McGING GAZETTE

Superannuation
Retirement Income
Wealth Management
Life Insurance
Risk Management
Governance
Actuarial Consulting

Published by McGing Advisory & Actuarial Pty Ltd www.mcging.com.au

Welcome

Welcome to the first edition of the McGing Gazette. The plan is to give you regular updates on the activities of McGing Advisory & Actuarial and in so doing provide insight into some of the issues facing our industry.

We would be pleased to get your feedback on the newsletter and your areas of interest for future articles. Drop a note to Sean at sean.mcging@mcging.com.au or call him on (03) 8641 6970 or 0411 229 641.

June 2011

Reducing Retirement Income Costs 1

Gender Diversity of Trustee Boards 3

Further insights from the Institute of Actuaries of Australia Biennial Convention 4

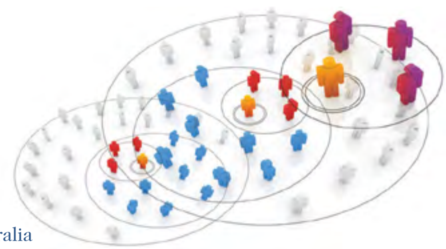
"Words of Wisdom" 4

BIENNIAL CONVENTION 2011

BEYOND THE MANDATE

10 – 13 APRIL 2011 • HILTON SYDNEY

Institute of Actuaries of Australia



The Biennial Convention is the flagship event of the Institute of Actuaries of Australia. It attracts a wide range of papers on topics where actuaries are actively involved – superannuation, wealth management, insurance (life, general and health), risk management, finance and investments, climate change, energy.

Reducing Retirement Income Costs

This article takes extracts from Sean's paper which was first prepared for and presented at the Institute of Actuaries of Australia's 2011 Biennial Convention, © McGing Advisory & Actuarial. Any opinions expressed therein are Sean's, not those of the Institute.

The full paper and a summary presentation are available online at www.mcging.com.au and www.actuaries.asn.au.

Summary: This article considers what gives rise to high levels of retirement income costs and how such costs might be reduced going forward.

Australia's retirement demographics

Australia's population is entering a period of great change as baby boomers move into their retirement years. As the inter-generational report, other actuaries and researchers have all pointed out, the proportion of the population reaching retirement is increasing rapidly. This effect is amplified by a maturing superannuation system via mandatory and voluntary contributions, so the expected cumulative monies available as a base for drawing retirement income will grow exponentially over the next 40 years.

High costs and repercussions

In the last year, the Cooper, Henry, Johnson and Ripoll reviews have all highlighted the sometimes complex but always very public issue of the perceived high cost in aggregate of Australia's superannuation and retirement incomes framework as it currently operates.

The Cooper Review stated:

- "Treasury estimates that the MySuper and SuperStream proposals would, in the long run, see a cut of around 40 per cent in fees for the average member."
- "The Panel doubts whether the higher fees for allocated pensions are justifiable." "The Panel considers there is scope for these fees to be reduced substantially."

