Institute of Actuaries of Australia

OUTSTANDING ISSUES FOR BENEFIT PROJECTIONS AND ONLINE CALCULATORS

DISCUSSION PAPER
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Outstanding Issues for Benefit Projections and Online Calculators

Abstract

This discussion paper identifies a number of current issues for benefit projection calculators and illustrations. Various suggestions, proposals and recommendations are made in the paper to resolve these issues. Each suggestion, proposal or recommendation is identified with a double asterisk (**) in the left-hand margin.

Key words: *benefit projection illustrations, calculators, disclosure, investment assumptions, standardisation, targeted communication.*

Actuaries and Calculators/Projections

Actuaries specialise in helping people understand the impact of uncertain financial outcomes. It is no surprise therefore that actuaries have been heavily involved in the development of projections, calculators and financial planning software, to assist consumers understand their likely financial position, especially their likely superannuation benefits in retirement. The Institute of Actuaries of Australia produced a guidance note in 2004 which is used by actuaries to prepare and review calculators/projections.

Outstanding Issues for Benefit Projections and Online Calculators

Outline

Problem	**Impact**	**Evidence**	**Discussion Paper Suggestion**
Very few printed projection statements currently being issued to superannuation members due to unclear regulation	Consumers missing out on valuable information to help plan retirement Significantly more consumers would be likely to consider a printed statement than an online calculator	We are not aware of any significant funds producing such printed statements Informal statistics suggest a small percentage of members use online calculators	▪ ASIC issue a class order exempting printed projection statements from Advice Provisions of Corporations Law for existing superannuation members ▪ Standard assumptions be mandated where exemption from advice provisions provided
Different online calculators can produce different results through different discounting and other inbuilt (and default) calculation features and assumptions	Consumers mislead or confused by apparently conflicting advice	Various studies including ASIC, Rice Warner , Darren Wickham (2001)	▪ Standard assumptions be mandated where exemption from advice provisions provided ▪ Assumptions set by Australian Government Actuary ▪ Results should be shown in today's dollars using a salary-based deflator ▪ Terms like "today's dollars" should be defined and standardised ▪ Projections / calculators should have standardised minimum disclosure explanation items ▪ We make observations on ASFA and IFSA calculator assumptions ▪ We make five suggestions about ASIC FIDO disclosure and assumptions
Some online calculators are of poor quality	Consumers mislead	As per above	▪ Projections / calculators should disclose who has reviewed the calculator and what professional standards have been used to review it ▪ Projections / calculators should have standardised minimum disclosure explanation items

Outstanding Issues for Benefit Projections and Online Calculators

Outline (continued)

Problem	**Impact**	**Evidence**	**Discussion Paper Suggestion**
Projections / calculators ignore Age Pension and concentrate on lump sums	Consumers not provided with major component of information about retirement planning	Informal review of available calculators shows few allow for Age pension	▪ Providers of Calculators / Projections be encouraged to include the Age Pension in results ▪ If included, the Age Pension should be shown separately from the superannuation income stream ▪ The Institute of Actuaries of Australia or the Australian Government Actuary should produce a "rule of thumb" for converting a lump sum into an income stream
Some calculators do not provide adequate information about sensitivity of results / investment risk	Risk of consumers being mislead, lost opportunity to educate consumers about variability of outcomes	Discussed in *Actuary Australia* article (May 2007) by the Institute's Benefit Projections Working Group	▪ We make suggestions about how sensitivity of results should be shown (and not shown)
Unclear regulations have lead to calculators being difficult to use - "stalemate between the industry and the regulator"	Consumers not benefiting from online calculators as they find them difficult to use (too many inputs) Consumer education and consumer protection is being hampered	Low usage rates of calculators Parliamentary Joint Committee Report	▪ Allow calculators to be pre-populated with member data and still be exempt from advice provisions ▪ ASIC should clarify meaning of Product Specific Calculators ▪ ASIC should clarify approach to Risk Profilers
Standardised fee disclosure does not provide long term impact of fees and costs	Consumers can be mislead	*Actuary Australia* articles (August 2003, August 2005) by Colin Grenfell and Ray Stevens	▪ Standardised benefit projections would be a powerful tool for comparing the administration fees and costs of different funds – or just for gaining a better understanding of the impact of one fund's fees and costs. We recommend the regulator use projections in consumer testing of standardised fee disclosure

1 Introduction / Uses of Projections

1.1 Preparation of this discussion paper has been prompted by the August 2007 report of the Parliamentary Joint Committee on Corporations and Financial Services entitled "The structure and operation of the superannuation industry".

1.2 In particular,

Recommendation 17

6.110 The committee recommends that ASIC provides guidance to superannuation funds on the provision of targeted communication to separate categories of fund members, so called limited advice, without triggering the need for a statement of advice.

Recommendation 18

The committee recommends that ASIC consult further with superannuation funds on the provision of online calculators. Following this process ASIC should provide additional regulatory relief that will better enable funds, without undermining consumer protection imperatives, to use the generic calculator exemption to provide benefit projections for their members."

1.3 The Institute's Benefit Projection Working Group agrees with the Parliamentary Joint Committee that there is currently a "stalemate between the industry and the regulator [which] is unhelpful to fund members seeking guidance on their retirement income planning." The Working Group hopes that this discussion paper will help identify areas where uncertainties exist and/or where regulatory or other changes are necessary and we hope that it offers some useful suggestions for resolving these issues.

1.4 Superannuation retirement benefit projection illustrations, and similar investment outcome projections, are very useful tools. Appropriately used, they can provide highly valuable information and analysis, in a practical form, to help inform superannuation fund members and investors in areas such as:

a) Potential retirement or maturity amounts that a current or proposed arrangement may provide.
b) Planning or budgeting contribution and savings levels needed to achieve a desired outcome.
c) The impact that fees and costs can have on the superannuation or investment outcome.
d) The relative impact that different fee and cost structures and levels may overall have on the outcome.
e) The potential impact that different investment strategies, assets invested in or investment managers may have on the likely benefit outcome.
f) The potential impact that different investment strategies, assets invested in or investment managers may have on the variability of the benefit outcome.

In considering these important and valuable uses, it is critical to understand however, that the type, form and presentation of a projection or illustration appropriate for these different uses can vary from use to use. In particular, uses (a) to (d) above will typically be best served by a very different approach to uses (e) and (f).

This paper deals with a preferred general approach to projections and illustrations supporting uses such as those of (a) to (d) above. That is, it focuses on illustrations that help investors and superannuation fund members assess the general benefit levels they are moving toward, the overall appropriateness of contribution rates being made versus their desired outcomes and basic fee and cost impact assessments and comparisons.

This paper does not deal with projections or illustrations that consider alternative investment strategies, asset suitability or potential investment manager performance relativities.

However the discussion paper does emphasize that the potential impacts of investment market variability and future return uncertainty should be clearly brought to the attention of users of such illustrations as being an important issue to be taken into account.

2 Background

2.1 In October 2004 the Institute of Actuaries of Australia (the Institute) issued a Guidance Note (No. 466) entitled "Projected Superannuation Benefit Illustrations". The purpose of the Guidance Note is "to require that where projected superannuation benefit illustrations are made, sufficient and appropriate information is given to enable the recipient to understand the benefits illustrated and the risks involved in the arrangement". The Guidance Note applies "to any actuary advising an employer, trustee, existing or prospective fund member or other party in relation to a projected superannuation benefit illustration."

2.2 In August 2005 the Australian Securities and Investments Commission (ASIC) issued a Consultation Paper on Online Calculators. In their respective submissions in reply to ASIC both the Institute and the Association of Superannuation Funds of Australia (ASFA) were supportive of the need for industry standard assumptions and critical of the current lack of prescription by ASIC in this area.

2.3 In September 2005 ASFA published on their website a seven page discussion paper "setting out industry standards for default assumptions for superannuation benefit calculators together with standards for disclosure of information about those assumptions". Sections 3 to 6 of this discussion paper draw extensively from the ASFA discussion paper.

2.4 In December 2005 ASIC's Class Order 05/1122 was issued concerning conditions for relief under paragraphs 926(2)(a) and 951B(1) (a) of the Corporations Act. The key points from this class order are summarised below:

- Revokes Class Order 05/ 611
- Applies to all calculators relating to all *"financial products"*, not just superannuation
- As per Class Order 05/611 – provides relief from need to hold license, or for licensee, exemption from certain divisions of Part 7.7 of the Corporations Act.

Conditions:

- The calculator does not promote products
- "If electronic device", the user can change assumptions other than *statutory assumptions (eg. tax, compulsory contribution rate)* and can perform calculations on basis of the changed assumptions
- Default assumptions (unless changed by user) are "reasonable"
- If "electronic" calculator - does not prevent printing or storing
- Keep copy of calculator for 7 years.

Calculator must display:

- Statement about purpose and limitations
- Explanation about why default assumptions are reasonable
- Explanation of the impact of limitations
- Statement whether or not estimate takes into account "the cost of living"
- Statement that users not to rely on for making decisions and should seek advice.
- The statement must contain as much detail as a person would expect regarding nature of calculator

2.5 In December 2006 the Investment and Financial Services Association (IFSA) released an exposure draft of a Best Practice Guidance Note on calculators for its members.

2.6 In April 2007 the Institute's Benefit Projections Working Group forwarded a letter to IFSA with comments on their exposure draft. The appendix to the letter detailed specific comments (the numbers are indicated below) under the following headings:

- General Principles for Calculators…………………………..…5
- Assumptions………………………………………………..10
- Superannuation Specific Calculators (accumulation stage)…...4
- Superannuation Specific Calculators (pension stage)……….....3
- Life Insurance – Life Expectancy…………………………......1
- Disclosure – Technical Guide…………………………….......2

Appendix C of this discussion paper contains the ten comments under the heading "Assumptions".

2.7 In July 2007 IFSA issued a Media Release which stated:

> The Investment and Financial Services Association (IFSA) have released a new Guidance Note No.21, *'Calculators - Best Practice Guidance'*, for providers of calculators intended for use directly by consumers.
>
> "Calculators play an important role in helping people engage with their superannuation, investment and risk protection strategies, however the results that any one customer sees can vary significantly depending on the underlying assumptions used by the calculator provider. Such variances have the potential to confuse customers", said IFSA CEO, Richard Gilbert.
>
> "The development of this Guidance Note follows extensive member consultation and sets out what we consider to be best practice in the determination and application of assumptions within calculators. For example, members are encouraged to show any results in *today's* dollar values, adjusted for inflation so customers will get an idea of the *purchase power* they will have at the time of retirement".

