

3 April 2014

Mr David Murray AO
Chairman
Financial System Inquiry
100 Market Street
Sydney NSW 2000

Dear Mr Murray

Challenger Limited is Australia's largest provider of annuities and seventh largest fund manager with a corporate vision to provide Australians with financial security in retirement. Challenger's life office is a substantial investor in infrastructure, property and domestic corporate bonds.

Themes

Our submission seeks recommendations from the Inquiry on three main themes:

Theme 1 – Longevity Insurance Products

The current settings of the superannuation system do not result in sufficient mitigation of longevity risk by either individuals or government. This is to the detriment of retiree welfare and the long term fiscal outlook.

There is a need to provide appropriate tax, regulatory and means test arrangements to facilitate growth in the market for immediate and deferred lifetime annuities bought with superannuation and ordinary money. There is also potential for lifetime private health insurance and aged care products.

The growth of life office assets as Australia's ageing population moves into retirement would provide long term funding for infrastructure and other long-tenor investments. It would also grow the domestic corporate bond market.

Theme 2 – Trustee and Adviser Management of Post-Retirement Risk

Financial risks in retirement are markedly different to those in accumulation. There are major gaps in training for superannuation trustees and advisers and gaps in the regulatory regime covering their responsibilities to fund members and clients.

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Regulators need to promote financial education for superannuation trustees and financial advisers to assist them to understand, and require them to better manage, the principal post-retirement risks; longevity, inflation and market risk.

Theme 3 – Minimising Deposit Guarantee Distortions

The introduction of an explicit guarantee on bank deposits has resulted in substantial distortions in the savings, investment and lending markets.

The size and scope of the ADI deposit guarantee needs to be reduced in order to minimise these distortions.

Benefits

Recommendations in these three areas would provide significant public benefits:

- a. Lifetime annuities can improve retirement outcomes by managing the principal risks for retirees safely, efficiently and at lower cost than relying on “self-insurance”, with the retiree gaining access to both mortality credits and illiquidity premia.
- b. The wider use of efficient forms of longevity protection will improve fiscal sustainability for both federal and state governments.
- c. A growing lifetime annuity market will contribute to funding economic development and growth. Life offices invest in infrastructure, long-dated fixed income securities and other assets with long tenors, particularly in areas in which the banks are tenor constrained.
- d. The removal of market distortions created by the excessively high cap on the ADI deposit guarantee will facilitate a return to more efficient allocations of investable capital by reducing the focus of retail savers on the government guarantee.

Prior Challenger Government Submissions

Challenger has made submissions to a number of previous reviews and government processes which have dealt with issues relating to the superannuation system generally, retirement incomes in particular, and other relevant matters, which include:

- The 2007 Simpler Super changes;
- The (Henry) Review of Australia’s Future Tax System;
- The (Cooper) Review into the Governance, Efficiency, Structure and Operation of Australia’s Superannuation System;
- The Tax Forum;
- The Productivity Commission Inquiry into Caring for Older Australians; and
- A number of consultations on ASIC regulatory guidance and APRA prudential standards.

Our approach to these processes has been to commission independent actuarial, economic and other expert third-party reports to provide the basis for submissions. These reports are attached to provide support for the views expressed and statements made in this submission.

Submission Overview

This submission deals with a wide range of issues broadly in the areas of the superannuation system, retirement incomes, funding Australia, and competitive neutrality within the financial system. A brief summary is outlined below:

Theme 1 – Longevity Insurance Products

Retirement incomes policy evolution

This submission commences with a chronology of post-retirement policy beginning, early last century, with the origin of the Age Pension as government provided longevity insurance for those exceeding average life expectancy and with the early adoption of tax treatment which gave rise to the Australian culture of lump sums. This chronology includes, early this century, the demise of policies (principally the Asset Test Exemption) intended to encourage the management of longevity risk. Finally, it records the recent and ongoing debate about the need for private longevity insurance in a financially efficient form to meet the needs of the baby boomers as they retire. This chronology places future policy options in their context.