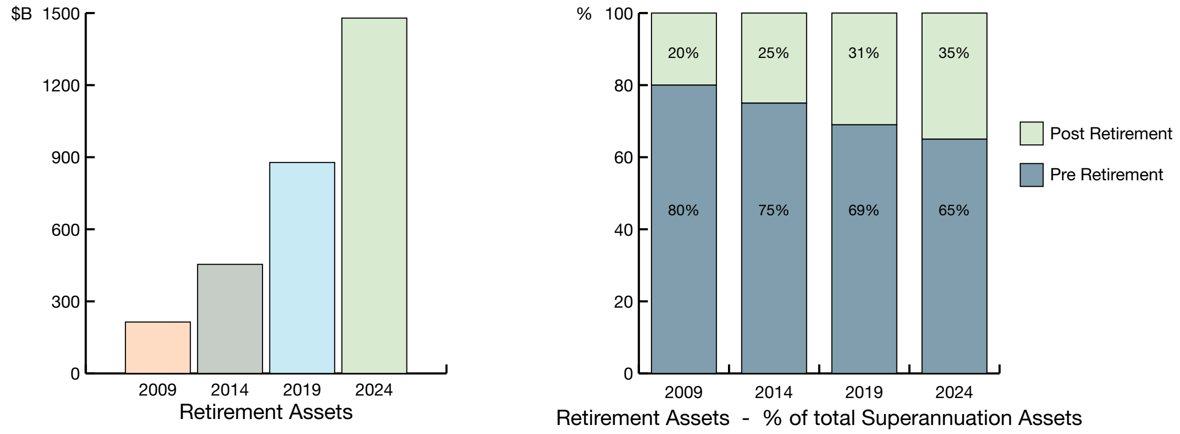
As a starting point, it is reasonable to expect that retirement income costs are in relative terms higher than accumulation costs reflecting several interacting factors including lower volumes and a higher administration load from making payments rather than receiving contributions.

The industry is heading for a lot of pain, public dissatisfaction and critically the risk it is not serving all its members well, unless it pre-empts such higher costs by reducing likely future retirement income costs before they arise.

Limited data in a changing world

Publicly available data on retirement income costs is very limited. Furthermore Australia's current retirement income product range is dominated by simple account based pensions. This cost base will

Projection Results: Post Retirement market



Data source: Rice Warner Actuaries, March 2010, Surviving Longevity.

change significantly as alternative income stream products offering reduced risk and greater security, including income for life, are developed, distributed, supported by capital and administered.

Key current issues affecting Retirement Income costs

The major cost related industry issues, perceived and/or real, are:

Issues affecting accumulation and retirement income costs

1. Costs are too high
2. Lack of transparency around costs
3. Too many clipping the ticket too often at too high a price
4. Cost and value of provision of advice
5. Rise of the SMSF

Issues specifically affecting Retirement Income costs

6. Retention of members before and during transition to retirement
7. Limited product and service range for retirement income
8. Lack of Government action to support greater diversity of retirement income products

Retirement Income costs versus value and benefits

For retirement income, value is critical in assessing products and services which meet retirement needs. Top of the list is security of income and risk reduction around receiving such income. This comes at a higher cost, but provides an additional valued benefit. Service and utility aspects including range of choice, flexibility and control over elements of the retirement income benefits and ancillary services being offered. At the same time we must be careful not to use value in the eyes of the provider as opposed to the member as a crutch for higher and less than transparent fees.

Chair Cathy Nance, Partner PwC prepares to introduce Sean McGing at the presentation of his paper at the Institute of Actuaries of Australia Biennial Convention. *Photograph © Institute of Actuaries of Australia.*

Drivers of Retirement Income costs

At a high level, the key drivers around cost and potential cost reduction are:

1. Business model, including:
   a. wholesale / industry / retail, strategy, markets
   b. distribution channel(s) and advice model
2. Scale and volume
3. Operational model – extent of efficiency
4. Operational model – extent of complexity, including:
   a. nature of retirement income products
   b. defined contribution vs defined benefit
5. Investing - active versus passive
6. Investing - asset allocation and access

To minimise retirement income costs requires a deep understanding of how these cost drivers affect a provider of retirement income's current business and an assessment of how to change the products, processes and supply chain to optimise the cost benefit equation and in so doing reduce costs for members and providers.

Assessments

In the paper I considered for each of the key current issues listed above, how the cost drivers behind them might affect retirement income costs. I considered the functional areas in which the costs arise, and how those costs might be reduced going forward. The costs equation is a web of interactions across these issues, cost drivers and functional areas – administration, investment and advice.

I identified what I consider to be the four aspects where there is greatest potential for cost reduction for retirement incomes.