The concerns raised by the Institute in relation to IFSA's exposure draft also apply to the published Guidance Note

2.8 In August 2007 the Parliamentary Joint Committee on Corporations and Financial Services published their report on "The structure and operation of the superannuation industry". Two relevant recommendations from the report are set out in the Introduction section of this discussion paper and other relevant extracts are set out in Appendix A.

2.9 In December 2007 the Productivity Commission issued a draft report on the "Review of Australia's Consumer Policy Framework'. Draft Recommendation 11.1 from that report states:

> "When imposing information disclosure requirements on firms, Australian Governments should require that:
>
> - information is comprehensible, with the content, clarity and form of disclosure consumer tested, and amended as required, so that it facilitates good consumer decision-making; and
>
> - complex information is layered, with businesses required to initially provide only agreed key information necessary for consumers to plan or make a purchase, with

other more detailed information available by right on request or otherwise referenced.

Consistent with these principles, reform on mandatory disclosure requirements in financial services should be progressed as a matter of urgency".

This draft recommendation is very consistent with our views expressed in Section 9 of this discussion paper.

3 Standardised Assumptions

3.1 Setting and Monitoring Assumptions

ASIC Class Order 05/1122 requires that the default assumptions for a financial calculator must be reasonable and the reason why the default assumptions are reasonable must be stated. The Institute indicated in its September 2005 submission to ASIC that it did not believe that these two protections were adequate. How does anybody judge whether investment earnings assumptions (in particular) are reasonable? Is it satisfactory for default assumptions to be judged adequate just because an independent expert sets them?

** We conclude that these problems with "reasonable assumptions" suggest that consumers would be far better protected and not mislead if the main assumptions were standardised and prescribed. As is the case in the United Kingdom we envisage that ideally standardised assumptions would:

a) cover investment earnings, contribution increases, inflation, salary increases, cost increases and translation into pensions and annuities, and

b) be set at realistic average levels, but

- the investment earnings assumption would then probably be applied as a maximum (to accommodate situations with cash-based investments, costly investment guarantees or abnormally high investment expenses), and

- the contribution increase assumption would then probably also be applied as a maximum (to accommodate situations where contributions do not increase or are inflation indexed), and

c) be monitored and gradually changed (prospectively) from time-to-time.

d) preferably be set on the basis of recommendations from the Australian Government Actuary which would be approved and policed by ASIC and/or Treasury.

** The actuarial profession has been active in assisting regulators to set standardised assumptions in the UK and we believe the most suitable mechanism for doing this here is through the Australian Government Actuary.

The Institute's view is that the task of monitoring and gradually changing all of the assumptions and the framework is critical and possibly, over time, more important than the initial setting. We feel that the sentence in section 6 of the ASFA discussion paper:

> Should there be any significant shift in either the rate of growth or [of?] prices or wages it would be necessary to review these assumptions, but no such significant shift seems likely in the immediate or medium term.

does not fully recognise the scope and importance of this task.

3.2 Uses of Standardised Assumptions

** Standard assumptions for investment earnings, contribution increases, price inflation, salary increases, cost increases and translation into pensions and annuities for superannuation benefit projections might be considered for various purposes. For example:

(a) in relation to the disclosure of fees and costs over a number of years via an illustration to show the impact of those fees and costs to help consumers compare different products, and

(b) in relation to superannuation funds providing benefit projections to individual members on a standardised basis as part of their annual reporting to members to give members a guide about the size of their future superannuation entitlement and to assist members to target their benefit objectives.

The scope of both the above is very much wider than online calculators. They have the potential to reach millions of Australians and not just the few (or many) thousand who use superannuation calculators or financial planning software.

3.3 Changing Default Assumptions?

One of the requirements of ASIC's Class Order 05/1122 is that:

If a calculator is an electronic facility…..the calculator enables a person using it to change any of the factors (the assumptions) that are applied by the calculator…..

** However, if standardised assumptions were to be adopted we question the need for a compulsory ability to change them, though we would have no objections to such a choice being provided on a voluntary basis. Of course, with paper-based projection illustrations such a choice should not be relevant – and then, if a choice is not needed for paper-based illustrations, it seems to make no sense having compulsory choice for online calculators.

3.4 Investment Earnings – gross or net of investment costs

** A key consideration is whether the standardised investment earnings assumption is net or gross of investment costs. This choice has many ramifications. For example, with a gross basis it is necessary to make different assumptions for different asset classes (or else, because the projection includes both administration and investment costs, cash-based products with lower investment costs will be favoured). This adds greatly to complexity. With a net basis it is possible to have one standardised maximum rate (refer section 3.1(b) above) for all asset classes, which is a valuable simplification.

Encl. Two Institute members, Colin Grenfell and Ray Stevens, have produced the attached article published in the August 2005 edition of the profession's monthly magazine "*Actuary Australia*". It deals directly with the question "*Should standardised assumptions for projections be gross or net of costs?*" and is relevant to both the uses in section 3.2 (a) and (b) above.

** The attached article expresses the views of two Institute members. These views are not necessarily those of the Institute itself, but the article does indicate that a key consideration with regard to simplicity is whether the standardised investment earnings assumption is gross or net of costs. The Working Group recommends a net basis for standardised assumptions.

4 Assumptions – Which Deflator?

4.1 Restrict Use of CPI Deflators

The use of different deflators (CPI and salary-based) is a major source of discrepancy between different online calculators. We believe that different approaches to deflating future dollar benefits is an issue which generates significant consumer confusion.

The Institute Guidance Note and the Institute's September 2002 Report to the Senate Select Committee on Superannuation (which is referred to in the ASFA discussion paper) both recommend the use of a salary or wage-based deflator rather than a CPI deflator. The following is an extract from the Institute's September 2002 recommendations:

> … the IAAust view is that adequacy of retirement income is best viewed as a relative concept, comparing retirement income to living standards and earnings at the time of retirement. The alternative approach of viewing adequacy as an absolute concept based on current living standards projected 30 or more years ahead is problematic because of the general change (usually an increase) in living standards that occurs over such periods. Increased community living standards lead to expectations of increased retirement incomes to maintain adequacy.
>
> The use of a CPI deflator (as has been used in the Treasury model) will produce results that are consistent with other Government projections. However other Government projections are usually undertaken over relatively short time frames (less than five years or so). For longer-term projections, such as are required when assessing adequacy of retirement incomes, IAAust believes it is more consistent to use an AWOTE deflator to ensure comparability with living standards at the time of retirement.

We note that the ASFA discussion paper also recommends using a deflator based on growth in average earnings but then adds:

> However, it would be appropriate for a calculator to allow a user to use a CPI deflator for future benefits, either through having an option available or by allowing the user to manually change the value of the deflator used to generate the benefit projection in real terms. This is consistent with ASIC's stipulation that users should be able to adjust the various parameters used in a calculator.

There are several reasons for the use of a salary-based deflator instead of CPI deflators:

- The major source of retirement income for the majority of Australians, the age pension, is indexed to wage, not price growth. Using a CPI deflator to deflate a total retirement income (including the age pension) produces an artificially large result as the age pension growth above CPI is capitalised.
- Wage growth provides a better indication of relative purchasing power (and indeed relative poverty)
- Relative purchasing power is more important than absolute purchasing power in order to ensure that retirees are not "left behind" as the remainder of society becomes wealthier
- There is considerable evidence that people's happiness is not determined by absolute level of wealth, rather the level of their wealth relative to others.

We also observe that the ASIC FIDO calculators have used a salary-based deflator instead of a price-based deflator (refer to our comments in section 12).

** We consider that a tougher stance against the use of CPI deflators is appropriate. This tougher stance applies in all situations, including where pension benefits are indexed to CPI. We feel it is important to highlight the loss of relative purchasing power of CPI indexed pensions.

4.2 Salary-based Deflators

In section 2.33 of their Consultation Paper ASIC stated:

> We strongly recommend that the results of online calculators be expressed in today's terms. Where this is not done, we think that online calculators should state clearly that results are expressed in future dollars and warn users that future dollars, especially over 10 years or more, will be worth far less than today's dollars.

** In response to the above, the Institute submitted that this needs to be strengthened in three ways:

1) Projected accumulation-based benefits should be deflated using a salary-based assumption not an inflation-based assumption,

2) Where projections extend beyond say ten years [or 5 years as suggested in section 6 of the ASFA discussion paper], deflation should be mandated, and

3) The rate of salary-based deflation should be standardised (and should reflect realistic average expected increases in AWE or AWOTE).

4.3 Also, we mention as an aside, that in the third paragraph of the section "Price indices or deflators" in the ASFA discussion paper, the discussion of "Age Based Contribution Limits" will, of course, need to be altered following their removal from 1 July 2007 (and replaced with a discussion of Concessional Contribution Limits).

4.4 Terminology

** The Working Group recommends that the terminology:

"in Today's Dollars" should be reserved only for adjustments which include both inflation and rises in community living standards – thus the terminology "in Today's Dollars would be used when projected amounts are deflated using salary-based, AWE-based or AWOTE-based assumptions,

"in Future Dollars" should be reserved only for situations where there are no adjustments, and

"in Deflated Dollars" should be reserved only for adjustments which include only inflation.

Introduction of such standardised terminology, either through regulatory guidance or mandated by legislation, would significantly simplify the explanations needed with calculators and projected benefit illustrations and hence facilitate better consumer understanding.

5 Assumptions – Recommended Levels

As mentioned in Section 3, the Institute recommends standardised assumptions should be prescribed by the Australian Government Actuary. Should a prescribed approach not be implemented, we offer the following comments on the recommended assumptions contained in ASFA's discussion paper and on the recommended process for setting assumptions in IFSA's Guidance Note.

5.1 Investment Earnings Assumption for Balanced Funds

Section 4 of the ASFA discussion paper recommends (with some underlining added for subsequent reference):

> (a) … the default assumption for investment earnings for a balanced fund or a generic calculator not specific to any fund should be 7% nominal, with this being after applicable taxes and <u>asset based</u> fees and <u>expenses</u>.
>
> (b) … the default rate should be decreased if the fund concerned has <u>ongoing</u> <u>fees</u> for a balanced portfolio higher than 1%, and increased to the extent that <u>all fees, including any external fees and charges affecting investment returns</u>, are less than <u>1% per annum</u>.

We agree with the general thrust of this proposal but would like to see it slightly refined. The discussion paper refers to the Institute's September 2002 Report to the Senate Select Committee on Superannuation which recommended a best estimate assumption of 7% nominal per annum after fees and taxes. The Institute's Professional Standard 101 "*Investment Performance Measurement and Presentation*" when distinguishing between net and gross of costs refers only to "any ongoing investment management and custody fees". This therefore excludes any asset-based administration fees or costs.