Henry Review and Challenger submissions on partial annuitisation

This submission discusses the Henry Review examination of the longevity settings for Australia's superannuation system. The Review made important but, as yet, unimplemented policy recommendations. Challenger made submissions the conclusions of which are supported by independent actuarial investigations and other expert reports. The topic areas included:

- The importance of mitigating sequencing risk;
- The propensity of allocated pensions to fall short of providing lifetime income including estimates of when allocated pensions with various starting balances could be expected to fail given withdrawal at the ASFA modest and comfortable benchmarks;
- Partial annuitisation strategies and the positive impact these have on portfolio performance, in both accumulation and pension phase, relative to strategies which do not include an annuity component;
- Behavioural biases of retirees in making annuitisation decisions resulting in systematic market failure drawing upon an academic literature survey;
- Pension arrangements in other jurisdictions drawing on an OECD summary; and
- Outcomes resulting from the Henry Review's consideration of the questions of compulsion, whether longevity products should be guaranteed, and government provision.

Purchase of longevity products with non-superannuation money

This submission discusses the merits of the Henry Review recommendation to allow the purchase of non-commutable lifetime annuities without restriction.

Deferred Lifetime Annuities continue to attract considerable policy attention

Challenger has been a proponent of DLAs (deferred lifetime annuities) to provide a financially efficient form of longevity insurance. These were the subject of a number of favourable findings and recommendations of the Henry Review which are provided here. They were subsequently considered at the Tax Forum which resulted in a limited policy announced in the 2013 Budget but not implemented. This submission summarises those policy debates and argues for a more

general treatment for non-commutable DLAs with appropriate tax and social security treatment consistent with the economic substance of DLAs as a risk product.

Role that Longevity Insurance, Aged Care Insurance and Lifetime Health Cover can play in reducing the longevity risk currently borne by Australian taxpayers

Our submission uses data from a recent Productivity Commission paper, *An Ageing Australia: Preparing for the Future* to argue the need to reduce the amount of longevity risk carried by government. There is a role for life offices providing products which will help retirees manage the longevity risks which they face in aged care and health. Our submission examines some of those product possibilities and the types of regulatory, tax and social security barriers which need to be dealt with by government to facilitate a larger proportion of the ageing population remaining self-reliant.

Role annuity providers play providing long term funding for infrastructure and growth

There is growing debate about the role that superannuation funds should have in funding infrastructure and in providing finance for other capital deepening investments. Superannuation funds have an appetite for infrastructure but, in a choice environment, face liquidity constraints which limit their capacity to invest in less liquid assets including infrastructure and domestic corporate bonds.

To the extent that retirees choose annuities as the defensive component of their portfolio, life offices will seek investments in long term assets such as infrastructure and domestic corporate bonds and are not subject to the same liquidity issues faced by superannuation funds. Long term and lifetime annuities perform better as the defensive component of a retirement portfolio. Life offices can provide better performing long term outcomes to retirees by sharing with policy holders the illiquidity premia the life office obtains by making long term investments, not just in fixed income securities but also in infrastructure assets and property.

Conservative capital standards applying to annuity providers mean the possibility of annuitant loss is remote

By world standards Australian life offices have very conservative capital standards and are well supervised by the regulator. This provides a very high level of protection for policy holders and no further protection by government is required.

Theme 2 – Trustee and Adviser Management of Post-Retirement Risks

Need for improved education for trustees and advisers and expanded responsibilities

Current training requirements for advisers are inadequate in the area of managing the principal post-retirement risks of; longevity risk, inflation risk and market risk (particularly sequencing risk). Challenger has partnered with the University of New South Wales to produce appropriate curriculum and the first course is now being taught to financial advisers. Challenger has also developed a state of the art post-retirement calculator which it provides free to advisers to help them optimise post-retirement solutions for their clients. The availability of appropriate education with accessible analytical tools should be taken into account by regulators in setting standards for the duty of care owed by advisers to their clients and trustees to fund members when providing post-retirement solutions.

Theme 3 – Minimising Deposit Guarantee Distortions

Minimising the distortions created by government guarantees of bank deposits

During the GFC, decisions were taken in relation to bank guarantees which represented a major shift from the previous reliance on depositor preference. These decisions were to introduce an explicit guarantee on most bank deposits under the Financial Claims Scheme and to entrench the assumed implicit guarantee of Australia's larger banks because they are considered too big to fail. Both the explicit and implicit guarantees have created major distortions in the market, including retarding the development of a domestic corporate bond market. This submission proposes a significant contraction in the explicit guarantees provided by government for ADI deposits to reduce the impact of those distortions.

Theme 1 - Longevity Insurance Products

1.1 Retirement incomes policy evolution prior to the Henry Review

A chronology of changes in retirement income policy which commences with legislation in 1908 to introduce the Age Pension is at Attachment 1 – Post-Retirement Policy Chronology. Private pensions have been regulated under the taxation power since 1965. Governments have also sought to influence the behaviour of retirees in relation to their use of private superannuation savings by the use of social security concessions and tax penalties.