These are:

1. Scale & volume
2. Investment – Passive vs active
3. Government support for retirement income product diversity
4. Advice paid by flat dollar fees

Retirement Income costs – targeting a minimum cost framework

I derived the following principles - to be adopted to achieve a minimal cost framework to members for retirement income:

1. Must have a primary focus on reducing dollar costs. These will then flow through to lower costs as a % of funds under management.

   This requires a fundamental cultural and attitudinal change across the industry.
2. The underlying superannuation (accumulation) industry must in itself be best practice in each of the functional areas affecting costs:
   a. Administration
   b. Investment management
   c. Advice.
3. The Retirement Income sub-industry must in itself be:
   a. Competitive
   b. Transparent
   c. Have a wide range of product solutions to meet retirees' needs
   d. Have supportive government policies, retirement income related legislation and related regulatory regime.
4. Must focus on increasing value for money as well as reducing costs - thus encouraging service(s), including product diversity, to members to be improved.
5. Must recognise the specific specialist needs of retirees and within the retiree group recognise the heterogeneity and different needs across sub-population segments – by age and socio economic circumstances.
6. A need to attack multiple cost issues in parallel.

Conclusions & Recommendations for reducing Retirement Income costs

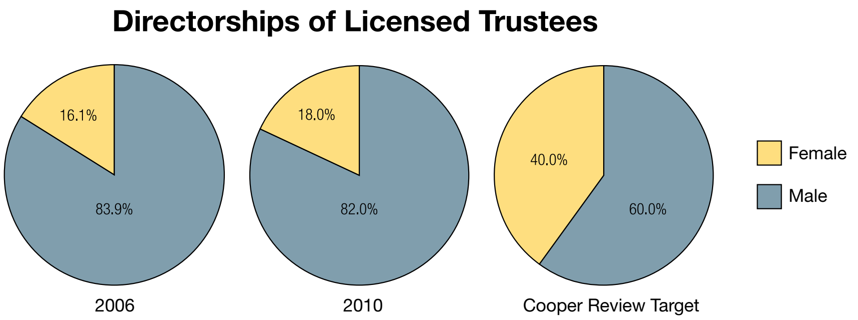
My assessments led me to conclude:

1. Stronger Super and Future of Financial Advice changes set a good base for reducing superannuation accumulation and retirement income costs. They
   - need to be implemented as soon as possible
   - need to be implemented well and need to achieve their objectives
2. Providers should pursue scale via mergers & acquisitions
3. Funds should passively invest a greater portion of their assets
   - target 50% of portfolios in liquid, well traded sectors
4. The Australian Government needs to implement key Henry Review and Institute of Actuaries of Australia recommendations to support retirement income product innovation by the private sector:
   - encouraging a diverse annuity market including deferred annuities
   - issuing or enabling long term suitable matching investments – inflation linked, ultra long term, longevity and infrastructure

   This will enable competitive, value products at higher volumes, less cost and less risk
5. Investment costs for retirement income could also be reduced by setting base contracts in dollars not % of FUM
6. The continued growth of SMSFs will increase the competitive friction around retirement income provision and hence constrain retirement income costs
   - demand for guaranteed and longevity products
   - investment & portfolio construction securities and products
7. Low cost flat dollar fee effective advice options for pre and post retirees will emerge as advice models are road tested and refined.

"A picture paints a thousand words"

Gender Diversity of Trustee Boards



Source: APRA Annual Superannuation Bulletin June 2010 (issued 19 January 2011) – Special Feature article on Gender Diversity of Trustee Boards.

Comment: The Superannuation industry faces a real challenge in changing from good intentions to real change in increasing the number of women as Trustees. It shares this challenge with the rest of the financial services industry – the 2010 figures from APRA range from 8.9% for Friendly Societies to 20.5% for Credit Unions.

Most of corporate Australia's statistics on gender diversity at Board level are similarly low. The lack of diversity is also found at senior management level where pressure is increasing on entities through increased public awareness and recently announced Federal Government detailed public reporting requirements around the progress on gender diversity.