** For a Balanced portfolio, wholesale investment management and custody fees and costs would probably average about 0.5% per annum gross of tax or say 0.4% net of tax. We would therefore like to modify (a) and (b) above to read:

> (a) … the default assumption for <u>annual</u> investment earnings for a balanced fund or a generic calculator not specific to any fund should be 7% nominal, with this being after applicable taxes and <u>investment fees and costs</u>.
>
> (b) … the default <u>annual</u> rate should be decreased if the fund concerned has <u>investment fees and costs (net of tax at 15%)</u> for a balanced portfolio higher than <u>0.4%</u>, and increased to the extent that <u>investment fees and costs (net of tax at 15%)</u>, are less than <u>0.4%</u>.

** If the standardised assumptions for projections are net of investment costs (refer section 3.4 of this discussion paper) then sub-para (b) should be disregarded.

** Our suggested changes to (a) and (b) above mean that the investment earnings assumption would allow only for **investment** fees and costs. It is of course necessary for projections to make appropriate allowance for **all** fees and costs. Hence a consequence of our suggested changes to the ASFA discussion paper is that administration costs (including asset-based administration costs) would be explicitly allowed for in projections.

Apart from consistency with our Professional Standards we have other reasons for the changes suggested in (a) and (b) above. The standard basis in the ASFA discussion paper is equivalent to:

- 8% per annum gross of costs but net of tax (if ASFA's 1% adjuster is net of tax), or
- 7.85% per annum gross of costs but net of tax (if ASFA's 1% adjuster is gross of tax)

whereas our suggestion is equivalent to 7.4% per annum gross of costs but net of tax. Equity market returns in the period from 2002 up until the end of 2007 were considerably above what might be considered a long term mean return. While there have been recent falls in markets, there is still potential for further "mean reversion" and we consider that it is probably not appropriate to now propose the use of higher future rates.

We also note that the ASIC standard Balanced portfolio rate for its FIDO super calculator is:

- 8% before tax, fees and costs, and
- (8% * .94 - .55% * .85) = 7.05% net of tax and ongoing "management costs" for a "typical not-for-profit industry superannuation fund".

The latter result is not very different from our recommendations.

** Another concern that we have with the ASFA 1% adjuster is that it tends to hide the first 1% of asset-based charges from consumers. We realise that this was not ASFA's intention but its out-workings appear to have this effect. We have a similar concern with the paragraph in section 4 of the ASFA discussion paper which suggests that:

> The standard approach should be to have any decrease or increase in the default earnings rate rounded to the nearest 0.5%. For instance, for a fund with ongoing fees of 1.8% per year the default earnings rate should be 6% per year, with the same rate applying to a fund with ongoing asset based fees of 2.2% per year.

For medium to long term projections a difference of 0.4% per annum in ongoing asset-based administration costs will make an enormous difference to the end benefits. The impact of such fees on benefits is significant. We believe that this should not be hidden from consumers and that round-off to say the nearest 0.1% or .05% would be more appropriate.

Also, we mention as an aside, that in the seventh paragraph of the section on "Earnings rate of the superannuation fund" in the ASFA discussion paper, there are two typographical errors. In the eighth line, "earners" should be "earnings". In the eleventh line, the word "below" should be deleted. In the next paragraph we suggest "after tax and investment costs" be inserted after "nominal rate".

In relation to IFSA's Guidance Note, the processes suggested for determining a default Estimated Earnings Rate is that the earning rate assumptions should be "appropriately sourced , using historic information that takes into account the last ten or 20 years' returns …" We believe this timeframe is too short and is very likely to produce strongly misleading guidance for users. It is relevant that for most of the last 10 to 20 years, bond rates have steadily decreased and this has resulted in significant capital appreciation of fixed interest and other securities. Further, we believe it is not unreasonable when setting assumptions, for a level of economic or financial judgement to be applied in relation to the future outlook for long term returns.

5.2 Investment Earnings Assumption for Pensions and Annuities

Our suggestions (a) and (b) above apply for superannuation in the accumulation stage.

** For consistency, for Balanced portfolio pension and annuity funds we would suggest:

(c) … the default assumption for annual investment earnings for a Balanced pension or annuity fund should be 8% nominal, with this being after imputation credits and investment fees and costs.

(d) … the default annual rate should be decreased if the fund concerned has investment fees and costs (gross of tax) for a balanced portfolio higher than 0.5%, and increased to the extent that investment fees and costs (gross of tax), are less than 0.5%.

We note that (c) above is similar to the ASIC standard Balanced portfolio rate (which is before investment fees and costs) for its FIDO allocated pension calculator.

** Again, if the standardised assumptions for projections are net of investment costs (refer section 3.4) then sub-para (d) should be disregarded.

5.3 Investment Earnings Assumption for Other Investment Choices

For other investment choices (i.e. not Balanced) the ASFA discussion paper recommends following the ASIC standard portfolio rates for its FIDO super calculator. Though we don't necessarily agree with the ASIC bases (and would not describe them as "quantitative estimates for historical returns") we agree that, if the standardised assumptions for projections are gross of investment costs, it is appropriate and pragmatic to refer to them.

We note that on a before tax and costs basis the ASIC standard bases, expressed relative to the ASIC standard basis for a Balanced portfolio are:

Growth	add 0.5% pa
Capital stable	subtract 2% pa
Cash or capital guaranteed	subtract 2.5%

** We have some doubts about whether the latter two differentials are appropriate. For example, in a paper presented to the Institute's September 2007 Biennial Convention, Colin Grenfell tabulates some before tax and costs compound means over various 38 year periods which show comparable differentials for Capital Stable and Cash of:

Capital stable	subtract 0.6% to 1.2% pa
Cash	subtract 0.8% to 1.6%

(Any such problems with the ASIC standard rates should be discussed with ASIC.)

5.4 Assumptions for Price Inflation and Community Living Standards

In section 4, we suggest that a salary-based deflator should be the primary measure used to translate future dollar values into today's dollars. In determining an appropriate salary deflator the most common approach is to:

- start with price inflation (CPI); and then
- add a margin for real wage growth (growth in community living standards).

Most commentators agree that a CPI assumption in the mid-point of the RBA's target range (ie 2.5%pa) is an appropriate default. However, opinions differ in relation to the assumption about real wage growth / growth in community living standards:

- ASFA's discussion paper suggested the allowance be 1.25% pa
- In the ASIC Fido Calculators – the default allowance is 1.0% pa
- In the Intergenerational Report 2007 the assumption is 1.75% pa

We have some specific comments on the assumptions used by ASIC in their FIDO calculators (refer section 12.5 of this paper). The assumptions used in ASICs calculators are an important benchmark for the industry and therefore we believe are worthy of comment.

The "*Annual Superannuation Bulletin for the year to 30 June 2006*" published in March 2007 by the Australian Prudential Regulation Authority (APRA) reports the following actuarial projections (averaging over the three years to June 2006, June 2005 and June 2004) for 421 defined benefit and hybrid superannuation plans:

421 defined benefit and hybrid plans	Average	Median
Actuarial projection for wage growth	4.51%	4.50%
Actuarial projection for CPI growth	3.18%	3.00%
Difference	1.33%	1.50%

Also, in a paper presented to the Institute's September 2007 Biennial Convention, Colin Grenfell tabulates some historical compound annual means over various 24 and 38 year periods which show differences between the growth in CPI and AWOTE of:

Over 24 years	1.0% to 1.4%
Over 38 years	1.8% to 2.2%

** We believe the allowance suggested by ASFA and the ASIC FIDO calculators are too low and an assumption of 1.5% is more appropriate.

6 Presentation of Results

6.1 Minimum Disclosure

** In the Institute's September 2005 submission to ASIC it was suggested that the following ten item list of assumptions and information, should be clearly disclosed and/or explained in the notes or explanatory information of on-line calculators:

1) Member account balance (or balances) at start
2) Contributions and contribution increases used
3) Fees and costs deducted (and increases allowed for)
4) Investment earnings assumed and whether net or gross of tax and investment costs
5) Salary or price deflation used
6) Death and disablement benefit costs deducted
7) Contribution tax allowed for (and now tax on Excess Concessional Contributions)
8) Government co-contribution allowed for
9) If lump sum – benefit tax allowed for
10) If income benefits – pension/annuity income basis and split/interaction with social security.

This list is not 100% exhaustive but we believe that it covers most of the information that should be disclosed (as a minimum) to users.

** While the Class Order does contain a basic level of disclosure, our recommendation is that careful consideration should be given to some additional prescription and standardisation of a minimum disclosure list consisting of these ten items or something similar. It may assist consumers if the order and format of these ten items was fixed and "nil" or "not applicable" entries were legislated. We recommended that this proposal be subjected to consumer-testing by ASIC.

6.2 Sensitivity Testing / Communicating Uncertainty and Risk

Section 4 of the ASFA discussion paper concludes with the following paragraph;

The calculator should also provide sensitivity testing for a given assumed investment return by providing results for investment returns one percentage point higher and lower than in the assumption adopted. This can be done through generated results of the calculator, or by way of description of the percentage impact on benefits in accompanying explanatory material.

** We feel this needs some modification and should permit other approaches. For example, Guidance Note 466 (para 3.5) states that actuaries (preparing online calculators and other illustrations) should describe or illustrate how the results will differ if the assumptions used are not borne out.

The Guidance Note suggests a number of ways of doing this including:

- Quoting the effect on the end benefit of an addition to and a deduction from the key assumptions (eg investment returns).
- Providing multiple illustrations with variations in key assumptions
- Providing stochastic illustrations, for example the illustration of the funnel of doubt or a demonstration using scenarios over a range of reasonably possible future investment returns.

** Also, as stated in the Guidance Note (para 4.9), we suggest that a comment be included that the recipient should obtain regular updates.

Extreme care is also needed about two aspects of the suggested +/- 1% range.

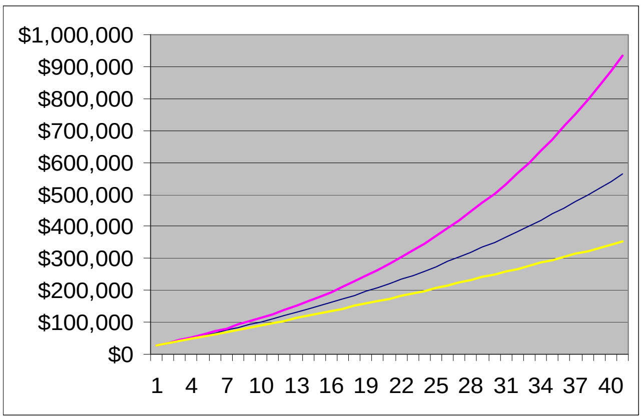
Firstly, its **level** may be misleading. We assume that the ASFA discussion paper suggested +/- 1% partly because the Institute's September 2002 Report to the Senate Select Committee on Superannuation referred to such a range. However this was a possible range for best estimate assumptions <u>not</u> a possible range of investment outcomes. The latter would be at least +/- 2%. In simplistic terms the reason for this is that the lower [1% below standard] assumption, for example, has its own probability distribution of outcomes, some above and some below the lower [1% below standard] assumption. Further, the central average or "standard" is itself subject to uncertainty and error.