1.1.1 Age Pension

In 1909 when it was introduced, eligibility for the Age Pension was 65 years and in 1910 it was lowered to 60 years for women. It was effectively a form of publicly provided longevity insurance since life expectancy at that time was lower than 65 years. In addition to age, eligibility was limited according to character, race, residency and means. With increases in longevity it became means tested income support for retirees with limited or no retirement savings who can now expect to live at least two decades longer.

In 1974 and 1975 the means test was progressively withdrawn for retirees over 70 years. It was reintroduced in 1983.

1.1.2 Lump sums

Australia's pension system is unusual by international standards because it allows retirees to take lump sums without a major tax penalty. This has been the case since income tax was first levied by the Commonwealth in 1915 with only 5% of lump sums included in assessable income under Section 14(f).

An attempt was made to tax lump sums more heavily in 1952 but, according to the Asprey Committee, the legislation was defeated on the argument that progressive tax scales would tax too heavily a lump sum in excess of the proposed RBLs (reasonable benefit limits), which were proposed to be 1 year's salary for every 20 years of service up to a maximum of \$20,000. This maximum RBL was only relevant to executive salaries at the time.

The tax on lump sum retirement benefits was increased in 1983 when a 15% tax was imposed on lump sums up to \$50,000 with a 30% tax rate thereafter up to the RBL (reasonable benefits limit) with larger amounts being taxed heavily unless they were used to buy a pension.

In 1998 RBLs were changed from a single multiple to a tapered scale reducing as income increases. With minor exceptions all benefits deriving from concessionally taxed sources or which were themselves concessionally taxed were made subject to the RBLs.

RBLs were abolished in 2007. At that time they were \$678,149 for a lump sum and \$1,356,291 for a pension. Lump sums were taxed at 0% up to \$129,751 then 15% up to the RBL and 48.5% thereafter. Superannuation pensions were taxed at the recipient's marginal rate with a 15% tax rebate.

1.1.3 Assets Test Exemption

Purchase of complying income streams, non-commutable lifetime annuities and fixed term nil RCV (residual capital value) annuities with a term equal to life expectancy were encouraged with a 100% ATE (Assets Test Exemption). This provided an incentive for those who did not have high enough retirement incomes to exclude them from any Age Pension under the Income Test to either buy longevity insurance or at least match a term certain income to their life expectancy.

In 2004, with account based pensions more prevalent than annuities, the government agreed to an industry request to provide an ATE for a new product TAPs (Term Allocated Pensions) which had both a minimum and maximum drawdown rate and which were non-commutable, except for any remaining balance on death. To pay for the higher Age Pension outlays that were expected to result from the higher take-up of complying income streams, the ATE for all complying income streams was reduced to 50%.

These arrangements were later considered too complex and in 2007 the Assets Test Exemption was abolished entirely in a suite of reforms which provided retirees over the age of 60 with access to tax free lump sums or a pension with no Earnings Tax, Capital Gains Tax or Benefits Tax.

NATSEM (National Centre for Social and Economic Modelling at the University of Canberra) estimate the fiscal cost of a 50% Assets Test Exemption on \$600 million of sales of complying income streams in 2013-14 (using expected sales of lifetime annuities for the year as a proxy for suitable complying income streams, although it should be noted that most current sales are commutable) at \$9 million with an average benefit to the 2,750 family units affected of \$1,600.

1.1.4 2007 Pension Regime

The new pension regime was formulated around ABPs (account-based pensions or allocated pensions), which have become the prevalent form of income stream. The principal requirement was that the retiree had to take a minimum amount each year as determined by a schedule in the pension rules. The schedule, which increases the percentage the retiree must draw over their lifetime, was set to ensure that tax-free superannuation money is used for retirement income and not for tax deferral or estate planning purposes.

Since the abolition of the Assets Test Exemption there has been no tax or social security policy setting on foot which addresses retirees' need for longevity protection. The year 2007 was the high point of the government's assumption that, unlike during accumulation, when an individual reached retirement age, there was no market failure requiring a policy response.

1.2 Henry Review and Challenger's submissions on retirement incomes

The Henry Review challenged some of the policy settings discussed above when it made both superannuation accumulation and superannuation pensions a major focus. Challenger made extensive submissions to the Henry Review. The relevant issues are discussed in this section.

