6] https://research.treasury.gov.au/sites/research.treasury.gov.au/files/2019-11/Accumulation%20of%20superannuation%20across%20a%20lifetime.pdf

The regulatory settings should aim at projections and calculators that are as accurate and meaningful as possible.

Specifically in relation to par RG 000.181 in the draft RG attached to CP351, consumers shouldn't be able enter unrealistic data in interactive tools. It is hard to think of why this would be an appropriate policy setting. It would be akin to allowing consumers to select 0% as the inflation rate or 25% for their investment returns. There should be a stronger onus on providers to set a realistic range of values that can be entered.

b. Age pension

The idea that a typical pre-retiree could make meaningful adjustments to assumptions vis-à-vis the age pension is problematic. The age pension is complex, particularly for those not already in retirement. It would be a different matter if Services Australia had age pension calculators on its website, but it does not. We imagine this would be difficult for consumers to navigate without assistance from financial advisers.

In answer to question C11Q2, we believe that age pension estimates should be included by default in all interactive retirement estimates and superannuation calculators. Pinpoint accuracy will almost never be achieved in any estimate or calculator. On the other hand, the age pension will be relevant to most people. It should not be left out of the picture simply because it presents some difficulty to include.

c. Recent reform in New Zealand – KiwiSaver projections

With effect from the 2019/20 financial year, New Zealand created a **mandatory** requirement for an annual retirement estimate for all members of KiwiSaver aged between 18 and 65.[7] In Australia, such estimates are still only voluntary, so New Zealand has moved ahead in this respect.[8]

The New Zealand regime is a half-way house between the existing fixed return assumptions in [CO11/1227] and the proposed 'reasonable assumptions' regime proposed in CP 351. These are the permitted KiwiSaver assumptions about rates of return:

Type of fund	Assumed rate of return
Defensive	1.5%
Conservative	2.5%
Balanced	3.5%
Growth	4.5%
Aggressive	5.5%

A superior approach would be for funds to use their YFYS super performance benchmark strategic asset allocations from APRA and attribute long-term return assumptions for those mixes, derived from the indices themselves. Even doing this still has the drawback that it unnecessarily focuses consumers on a specific product and (incorrectly) conveys the

[7] Amending legislation is here: https://www.legislation.govt.nz/regulation/public/2019/0104/latest/LMS146457.html#LMS146457

[8] This is despite recommendations from the Super System Review in 2010 and the Financial System Inquiry in 2014 that they be mandatory.

impression that the forecast will be more accurate than a 'general' estimate because it is tailored to that specific product.