** Hence it needs to be clearly explained to consumers that projected amounts will often lie outside the +/- 1% or, if our suggestion is accepted, the +/- 2% range.

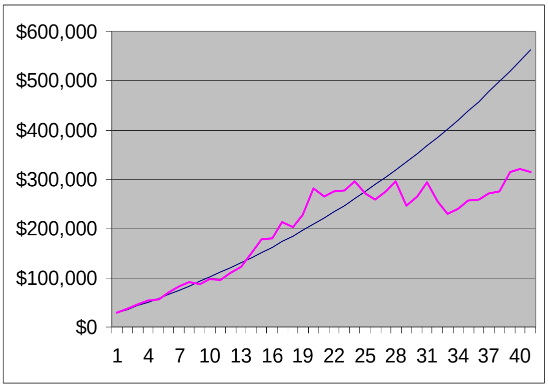
** Secondly, its **shape** may be misleading. For this reason we suggest the two additional full sets of (deterministic) results not be shown, <u>only the end values</u> or percentage impact on end benefits. It is difficult for deterministic projections to demonstrate investment risk – for this we would prefer the use of **stochastic** or **historical** graphical illustrations.

To illustrate, consider the following three illustrations of salary-deflated retirement accumulations at the end of each year over a 40 year period:

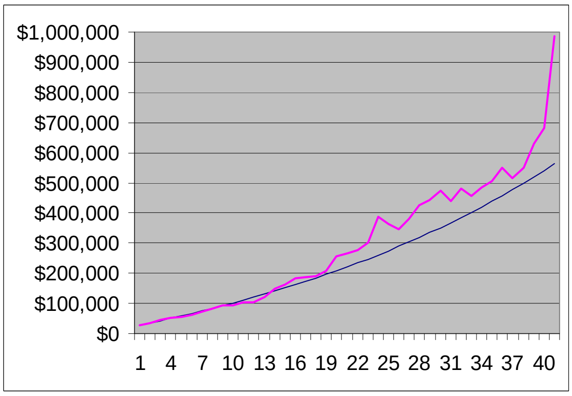
A



B



C



** We consider that the lower and higher curves in A convey a misleading indication of possible investment and salary fluctuation impacts whereas the second curves in B and C, which are stochastic, are far more realistic. Alternatively, historical projections might be used.

The Institute's September 2005 submission to ASIC explained that the types of calculators considered in Sections 1.1 to 1.6 of the consultation paper (and in A above) are "deterministic". That is they are based on constant or average assumptions and produce a single estimated outcome. In contrast "stochastic" calculators and software packages are not based on constant or average assumptions and are used to illustrate investment and other fluctuations by showing scenarios and the likely range of outcomes.

** We assume that stochastic calculators and software packages do not fall within the scope of ASIC Class Order 05/1122. They are most commonly used by investment professionals and actuaries (when advising superannuation fund trustees) but in relation to individual members are a new developing area, which we believe should be encouraged, and it would be impractical and counter-productive to regulate them at this stage. One of their prime uses is to assist with asset allocation advice which, in accordance with Corporations Act regulation 7.1.33A, is not considered as being financial product advice.

6.3 Benefits Illustrated in Income Form

** We suggest that section 7 of the ASFA discussion paper could usefully encourage providers of calculators to illustrate benefits in income form or forms despite the difficulties. This would only require slight changes to the current wording.

The following is a relevant extract from Section 7 of the ASFA discussion paper:

> … to calculate a precise income stream in retirement might require what is in effect a complete financial plan, involving consideration of all of the assets of an individual (and their spouse) and the use of multiple financial products. For instance, depending on the level of retirement and other assets involved, an individual might make use of allocated pension, a Market Linked Income Stream, a life annuity, and a part Age Pension. Within such a framework there is a possibility of an array of drawdown patterns.
>
> Accordingly, the designers of a calculator may choose not to provide any estimate of income in retirement, or if they do to only do so in terms based on applying a broad rule of thumb calculation. In the latter case, the assumptions adopted and the approach used would have to be clearly disclosed in the explanatory material for the calculator.

The Working Group believes that the idea of a "broad rule of thumb calculation" has merit. However, as ASFA explain, the assumptions used and the approach used would have to be clearly disclosed in the explanatory material for the calculator. This can be a daunting task. For a lifetime pension or annuity, such an explanation has to cover:

- Age at retirement
- Basis for the primary income stream
- Basis for any term certain and/or reversionary income stream
- Market annuity rates assumed,

or, if market annuity rates are not used:

- Age at retirement
- Basis for the primary income stream
- Basis for any term certain and/or reversionary income stream
- Expected investment earnings
- Expected pension/annuity annual increases
- Mortality assumptions
- Mortality improvement assumptions
- Allowance for pension/annuity expenses

** We therefore recommend that the Institute of Actuaries of Australia or the Australian Government Actuary should consider publishing a broad rule of thumb "standard annual life annuity conversion factor" (such as 5.5%) for a married male aged 65. This would include a carefully researched explanation covering the above dot-points together with suggested approximate conversion factors (or adjustments) for females and males at selected other ages. The Working Group considers that such a standard basis and explanation would significantly simplify and encourage the presentation of illustrated benefits in income form.

This rule of thumb would be useful even though the vast majority of superannuation pensions are likely to be account based pensions (and not guaranteed lifetime annuities). While the account based pensions have tremendous flexibility in the size of pensions that can be withdrawn, having a rule of thumb may also provide useful guidance to people considering how much they should withdraw each year.

6.4 Co-contribution

Sections 2 and 6 of the ASFA discussion paper appropriately explain that the maximum co-contribution is capped at a frozen $1500. Section 6 then comments that "the arithmetic of most calculators assumes that such dollar amounts are maintained in real terms". Though this is true of some calculators we doubt whether it is true of most. ASIC's FIDO calculators do not allow for any future growth in co-contributions.

6.5 Contribution, Exit and Benefit Fees

We consider that a weakness of the ASIC calculators is that they exclude all exit and benefit fees. The ASIC calculators do allow for contribution fees.

Section 3 of the ASFA discussion paper states:

> In other [negotiated] cases where an entry fee might apply the explanatory material relating to the calculator should explain the range of permitted entry fees and the fact that contribution fee can be negotiated with the adviser. Any consequence of a negotiated low or nil entry fee, such as a higher ongoing administration fee, part of which is paid to an adviser, or an exit fee should also be noted.

** In addition to "noting" we suggest that any contribution, exit or benefit fee, based on at least one illustrative negotiated possible outcome, should be allowed for in the projection.

6.6 Benefits Tax

** Most superannuation benefit calculators do not allow for tax on benefits. While the Better Super reforms have simplified the tax on benefits for those over age 60, tax may still be payable before that age. We suggest the explanatory notes to such calculators should include a comment such as:

> The calculator does not allow for the tax which may be payable on any lump sum benefit or income stream because this varies considerably according to the personal circumstances of the person.

7 Quality Control – Disclosure of Certification

7.1 ASIC Comments

When explaining the pitfalls of online calculators, ASIC comments on its website page (http://www.fido.gov.au/fido/fido.nsf/byheadline/Online+calculators?openDocument) that:

> On the same facts, we found widely differing results, ranging from $283,000 up to $965,000. Information included with the calculators was generally inadequate to explain the differences.

7.2 Certification

** We believe that the variability and quality of calculators would be greatly enhanced by having the calculators and their assumptions certified by suitably qualified professionals adhering to professional standards or industry guidance.

Having professional review of calculators was envisaged in ASIC's regulatory impact statement accompanying 05/1122 which indicated that costs would be incurred by providers in "hiring actuaries or other suitable professionals to check the reasonableness of assumptions"

7.3 Suggested Additional Disclosure

** While we do not necessarily believe certification should be compulsory, we recommend that ASIC amend class order 05/1122 to require the following additional disclosure to allow consumers to have some confidence in the quality of the calculator:

- Statement of adherence to professional standards or industry guidance notes
- Name and qualifications of the person making this statement
- Name of the entity responsible for the calculator.

8 Social Security Age Pensions

8.1 For the vast majority of retirees the social security Age Pension is, and will continue to be, a significant component of their post retirement income.

8.2 Very few calculators incorporate the Age Pension. This may be a result of the perceived difficulty of doing so, or the added complexity in setting assumptions (in relation to means testing). Nevertheless, we do not believe the difficulties are insurmountable and strong guidance from the regulator would encourage providers of calculators to incorporate this very useful piece of information.

8.3 We therefore suggest that wherever possible, an estimate of the Age Pension should be included in benefit projection calculators and illustrations – the ASIC FIDO Retirement Planner (refer section 12.1) is a good example of one approach for doing this. We also suggest that if a projection includes the Age pension, then the amount of such pension must be shown separately from the income stream arising from superannuation.

8.4 Consistent with the above we recommend that ASIC should:

** (a) <u>encourage</u> providers of benefit projection calculators and illustrations to include an estimate of the Age Pension, and

** (b) <u>require</u> providers of benefit projection calculators and illustrations which do include an estimate of the Age Pension, to ensure that the amount of such pension is shown separately from the income stream arising from superannuation.

9 Disclosure of Fees and Costs via Projections

9.1 Section 3 of this discussion paper mentions that a possible use for "standardised" benefit projections is in relation to the disclosure of fees and costs over a number of years via an illustration, to show the impact of those fees and costs and to help consumers compare different products.

9.2 ** The Working Group considers that standardised benefit projections would be a powerful tool for comparing fees and costs of different funds – or for just gaining a better understanding of the impact of one fund's fees and costs.

9.3 The following is an extract from Chapter 6 of the August 2007 report of the Parliamentary Joint Committee on Corporations and Financial Services (further relevant extracts are set out in Appendix A of this discussion paper):

> 6.140 ... the issue of how fees are templated and provided needs to be addressed more. It is almost impossible, basically, for the average consumer to look through three or four PDSs and understand what the fees are. …
>
> 6.144 The committee is of the view that the readability of PDS' could be improved by ensuring that important information is prominently displayed, in summary form, at the front of the document. This would enable those seeking to make a comparison between products to do so without needing to endure rifling through the entire document. The committee strongly encourages superannuation product issuers to improve their PDS' in this fashion.
>
> **Recommendation 20**
>
> **6.146 The committee recommends that the government conduct market research on the readability of superannuation product disclosure statements with the goal to introduce simple, standard, readable documentation."**

9.4 The Working Group also is aware that Submission No. 94 to the Parliamentary Joint Committee on Corporations and Financial Services directly addresses this issue. This submission was made by two of the members of the Working Group -- Colin Grenfell and Ray Stevens. A copy of the submission and its enclosure is included as Appendix B to this discussion paper.