Industry players need to devise and implement strategies to improve the balance while enhancing their talent pools and reducing reputation and under-performance risk.

Further insights from the Institute of Actuaries of Australia Biennial Convention

Institute of Actuaries of Australia

From the plenary sessions, some of the key messages were:

Hazel McNeilage, Head of Funds Management, Queensland Investment Corporation - on Global themes and their implications for investors:

- Distinction between developed and emerging markets losing relevance
- Innovation occurs on a global scale
- Sustained global need for infrastructure investment
- Liabilities matter - be clear on investing needs
- Focus on diversification of risk premia, not asset class labels.

Bernard Salt, Partner, KPMG – on the interaction of demographic change with social issues

- Big impact of Asian influences on Australian lifestyle and consumer preferences
- Extension of working life and change from single target retirement age to transitioning to retirement over a period of several years and at older ages
- Life stages now – Child -> Adolescent -> Adult -> Lifestyle/ Transition -> Retired -> Old
- Rise of the moral consumer
- GFC driven change from celebrity to hero admiration – e.g. Paris Hilton to Susan Boyle.

From a superannuation and wealth management perspective, the main themes discussed were retirement income, longevity, risk management and retiree behaviour.

To illustrate and to whet your appetite for further reading, Sean has summarised the key findings from one of the concurrent sessions he attended:

Financial Wellbeing, Actions and Concerns - Preliminary Findings From a Survey of Elderly Australians *© Tim Higgins & Steven Robert*

In the paper the authors describe a 2010 survey of approximately 3,500 Australians aged 55 and over and report on some preliminary findings. The survey is part of an ARC project which aims to examine how consumer needs and preferences vary over retirement. This research has been funded through an Australian Research Council (ARC) Linkage Grant (LP0776784), and has been supported by AMP and Rice Warner Actuaries (RWA) as linkage partners.

Key Findings:

On financial strategies

- 3 out of 4 cut back or intend to cut back spending
- 3 out of 4 obtained or intend to obtain professional financial advice
- Spending less likely to have been cut back for age 80+
- Less chance of cutting spending for least financially engaged
- Less chance of seeking advice for least financially literate

On financial concerns

- 2 out of 3 concerned about inflation eroding their savings (consistent with US findings)
- 59% pre-retirees/46% retirees concerned about outliving their savings
- Concern drops off after age 75
- Less concern among those in excellent health
- Less concern about inflation or outliving savings for those who never consult with professionals
- Less concern about outliving savings for financial illiterate pre-retirees

The full set of papers and presentations can be found at the Institute's web site www.actuaries.asn.au All opinions expressed are those of the authors and not necessarily those of the Institute.

"Words of Wisdom"

"When a person with experience meets a person with money, the person with experience will get the money and the person with the money will get some experience." - Leonard Lauder

Comment: Leonard Lauder is the son of Estee Lauder, founder of the renowned cosmetics empire, and is currently its Chairman Emeritus. Applying this comment to our world of financial services, our first thoughts are of the interaction of superannuation fund members / investors / policyholders with those who sell them financial products. As the Future of Financial Advice reforms are rolled out, we must remember the power and responsibilities of the salesperson and work hard to ensure that the experience of the member is beneficial and that "the money" passing to the "person with experience" is a fair exchange.

McGing Advisory & Actuarial has a primary focus on the superannuation and wealth management industry. We provide a personalised consulting and support service to directors, senior executives and their teams. Sean McGing and/or his associates can "embed" in your project team as a specialist, lead your team, or provide strategic, operational or technical reviews.

McGING ADVISORY & ACTUARIAL

Suite 8.05 Equitable House
343 Lt Collins Street
Melbourne VIC 3000
Phone (61 3) 8641 6970

sean.mcging@mcging.com.au
www.mcging.com.au
LinkedIn: Sean McGing