1.2.1 Sequencing risk

Attachment 2 is a report by Towers Perrin presenting stochastic modelling showing the age at which a 65 year old retiree could expect their allocated pension to fail if they drew the ASFA modest but adequate (then about \$19,000) or comfortable (about \$37,000) benchmarks (which include Age Pension entitlement) given starting balances of \$50,000, \$150,000, \$300,000 and \$500,000.

This revealed that if a retiree chose to live modestly even from a \$50,000 starting balance they could expect it to last until they were 84. With a \$150,000 balance, or more, they could expect it to last their lifetime. However if they chose to live comfortably even a starting balance of \$500,000 couldn't be expected to last until age cohort life expectancy. Expected pension failure ages were also provided for a 60 year old retiree. A single conclusion can be drawn from these – don't retire early.

This report was done in 2009 and the outcomes for the same nominal starting balances will have changed, with deterioration since the original investigation as a result of inflation of the benchmark drawdowns offset by the effect of the real increase in the single rate for the Age Pension.

Sequencing risk is a major issue for those approaching, at or just after retirement. While the order of returns is less important to the outcome of a long period of accumulation it can be more critical than the average rate of return when the fund is moving into pension phase. The requirement to draw on capital to provide income means the reduction in the capital base resulting from even a single severe adverse event may reduce the account to a level from which it is unlikely to recover. The consequences for the retiree is a smaller income stream, an income stream which fails earlier than planned, or a combination of both.

Sequencing risk can be reduced with a more defensive asset allocation before and during retirement. Lifecycle funds are designed to address precisely this issue. However there is considerable debate within the industry about when to adjust and by how much, with some funds offering account-based pensions with exactly the same asset allocations as offered in accumulation. To the extent that a retiree annuitises their superannuation assets, sequencing risk is eliminated.

1.2.2 Asset allocation

Australia has the heaviest allocation toward growth assets in the OECD. This is not fully explained either by the preponderance of DC (defined contribution) schemes in Australia or the weight of money in accumulation. The development of compulsory superannuation in Australia coincided with the 'great moderation' and superannuation funds and their members became accustomed to receiving a significant equity risk premium.

This pattern of behaviour was disrupted by the GFC. For five years the government had to halve the minimum draw down rule rates to allow retirees to preserve their capital. This of course meant that retirees availing themselves of this relief had to at least halve (since some had been drawing more than the minimum) the income they were receiving from their allocated pensions. Annuities

required no such relief and performed according to their contractual promises in terms of rate, indexation and duration contained in policies with no losses being borne by policy holders.

The 2012 report of the Melbourne Mercer Global Pension Index (MMGPI) which ranks country pension systems said:

For countries with a “growth” asset allocation higher than 60 percent, as is the case for Australia, a maximum score was not achieved. The reason is that such an allocation provides a high level of exposure to volatile assets, particularly in a country which is predominantly DC, where members bear all the investment risk. A broader range of assets, including corporate bonds and credit, is likely to provide a better long-term outcome for members retirement income products.

The 2013 MMGPI said that the overall index value for the Australian system could be increased by:

- Introducing a requirement that part of the retirement benefit must be taken as an income stream; and,
- Removing legislative barriers to encourage more effective retirement income products.

1.2.3 Behavioural finance

A number of attitudes and assumptions about annuities are widely entrenched in the financial services industry, the principal objections being assumptions that; annuities are not good value relative to allocated pensions; fear of dying early and for estate planning reasons reluctance to commit retirement savings to a product with no death benefit; and reluctance to make an irrevocable investment decision. Some of these assumptions are capable of being addressed by education or product features but others reflect underlying behavioural biases.

Challenger conducted a review of relevant behavioural finance literature (see Attachment 3) and found that there are a number of systematic biases that influence individuals' decisions to buy lifetime annuities:

- Consumers view annuities as risky gambles rather than insurance: “if I die early, I lose; if I live a long time, I win”. On the other hand, economists view annuities as insurance: not against dying but against the risk of outliving your wealth;
- When people evaluate risk, they often depart from the predictions implied by expected utility;
- Overweighting of low probability events and underweighting more frequent events;
- Events or facts that are more easily imagined carry greater salience and hence are assigned greater likelihood overemphasizing the possibility of dying shortly after the annuity is purchased;
- Individuals also overstate the likelihood of catastrophic events that may require sudden spending that could not be met after annuitisation (health costs are often used as a sales argument to steer customers into allocated products with access to capital when in reality the public health system will provide free treatment);
- Survey participants are significantly more likely to choose an annuity in a context that emphasized spending over the lifecycle as opposed to one that emphasized risk and return;
- The main driver of the effect is the overall difference in framing language and not specifically the mention of the purchase price;
- Individuals are more averse to uncertain gambles (where probabilities of outcomes are unknown) than to risky gambles (where probabilities of outcomes are known);
- Any annuity evaluated narrowly as a gamble in its own separate mental account will look more unattractive, because an annuity shifts money from the present into the future;
- The “illusion of control” or the tendency of individuals to believe they can control outcomes even when they have no such control; and