9.5 The covering letter of Submission No. 94 states:

> …we … enclose a summary of our proposal, entitled the "Way Forward", for your consideration. We recommend that it should be subject to rigorous consumer testing to confirm its suitability and to identify further improvements. Note that under our proposal consumers do not have to examine and understand each individual fee or cost reducing their account balance. The material a fund must issue demonstrates the combined effect of the fees and costs over five periods on a standard basis which provides a sound basis for a comparison of the fees and costs of two or more funds the consumer is interested in.

9.6 The enclosure to Submission No. 94 states:

> **Impact of fees and costs**
>
> This third and final component would have two distinct parts, one for Investment fees and costs and one for Administration fees and costs. For example;

INVESTMENT

For each investment option, list:

(a) the ongoing net of tax fees and extra costs as a single annual dollar amount per $10,000 of average assets (eg. if fees were .44% net of tax and the only other investment costs were Consultant's fees of .09% net of tax, then list $53 per annum for this option), and

(b) the buy-sell spread (if any) and state whether this margin is paid to the fund manager or left in the fund for the benefit of other members.

ADMINISTRATION

A standardised expense deduction table (similar to that now required in the United Kingdom) for at least two levels of contributions. This is probably the most important part of the framework.

This part includes the following five columns for initial annual contributions of $2,500 and $5,000 respectively:

(1)	At end of years	2, 5, 10, 20 and 40
(2)	Total paid in to date	3 or 4 significant figures
(3)	Account balance without fees and costs deducted	3 or 4 significant figures
(4)	Effect of fees and costs to date	2 or 3 significant figures
(5)	Account balance with fees and costs deducted [= (3) - (4)]	3 or 4 significant figures

9.7 ** The Working Group recommends that the three components of the above proposal should be subject to rigorous consumer testing to confirm their suitability and to identify further improvements. Page 40 of this discussion paper contains an illustration of the third component.

10 Printed Projection Statements

10.1 Current Position

We understand that printed benefit projection statements are not considered "Calculators" as defined in the Class Order 05/1122 and therefore providers of these statements are required to provide them in the form of a Statement of Advice (and the full Advice provisions of the Corporations Act apply).

In their September 2005 submission to ASIC, the Institute recommended that ASIC relief and guidance (see section 2.4) should be extended to paper-based statements and stand-alone computer software packages (eg spreadsheets, CD Roms). Without such extension consumer protection would be inappropriately restricted to just online calculators. For this reason, section 2.6 of our Guidance Note states:

> This Guidance note covers illustrations provided in writing or as the output of any form of computer software (including websites).

10.2 The Need for Printed Projection Statements

** In the superannuation context, we believe paper-based illustrations of future benefits are an extremely useful and effective way of helping members plan for their retirement. We consider that this is an important issue for ASIC to address as experience has shown only a small proportion of fund members use the online calculators. Paper-based illustrations are usually based on a member's own personal details (account balance, age and salary) and product specific details (fees, costs and insurance premiums).

10.3 Current Uncertainly with Advice Provisions

While there is presently no legislative requirement to produce illustrations, many superannuation trustees would like to provide these for their membership as a Statement of Advice but are discouraged by the lack of clarity in relation to how obligations under section 945A ("reasonable basis for advice") would operate in those circumstances.

** We recommend that such printed projections provided by a superannuation trustee to existing superannuation members (and not prospective ones) should be exempt from the advice requirements.

Alternatively, one possible solution is to have another category of "Standardised Assumption - Product Specific Calculators" to allow ASIC to give license holders giving personal financial product advice greater clarity about obligations under s945A. Another solution is for ASIC to clarify a trustee's obligations under PS175.

11 Universal Retirement Income Forecasts

It has been a long standing Government (formerly Opposition) policy to introduce a universal retirement income forecast (ie benefit projection) as is produced in other countries such as the UK and Sweden. Such a universal retirement forecast might be in the form of a printed statement provided with the member's annual benefit statement.

We believe the following areas need to be addressed in the development of regulations and guidelines. Many of the issues enumerated are dealt with elsewhere in this paper and are only listed here (and not discussed)

- *Standardised assumptions (refer to Section 3.1 (a) to(c)) and who sets them*
- *Whether the investment earnings assumption is gross or net of investment costs*
- *Which deflator?*
- *How to show results as an income (based on life expectancy)*
- *Inclusion of age pension*
- *Communicating risk*
- *Exemption from Corporations Act advice provisions (refer to Section 10)*
- *Technical Memorandum*

  This would be required to ensure consistency of the calculation across providers. An example of an issue to address would be how to provide a forecast where no salary data is available.

- *Format of Statement*

  We suggest that like PDS "incorporation by reference", the statement be kept as simple as possible with greater detail provided on the web. We also strongly advocate the statements be consumer tested before final rules are prescribed. How the statement is delivered is also important. In Sweden the statements are delivered in orange envelopes – this might be an innovative way of avoiding some of the recall difficulties that UK recipients have apparently experienced.

- *Limitation of liability.*

  While some form of exemption from the Corporations Act advice provisions is necessary, the Government may further clarify the responsibility of trustees for liability in the event that the forecast assumptions are not, perhaps significantly, borne out in practice.

- *Referral to / Consistency with a fund's web calculators*

  We would suggest that the forecast should provide information about the fund's own web calculator (or perhaps ASIC's) to encourage members to consider what level of contributions is appropriate for them. Ideally, the same result would be given on the fund's own web calculator to what is provided on the statement.

  This would also mean that the default assumptions on the web calculator would need to be the same as the standardised assumptions for the Universal Retirement Forecast. (This is the case in the UK). This would require a change to the current Class Order exemption for web calculators.

- *Consistency with other standardised new business fee disclosure.*

  One issue that is currently being discussed in the UK is the inconsistency between assumptions used in:

  – forecasts provided at point of sale of a retail product
  – the universal retirement forecast (known as a Statutory Money Purchase Illustration) which is provided to members on an annual basis after they have joined a fund

** While Australia no longer requires compulsory forecasts at point of sale, we would suggest that if they were re-introduced some time in the future, the same set of standard assumptions should apply for both types of forecasts.

12 Pre-populating, Product Specific Calculators and Risk Profilers

12.1 Pre-populating Calculators with Member Data

The single most important factor in improving the useability of an online calculator is to "pre-populate" the calculator with consumers' own data. This is possible where a fund administrator holds information about consumers' account balances, contribution history (and possibly salary details). Pre-population, allows the user to be presented with a projection result immediately instead of being deterred by the perceived complexity of inputting data, which they may not understand.

Prior to the introduction of FSR, many calculators were pre-populated with member data. However, ASIC Information Release IR 04-17 stated that calculators can be provided where "any default settings are based industry wide rather than fund specific information". Providers interpreted this as meaning that calculators should not contain member data and many calculators were withdrawn.

Class Order 05/1122 no longer refers to "industry wide rather than fund specific" assumptions and so it is not clear as to whether a calculator can be pre-populated with member data and still obtain the exemption. We understand some providers have formed the legal opinion that this is possible.

** We strongly recommend that ASIC give clear guidance on this matter and recommend that superannuation trustees be able to pre-populate the calculators with data for existing fund members and be exempt from the advice provisions.

12.2 What is a Product Specific Calculator?

In the Regulatory Impact Statement accompanying the Class Order 05/1122, ASIC stated that it would consider the issue of Product Specific Calculators and Risk Profilers later. To date, the industry is unaware of the outcome of ASIC's deliberations.

If member data can be pre-populated in a calculator, it raises the question – what is a product specific calculator and what distinguishes it from a generic one?

Class Order 05/1122 requires that default fees and costs in a calculator need to be "reasonable". Without guidance as to what is reasonable, many providers are using the products own fee structure as the default instead of an industry wide fee,

The question remains, does using a fund's own fee and cost structure in a calculator make it a "product specific calculator"? ASIC's Online Calculators discussion paper
** (August 2005) defined such calculators in a broad way. Further clarification seems to be required.

12.3 Risk Profilers

We note that many websites are offering "Risk Profilers" to assist members with the selection of an appropriate investment strategy.

** We believe the industry would benefit from clear guidance as to how far these calculators can provide information before it is considered financial product advice.

13 ASIC's FIDO Calculators

13.1 During the past three years ASIC have placed on their website a number of calculators and guides. These include:

Date	What	Title
2006		
Jan-06	ASIC Calculator & Guide	FIDO Allocated Pensions Calculator v2 (before 1 July 2007)
Feb-06	ASIC Calculator	FIDO Compound Interest Calculator v1
Mar-06	ASIC Calculator	FIDO Risk and Return Calculator v1
Mar-06	ASIC Calculator & Guide	FIDO Term-allocated Pension Calculator v1
2007		
Apr-07	ASIC Calculator & Guide	FIDO Superannuation Calculator v7 (from 1 July 2007)
May-07	ASIC Calculator & Guide	FIDO Account-based Pensions Calculator v1 (from 1 July 2007)
Jun-07	ASIC Calculator & Guide	FIDO Retirement Planner v1 (includes Govt. Age Pension)

These can be found at:

http://www.fido.gov.au/fido/fido.nsf/byheadline/Calculators?opendocument

13.2 When the FIDO Retirement Planner was issued in June 2007 a Consumer Alert issued by ASIC stated:

> ‘Do you know whether your super, together with the government age pension, could be enough to give you the retirement income you would like? Ask the FIDO retirement planner to crunch the numbers for you’, ASIC’s Executive Director, Consumer Protection, Mr Greg Tanzer said.
>
> ‘You can plan just for yourself, or together with your partner*. The planner will show you how long your retirement income could last for, and when you may need to start relying entirely on the age pension.’
>
> The planner works out how much super you could save before you retire. It then calculates how much you can draw out of your super, assuming you don’t contribute any more to your super after retirement. Finally, it shows you how much of the government age pension you may be eligible to receive.
>
> ‘If it looks as if you’re not likely to meet your goals, you might want to consider postponing retirement for a few years, or making some extra super contributions. It is surprising what a difference this can make’, Mr Tanzer said.
>
> Some people may also need to consider making changes to their super. For example, if you’re paying high fees, make sure you’re getting value for money. Just an extra one per cent each year in fees can cut up to 20 per cent from your retirement benefit over 30 years**. A very conservative investment strategy can also make it hard to build up your super savings, and a more growth-oriented investment strategy could suit you better.
>
> ‘The retirement planner will show you what each of these options could mean for you. Consider your own circumstances carefully when using this calculator. You might need expert, licensed advice on retirement planning’, Mr Tanzer said.

13.3 Each of these calculators has been issued as an Excel workbook and they have been welcomed by superannuation product and service providers. However the Working Group believes that online calculators generally are seldom used directly by consumers. As stated in section 10 of this discussion paper, the working group believes that paper-based illustrations of future benefits would be a far more useful and effective way of helping members plan for their retirement. We consider that this is an important issue for ASIC to address as experience has shown only a small proportion of fund members use online calculators.

13.4 Further, as also mentioned in sections 3.2 of this discussion paper, paper-based illustrations prepared on the basis of standardised assumptions have a potential scope which is very much wider than that of online calculators. They have the potential to reach millions of Australians and not just the few (or many) thousand who use superannuation calculators or financial planning software.

13.5 The Working Group considers that the effectiveness of the FIDO calculators could be improved if the following five changes were introduced:

<u>(1) Exit and Benefit Fees</u>

** The calculators could easily (and should) allow for percentage-based and dollar exit and benefit fees. By leaving these out ASIC is indirectly encouraging promoters to charge them.

<u>(2) Warnings</u>

** There is no warning when input earnings rates fall outside the “acceptable range” in the guides but inside the much wider “conservative limits” on the “assumptions” sheets. We suggest that such a warning should be added (and we question whether it is necessary to have both an “acceptable range” and “conservative limits”).

<u>(3) Earnings tax</u>

The guides to the FIDO calculators explain that superannuation funds can pay an effective tax rate of between about 4% and 15% because their tax bill will usually be reduced by franked dividends from Australian shares and other tax deductions.

** However the calculators assume a default effective tax rate of 6% for all investment options despite the evidence that many “growth” portfolios have high exposures to overseas equities and hence relatively high effective tax rates. The Working Group also considers that significantly higher default effective tax rates should be allowed for Balanced, Capital stable, Capital guaranteed and Cash options.

<u>(4) Balanced Investment Option Proportions</u>

** The FIDO calculators suggest that “Balanced” investment options usually invest 60% to 70% in shares or property. The Working Group considers that a range of 65% to 75% would be more realistic. For example, the Mercer Pooled Fund survey of 33 managers with “Balanced Funds” showed an <u>average</u> benchmark exposure to shares and property as at 30 September 2006 of 68.6% and a <u>weighted average</u> allocation to shares and property at the same date of 70.4%.

<u>(5) Adjustments for Inflation and Community Living Standards</u>

The Working Group believes that this is the single biggest cause of variability of results from online calculators.

Section 4 of this discussion paper explains the Institute of Actuaries' view that projected benefits should be deflated using a salary-based assumption not an inflation-based assumption. The Working Group is pleased to see that this view seems to be supported by ASIC because the FIDO calculators have been published on this basis. However there is an apparent lack of clarity about this. In a number of places both guides and calculators refer to "… adjust automatically for inflation" or "… adjust
** today's dollars automatically for inflation …". **It should be made clearer that all the adjustments are for inflation <u>and</u> rises in community living standards**.

** The Working group also considers that some change or clarification is required to page 3 of the guide to the FIDO Retirement Planner where an annual discount of 2.91% is suggested "to adjust a loan repayment back to today's dollars".

The more recent FIDO calculators assume that community living standards will increase by 1% each year after allowing for inflation. Users can change the assumed rate but are warned using figures outside an "acceptable range" of 0.5% to 1.5% may
** produce unlikely or unrealistic results. **We consider that this default allowance for rises in community living standards should be increased to 1.5% and the upper and lower values of the "acceptable range" should both be increased, probably by 0.5%.**

In Section 5 of this paper we provide some analysis on the default assumption in relation to the rise in community living standards.

14 Appendix A – Parliamentary Joint Committee

The following are two extracts (with some formatting-borders added for emphasis) from Chapter 6 of the report regarding "The cost and accessibility of financial advice":

"***Facilitating information from non-licensed entities***

6.107 The committee also recognises the concerns that superannuation funds have over the limits imposed on them by FSR. From their perspective, 'financial product advice' as currently defined in the Corporations Act could potentially capture instances that funds legitimately claim are related to providing informative or educational material. Therefore, in addition to the problem of costly disclosure requirements being triggered, funds have expressed concern that useful superannuation-related information may not be provided at all by funds without an AFS licence.

6.108 The committee reiterates that ASIC's evidence suggested that its priorities did not lie with enforcing these provisions to their limits. ASIC also assured the committee that factual information may be provided without requiring a licence. However the committee again notes that superannuation funds seeking to comply with the Corporations Act will naturally adopt a conservative approach to the legal risks associated with communicating with their members.

Accordingly, two specific areas of uncertainty within the industry ought to be dealt with through further regulatory guidance:

• the ability of funds to provide targeted information to different categories of their membership; and

• the provision of benefit projections.

6.109 On the first matter, the committee is of the view that superannuation funds should be able to provide material that is relevant to their members. At present, funds appear to be uncertain as to whether providing targeted information to their membership constitutes personal advice. The committee does not believe that funds should have to provide exactly the same information to every member in order to avoid being deemed to have provided personal advice. For example, they ought to be allowed to communicate different information to their younger members than they do to near-retirees. Given some uncertainty within the industry, whether or not communications of a targeted nature would constitute 'personal advice' under the Corporations Act is a matter that should be clarified by ASIC.

Recommendation 17

6.110 The committee recommends that ASIC provides guidance to superannuation funds on the provision of targeted communication to separate categories of fund members, so called limited advice, without triggering the need for a statement of advice.

6.111 The committee also believes that the issue of online superannuation benefit calculators requires further consultation and clarification. Even though ASIC has provided regulatory relief for non-licensees to provide generic online calculators, the committee still heard strong criticism on ASIC's regulatory approach to this tool.

The difficulty here stems from the fact that the effect of a future superannuation benefit projection can range from being either highly beneficial or extremely detrimental. While an accurate projection can be very useful to assist with deciding on suitable contribution levels, an inaccurate one may cause superannuation fund members to leave themselves without the retirement income they had planned for.

6.112 ASIC's concerns over online calculators are shared by the committee. Regulations pertaining to benefit projections must ensure they are not used as promotional tools for superannuation product providers as this will inevitably lead to the promotion of unreasonable expectations amongst consumers. Further, the committee also questions whether consumers in general possess the requisite financial literacy to use the tool and interpret its results in an appropriate way.

6.113 However the committee is of the opinion that further efforts are required to facilitate superannuation funds' ability to offer its existing members this facility. Having a grasp of the relationship between current contribution levels and future retirement income is an important element of superannuation-related financial decisions. Superannuation funds are an appropriate entity to provide this information. However the evidence during this inquiry suggested that funds view providing benefit projections within the parameters set by the regulator as unfeasible.

While the committee is not convinced that ASIC's restrictions applying to online calculators are unreasonable, any stalemate between the industry and the regulator is unhelpful to fund members seeking guidance on their retirement income planning. The committee therefore suggests that this matter be subject to further consultation between the superannuation industry and ASIC, followed by the provision of further regulatory guidance that reflects a suitable compromise.

Recommendation 18

6.114 The committee recommends that ASIC consult further with superannuation funds on the provision of online calculators. Following this process ASIC should provide additional regulatory relief that will better enable funds, without undermining consumer protection imperatives, to use the generic calculator exemption to provide benefit projections for their members."

…

Standardisation

6.139 Since 1 July 2005, in accordance with *Corporations Amendment Regulations 2005 (No.1)*, PDS' for superannuation products have been required to include a standardised fees and costs template. Previously, information on fees could be presented as issuers deemed appropriate, making comparisons difficult. This measure was intended to address that problem.

6.140 Despite the change, the committee heard evidence that it is still difficult to make fee comparisons between superannuation product providers. ICAA commented that:

> ...the issue of how fees are templated and provided needs to be addressed more. It is almost impossible, basically, for the average consumer to look through three or four PDSs and understand what the fees are.

6.141 Aside from fees, the government has not mandated that other information needs to be presented in a standardised fashion within the PDS. ASIC told the committee that extending mandated standard forms of disclosure would not necessarily improve readability:

> ...historically, there have been some problems with the consumer-effective mandated content or lengths ... the assumption on which we are proceeding is that it is better if these things emerge over time. For example, the old prospectus regime had a mandated series of disclosures, and it was not always obvious that complying with those mandates was in the interests of good or accurate communication. I do not think we see a case at this stage for changing that fundamental setting.

6.142 It also contended that comparability was not always practicable:

> The objective of comparability is not evenly achieved across the spectrum. In some cases it is quite difficult for that to occur. We really need to be talking about similar product types being offered to consumers whose objectives are similar ... [W]e have asked ourselves whether there is a case for a more standardised disclosure of risk, but that is something you would not want to close down by standardisation because it is very particular to the individual product and the individual issuer.
>
> Similarly, the other leg of what we say is important here is for people to understand in a clear way what they are buying and, given the variety of products on the market, that is difficult to standardise. It would seem better that we drive disclosure towards clear and effective communication of what people are being offered, how much they are being asked to pay for it and what risks are associated with it than to try and standardise those things in a way that works in fees. It is unclear whether that would work as well outside the fee area.

Committee view

6.143 Consumers would benefit greatly from shorter, more comprehensible and more comparable product disclosure statements. While the objective of more consumer-friendly disclosure is not subject to disagreement, the means by which it may be achieved are. Short-form PDS' have not worked because there is little or no incentive for product issuers to supply one. Further, lengthy documents are only problematic where their length itself makes the key information they contain difficult to find. Achieving comparability through mandated standardisation also has its deficiencies, as ASIC pointed out. Finding a one-size-fits-all model that could be practically used by product issuers offering a diverse array of financial products could potentially create more problems than it solves.

6.144 The committee is of the view that the readability of PDS' could be improved by ensuring that important information is prominently displayed, in summary form, at the front of the document. This would enable those seeking to make a comparison between products to do so without needing to endure rifling through the entire document. The committee strongly encourages superannuation product issuers to improve their PDS' in this fashion.

6.145 If this cannot be achieved by the industry of its own volition then it should be mandated by government. In doing so, it would be advisable for Treasury or ASIC to have undertaken market research on the readability of PDS' to ascertain the most consumer-friendly way to present such material in a standardised format. Such research should be conducted as soon as possible.

Recommendation 20

6.146 The committee recommends that the government conduct market research on the readability of superannuation product disclosure statements with the goal to introduce simple, standard, readable documentation."

15 Appendix B – Submission 94 to Parliamentary Joint Committee

Disclosure of Fees and Costs

The following letter is a submission to the Parliamentary Joint Committee on Corporations and Financial Services that was made by two members of the Working Group. The submission is referred to in section 7 of this discussion paper.

23 April 2007

Senator Grant Chapman
Chair, Parliamentary Joint Committee on Corporations and Financial Services
PO Box 6100
Parliament House
Canberra ACT 2600

Dear Senator,

DISCLOSURE OF SUPERANNUATION FEES AND COSTS

We are both Melbourne-based actuaries with many years experience in superannuation. Over the years we have regularly participated in consultations with Government authorities either as representatives of industry bodies or on our own behalf. More recently we have been involved in industry consultations with ASIC and Treasury in the development of regulations governing the disclosure of fees and costs in Product Disclosure Statements for superannuation funds.

On Monday 16 April 2007 we read in the Melbourne Herald Sun:

> Chair of the inquiry, Senator Grant Chapman, says that disclosure is the biggest issue the committee is hoping to tackle.
>
> "There's a need for much greater transparency and disclosure across the board, both industry and commercial funds. The Act might need tightening up in that regard," Senator Chapman said.

We would welcome changes to the current superannuation disclosure requirements and are pleased to see that this is now being given priority through your inquiry.

We believe that the current disclosure regime is ineffective and confusing and does not adequately assist consumers to compare the costs of different funds – in fact in many situations it is potentially misleading. We agree with the officials from APRA who reportedly told your committee:

> … putting a man on the moon might be easier than finding comprehensive information on superannuation costs, fees and charges.

However we also believe that this matter can be rectified and enclose a summary of our proposal, entitled the "Way Forward", for your consideration. We recommend that it should be subject to rigorous consumer testing to confirm its suitability and to identify further improvements. Note that under our proposal consumers do not have to examine and understand each individual fee or cost reducing their account balance. The material a fund must issue demonstrates the combined effect of the fees and costs over five periods on a standard basis which provides a sound basis for a comparison of the fees and costs of two or more funds the consumer is interested in.

We would be happy to discuss this matter further as required.

Yours sincerely,

Colin Grenfell and Ray Stevens

Standardised Disclosure of Fees and Costs - the Way Forward

[Updated April 2007]

Earlier versions of this note were published in the August 2003 and May 2004 editions of *Actuary Australia*, the monthly magazine of the Institute of Actuaries of Australia. The purpose of this note is to update the original articles and to include a number of useful refinements suggested by various industry participants.

To help consumers compare different superannuation plans and products requires some standardisation in the way that fees, charges and costs are disclosed in Product Disclosure Statements (or PDS's). In fact, the same can be said of any product with an investment component, such as a managed fund or a life office or friendly society investment-linked policy or bond.

Just over eight years ago, Colin Grenfell wrote an article "KFS Disclosure - no easy matter" which was published by the Association of Superannuation Funds of Australia (ASFA) in the December 1998/January 1999 edition of SuperFunds. The article summarised the then public views on fee disclosure as expressed by the Liberal-National Coalition, the Labor Party, the Australian Securities and Investments Commission (ASIC), the Industry Funds Forum and others.

The article also noted that the Institute of Actuaries of Australia recommended that:

(1) Investment performance should be reported net of tax and investment transaction costs and net of all investment costs.

(2) Key Features Statements should include a brief description of all fees and charges.

(3) In addition there should be some form of analysis of the impact of fees and charges which should focus on all non-investment fees and charges.

(4) The impact of these fees and charges should be shown net of employer subsidies but should include any costs in excess of fees and charges.

The authors of this note believe that these four recommendations reflect sound principles that remain valid today.

The authors note that the Institute's principles include the need to show separately the effect of investment fees and costs and of non-investment (or broadly administration) fees and costs. The authors consider this split is essential for a sound comparison of funds. The split also facilitates member investment choices. It is noted that the Report commissioned by ASIC from Professor Ian Ramsay, released in September 2002, recommended that investment and administration fees should be separated.

The August 2003 and May 2004 articles explain the background and relevant events since 1998. A further article in August 2005 expands on recommendations (1) and (3) above.

<u>What happens next?</u>

We suggest that the way forward should include the following <u>three</u> level fee disclosure framework:

1. At a glance

This component of the framework would summarise the existence of various fees and costs using standardised terminology, order of contents and grouping. For example;

INVESTMENT		ADMINISTRATION	
Ongoing fees	***Yes***	Initial fees	***No***
Ongoing extra costs	***Yes***	Ongoing fees	***Yes***
Switching fees	***Yes***	Ongoing extra costs	***Yes***
Buy-sell spread	***Yes***	Benefit fees	***Yes***
		Exit fees or penalties	***No***

OTHER		
	Any other fees or costs?	***No***
	Are any dollar fees indexed	***Yes***
	Might fee rates increase in next 5 years?	***No***
	Are some tax deductions withheld?	***No***

2. Brief description

This component would be similar to the brief descriptions of fees and charges used in Member Booklets and some PDS's, but there would be a few important constraints. For example;

- Must include brief descriptions of how each of the above "***Yes***" responses is calculated and charged.
- Must start a new paragraph for each fee or cost.
- Must be in the same order as the first component and use the same grouping.
- Must use standard terminology similar in style and depth to the requirements of Corporations Amendment Regulations 2005 (No. 1) but, primarily as a consequence of the separation of fees and costs into "investment" and "administration" components, <u>without the unnecessary and confusing terms "management costs" and "other management costs"</u>.

3. Impact of fees and costs

This third and final component would have two distinct parts, one for Investment fees and costs and one for Administration fees and costs. For example;

INVESTMENT

For each investment option, list:

(c) the ongoing net of tax fees and extra costs as a <u>single annual dollar amount per $10,000</u> of average assets (eg. if fees were .44% net of tax and the only other investment costs were Consultant's fees of .09% net of tax, then list $53 per annum for this option), and

(d) <u>the buy-sell spread</u> (if any) and state whether this margin is paid to the fund manager or left in the fund for the benefit of other members.

ADMINISTRATION

A standardised expense deduction table (similar to that now required in the United Kingdom) for at least two levels of contributions. This is probably the most important part of the framework.

This part includes the following five columns for initial annual contributions of $2,500 and $5,000 respectively:

(1)	At end of years	2, 5, 10, 20 and 40
(2)	Total paid in to date	3 or 4 significant figures
(3)	Account balance without fees and costs deducted	3 or 4 significant figures
(4)	Effect of fees and costs to date	2 or 3 significant figures
(5)	Account balance with fees and costs deducted [= (3) - (4)]	3 or 4 significant figures

<u>Sample Product Disclosure Statements</u>

Two sample Product Disclosure Statements, which reflect the principles that we consider should apply to fee and cost disclosure, have been prepared and can be supplied if required. One sample is for a hypothetical Retail superannuation fund and the other is for a hypothetical Industry plan. (They have not been updated to reflect legislative changes since 2004.)

The next page is an extract from the latter PDS to illustrate the third component of our recommended framework.

Colin Grenfell and Ray Stevens

[extract only]

Table 4: ZIS Annual INVESTMENT Fees and Costs Summary per $10,000 account balance in each investment option	
Ongoing (and Extra)	Option A: $161 Option B: $140 Option C: $124
Buy-sell spread	Nil

Assumptions on which the following fee table is based

The table below uses the standard assumptions about account balance, contributions and investment returns that all funds must use to show the impact of their administration fees and costs. These assumptions are as follows:

- Account balance at start: nil.
- Initial Annual Employer contributions of $2,500 or $5,000 (before tax).
- Contributions payable mid-year (or say weekly) and increasing by 4.5% each year.
- Member contributions: nil.
- Net annual investment return of 7% (net of tax and net of investment fees and costs).
- Dollar fees increase by 3% each year.
- Results in **"today's dollars"** (i.e. deflated using a salary increase assumption of 4.5% each year) .
- No allowance for any tax payable on benefits..

Table 5: Effect of ZIS ADMINISTRATION Fees and Costs

If withdrawn after	Total paid in to date	Account Balance without fees and costs deducted	Effect of fees and costs deducted *	Account Balance with fees and costs deducted *
		Initial Annual Contribution $2,500		
2 years	$5,000	$4,350	$120	$4,230
5 years	$12,500	$11,280	$330	$10,950
10 years	$25,000	$23,970	$860	$23,110
20 years	$50,000	$54,300	$2,800	$51,500
40 years	$100,000	$141,500	$12,300	$129,200
		Initial Annual Contribution $5,000		
2 years	$10,000	$8,700	$120	$8,570
5 years	$25,000	$22,560	$420	$22,140
10 years	$50,000	$47,940	$1,260	$46,680
20 years	$100,000	$108,600	$4,600	$104,000
40 years	$200,000	$283,000	$22,500	$260,500

* The fees and costs include all fees and costs, except investment fees and costs and insurance charges. They include the benefit payment fee. For ZIS there are no other surrender penalties or exit fees and ZIS does not pay any commissions.

The last line of Table 5 (for an annual contribution of $5,000) shows that over a 40 year period the effect of the total deductions could amount to $22,500 (in today's dollars). Putting it another way, this would have the same effect as bringing investment returns down from 7% a year to 6.61% a year.

16 Appendix C – Letter to IFSA

The following is an extract from the appendix of an April 2007 letter to the Investment and Financial Services Association (IFSA) from the Benefit Projections Working Group. The letter commented on IFSA's December 2006 exposure draft of a Best Practice Guidance Note on calculators for their members. The letter is referred to in section 2.6 of this discussion paper and the full letter is available on the IAAust website.

"**<u>Assumptions</u>**

- As you may be aware, the view we have expressed to ASIC is that it is very difficult to obtain consensus on "industry wide assumptions" and that there should be some prescription of default assumptions, perhaps by the Australian Government Actuary.

- Measures of inflation - we believe this is the most likely area to cause confusion for consumers. Although there are some circumstances where discounting using CPI is appropriate, we believe that it is preferable to discount future dollar values into current dollar values using wages growth (eg AWOTE or other wage inflation measures) rather than using a price inflation measure (CPI etc).

  Discounting with wage inflation ensures that benefits are understood in terms of relative standard of living (behavioural economics studies show that relative standard of living is more important to consumers than absolute standard of living measures that would be produced by using CPI / price deflation).

- Effects of different types of fees: Dollar based fees and charges- we strongly suggest that some inflation be allowed for in these fees and charges and the method of this inflation be disclosed.

- Effects of different types of fees: your best practice guidelines suggest that these fields might be left blank. We believe this is very misleading and suggest that if the calculator is related to a particular product then a default assumption should be chosen to be reasonable for that product. If the calculator is generic (and not linked to a particular product), then an industry average fee or cost would be more suitable than a blank figure.

- Estimated Earnings Rate – your best practice paper suggests that the guide for earning rate assumptions should be "appropriately sourced , using historic information that takes into account the last 10 or 20 years worth of returns..". We believe this timeframe is too short and is very likely to produce strongly misleading guidance for users. It is relevant that for most of the last 10 to 20 years, bond rates have steadily decreased and this has resulted in significant capital appreciation of fixed interest and other securities. Further, we believe it is not unreasonable when setting assumptions, for a level of economic or financial judgement to be applied in relation to the future outlook for long term returns.

- Estimated Earnings Rate – Option 1 Leaving Earnings Rate Blank – our view is that approach should be strongly avoided (even with the use of appropriate flags) as most users will not have an understanding of reasonable assumptions.

- Estimated Earnings Rate – Option 2 default assumption – as mentioned above we would suggest that best practice involves independent certification of assumptions (particularly the earnings rate).

- Sensitivity of results to key assumptions – we believe it is vitally important that users of calculators understand the impact of actual experience varying from that assumed. We would strongly recommend that best practice is to provide some illustration of sensitivity of the results. This may be in several forms including:

  – Recalculating the end results based on adjustments to the earning assumptions.
  – Showing graphically the impact of using historical returns
  – Showing graphically the impact using a stochastic return series with end results significantly different to the selected assumptions (a variation from the end benefit of say 20%)

- Crediting the Earnings - we believe this section of the best practice paper is not relevant. Most IFSA member's products will be unitised and a continuous crediting of rates occurs in practice.

  In any case, we would suggest that earnings assumptions should be specified as annual effective rates. More frequent compounding should be allowed for by converting annual nominal returns into their annual effective rate equivalents.

- Future dates used to display calculation result– a common issue arising in these calculators is whether the future dates used in the projections reflect the user's future birthdays or their ages at the end of each financial year. We believe the type of dates used should be disclosed."

Standardised Assumptions for Projections

– Should they be gross or net of costs?

In the April 2005 edition of *Actuary Australia, Notes from the President* stated:

Choice of Fund	**Our Response**
One of the key Choice of Fund (C of F) issues is meaningful disclosure of fees and charges, which was the subject of a separate submission on January 14.	Yes, meaningful disclosure of fees and costs is a very key C of F issue.
We have submitted that a projection basis is a sound and informative way to compare superannuation and other investment products.	Yes, for both superannuation and other investment products.
The Government has an understandable desire to keep fee disclosure in Product Disclosure Statements as simple as possible.	Yes but the post-July 2005 regime (with a template, additional explanation, the example, associated notes and advisory warning) is far from being 'as simple as possible'.
It is also important to consider the role of superannuation calculators and financial planning software in the consumer choice and advice process.	Yes, this is important but we hope that most consumers will not require them. Many consumers will not be able to use a website calculator correctly or even use it at all.
And the potential valuable role of incorporating benefit projections that also show the impact of fees and charges.	Yes but which fees and charges? More importantly, which fees and costs?
For valid comparisons to be made, we have submitted that a standardised set of assumptions is important – this would include investment earnings, contribution increases and inflation.	Yes. We explain below why the standardised investment earnings assumptions should be net of investment fees and costs (and, in the case of superannuation products, net of tax).

Before expanding on some of our responses, some background might assist.

The August 2004 edition of *Actuary Australia* included the following results from 314 responses to question 3 of the July 2004 Actuarial Pulse:

In relation to the disclosure of fees and charges of investment and superannuation products, which of the following do you prefer:

(a) Disclosing only the first year's fees and charges (Government model) – 8%
(b) Disclosing the fees and charges over a number of years via an illustration – 92%

It is very clear from this that most actuaries do not like the Government model.

The September 2004 edition of *Actuary Australia* included the following results from 395 responses to question 4 of the August 2004 *Actuarial Pulse*:

The last Pulse survey showed strong support for some form of disclosure of fees over a number of years via an illustration. In relation to standardised disclosure, which of the following do you prefer:

(a) separately showing the impact of investment and administration fees – showing the first year's investment fees and costs and showing the impact of administration fees and costs over a number of years via an illustration (as suggested by Colin Grenfell and Ray Stevens in the May 2004 edition of *Actuary Australia* – 67%
(b) showing the combined impact of investment and administration fees and costs over a number of years via an illustration – 33%

This shows a majority but not unanimous support for judging the impact of investment fees and costs and **administration** fees and costs separately.

Why did 33% of the actuaries who responded to the second survey favour showing the combined impact of investment and administration fees and costs? The authors are not sure of the answer to this because these opponents to separation have not spoken up. We can only suspect that they either (a) had concerns about how investment and administration costs would be separated or (b) like the Government, considered that a combined approach might be simpler. Let's consider each of these possibilities:

(a) Separation When the fees are combined, we suggest that the trustees will usually know the investment component or can make a reasonable estimate of this component. In practice we would expect that a responsible trustee would already be regularly making a subdivision as part of its normal supervision of the costs of operating the fund. The key issue is that such a split should be determined on a basis set by the trustee and applied consistently from year to year. Approval of the auditor could be required if considered necessary. We note that while there may be differences in the results of reasonable estimates of a split by different people, total fees and costs are still accurately disclosed. The effect of these differences is to either slightly increase (for example) disclosed administration costs or to slightly reduce disclosed investment returns (see below). There is limited scope to gain a competitive advantage.

(b) Simplicity We believe that separating investment and administration costs will actually lead to simpler disclosure overall. Experience to date has shown that PDSs are often more than 80 pages. The Government's new fee and cost disclosure regime requires:

- a fees and costs template
- an additional explanation of fees and costs
- an example of annual fees and costs based on $5,000 contribution and $50,000 account balance for a 'balanced' investment option
- associated notes about additional, establishment and withdrawal fees
- a consumer advisory warning statement that includes a closing section 'TO FIND OUT MORE' that suggests the consumer who wishes to see the impact of fees based on their own circumstances should go to the ASIC website superannuation calculator

This is not simple.

The superannuation industry has also started to realise that the new combined regime involves double-counting. ASFA's *Best Practice Alert No.4 – Disclosure of Fees and Costs* states:

… The major problem is the fact that earnings are reported net of fees, while 'other management costs' include fees deducted from earnings. The 'double-counting' of such fees would prevent the [periodic statement] summary balancing.

A letter dated 14 January 2005 from the Institute of Actuaries of Australia to The Hon Chris Pearce MP stated:

We note that ASIC consumer testing showed strong support for a multiple-year standardised illustration of fees and charges. … Disclosing fees and costs over a number of years via an illustration is a sound and informative way to assist consumers to compare superannuation and other investment products.

A multiple-year standardised illustration would require a standardised set of assumptions that would include investment earnings, contribution increases and inflation. We believe that the standardised investment earnings assumption should be net of investment fees and costs and net of tax.

Why net of investment fees and costs?

There are many reasons for this:

(a) It is consistent with the views above about separating total fees and costs into investment and administration. It means that the projection will show the effect of **administration** fees and costs on members' benefits (because the standardised investment costs have been netted against investment earnings).

(b) Showing the effect of administration fees and costs (not total fees and costs) means that administration fees and costs will not be swamped by investment costs.

(c) The regulations, IFSA standards and Institute professional standards require disclosure of investment earnings and returns net of tax and net of costs. If management costs are split into 'investment ' and 'administration', it is logical and consistent for net investment earnings and returns to be net of investment costs but not net of any administration costs.

(d) The above avoids the 'double-counting' referred to in ASFA's *Best Practice Alert No.4*.

(e) It is extremely difficult for consumers to compare the total fees and costs of any two plans. However it is **much easier** and logical to compare the administration costs (<u>and services</u>) of two plans and then to separately compare the investment costs (<u>and expected returns</u>) of the two.

(f) A projection of investment costs is not necessary because such costs are usually a flat percentage of assets. In these cases the percentage is unchanged from year to year and it is easy for a consumer to compare these costs between funds, provided like investment options exist in each fund.

Projecting investment costs will not assist this decision.

Most funds now offer a selection of investment options varying from as few as two options to an infinite number of possible combinations. Investment costs vary significantly for different types of investments such as bonds, shares and property.

With a gross standardised assumption

If a gross-of-fees standardised investment-earnings assumption approach were adopted (which implies a projection of total costs) it therefore becomes necessary to decide which investment option will be chosen.

The new disclosure regime attempts to overcome this difficulty by including in the example of annual fees and costs only the costs for 'the balanced investment option'. But there is no such thing as a standard 'balanced option'. Options described as 'balanced' can contain anything from 50% to 70% investment in shares. In addition the shares can contain only Australian shares or a variety of combinations of Australian and international shares. Some property may also be included and this may include various combinations of listed and direct properties with very different costs. So the cost of the 'balanced' option for a group of funds may differ because of the different levels of Australian shares, other shares and property making up the option rather than because of any difference in the charges made by the funds for each type of investment.

With a net standardised assumption

Page 15 of the May 2004 edition of *Actuary Australia* included an example of a net assumption projection for two levels of initial contribution with illustrations after 2, 5, 10, 20 and 40 years.

Use of a net-of-investment-costs standardised investment-earnings assumption approach avoids the need to make an arbitrary assumption about which investment option applies or what is a 'balanced' option.

Further we consider consumers need to have information on the costs of the different investment options available from a fund to make a fully informed selection of the option they wish to use. **This does not require a projection of investment costs; it requires an assessment of expected returns, risks and costs (including buy-sell spreads) of each investment option.**

In the past some funds have used the lack of separate information on investment and administration costs to, usually unintentionally, 'bury' part of their administration costs. Where a fund has a specific administration fee and recovers excess administration costs by deduction from investment income, the excess costs have not been disclosed as a cost but have been allowed for in the past investment results. This gives the impression that the fund's administration costs are much lower than those of funds fully disclosing their administration fees AND costs.

Encouraging the separate disclosure of administration and investment costs will help ensure funds disclose the true administration fees and costs affecting the benefits of their members. Consistent with this, we believe that the use of a net-of-investment-costs standardised investment-earnings assumption approach in **a projection that discloses administration fees and costs over a number of years, is a sound, informative and overall simpler way to assist consumers to compare superannuation products.**

ASIC website superannuation calculator

The ASIC website superannuation calculator has two options in respect of the assumed fund earning rate. You can specify an earning rate 'before costs and taxes' or an earning rate 'after costs and taxes'. If you select the 'before costs and taxes' option, then you also need to specify the costs and taxes allowed for. There is a number of difficulties in using this option properly that are beyond the scope of this article. We would prefer to see this option deleted.

However if the gross option remains, and standardised assumptions are introduced as an option, we would like to see a clear instruction to use the 'after costs and taxes' option when using the standardised assumptions. Better still the calculator could be programmed to not allow the 'before costs and taxes' option to be used when the standardised assumption option is selected.

After considering this article, we hope that more than 67% of actuaries agree with our views. ▲

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