- Denial, individuals do not like to think about unpleasant events (e.g., dying young, or being old but poor). As such, this bias will lead fewer individuals to even consider the annuitisation decision.

At its simplest, rather than evaluating annuities as insurance or part of an investment optimization exercise, many individuals use the narrow framing of “will I live long enough to make back my initial investment?” As a result annuities look less attractive because the “losses” resulting from an early death loom larger in the individual’s mind than the potential “gains” from living a long time. This is as much a market failure as the market failure which the Superannuation Guarantee Levy (SG) is intended to address, in particular an individual’s preference for early gratification over deferred gratification.

The uncertainty, “will I live long enough to make back my initial lifetime annuity investment?” has been removed by life offices providing a guarantee period which ensures that if the policy holder dies early they get a known return. Challenger has introduced lifetime annuities which not only provide a guaranteed return of capital if the annuitant dies within 15 years, but also the option for the annuitant of changing their mind in the first 15 years and getting the same return of capital. After 15 years the annuity becomes non-commutable. This innovation is intended to remove the objection an individual may have with making an irrevocable investment decision. These annuities have sold well. In the year before Challenger entered the lifetime market only 14 lifetime annuities were sold in Australia. Challenger now sells a greater value of lifetime annuities per year than the entire Australian lifetime market when it was at its previous peak. Albeit as a percentage of the total dollars flowing into retirement it represents seven tenths of 1%.

Consumer behavioural biases are a source of market failure. There is strong evidence of market failure in retirees management of their own longevity risk. Policy settings need to address these biases.

1.2.4 Partial annuitisation

Behavioural biases of retirees aside, the critical question is do lifetime annuities make retirees better or worse off? One of the problems with the post-retirement debate is that many critics of annuities typically frame their arguments as an all or nothing decision and make comparisons between lifetime annuities and equities, not the defensive component of a portfolio. They also argue that a lifetime annuity denies access to capital for emergencies and risks a loss of all of the annuitant’s capital if they die early. With partial annuitisation none of these comparisons is valid, including in relation to the consequences of early death given the availability of lifetime annuities which provide survivor benefits, payment guarantees for early death, and the opportunity to choose to commute within a specified period. These are all features which have been introduced by life offices to help potential policy holders overcome their behavioural biases.

What an allocated product does do is allow a retiree to draw a higher income early in retirement and have unlimited access to their capital, at the expense of future income. Lifetime annuities on the other hand help retirees regulate their expenditure. There are also significant factors beyond the control of the retiree (market risk, inflation and longevity) which may well result in an allocated pension failing. The result, in the absence of non-superannuation income, is total dependency on the Age Pension. This is an outcome that those who argue against any annuitisation think retirees should be prepared to risk in the hope that either their fund or the market will out-perform. At page 118 of its Final Report the Henry Review said, “*an allocated pension cannot ensure security of retirement on its own.*” The relevant question for the individual retiree to answer is whether they want their security in retirement to be limited to the Age Pension or the Age Pension with the buffer of a lifetime annuity bought with part of their retirement savings.

Challenger commissioned independent consulting actuaries Watson Wyatt to conduct investigations to answer that question. These investigations, discussed below, did not look at the option of annuitising 100% of the retiree's superannuation balance; rather, these investigations examined combinations of annuities and allocated products, and compared their expected performance, using stochastic modelling, with placing 100% of an individual's superannuation assets into allocated products. The actuarial investigations showed that partial annuitisation resulted in outcome ranges which were superior to the outcome ranges of allocated products where there was no annuitisation. This was true in both accumulation and in pension phase.

1.2.4.1 Use of fixed term annuities in accumulation

An accumulation strategy which included fixed term annuities as the defensive component of the asset allocation produced superior results compared to an accumulation strategy which used bond funds as the defensive component. This reflects, among other things, the fact that annuities pay attractive rates of return given the defensive nature of the product. Watson Wyatt was able to express this additional performance as being equivalent to an increase in the SG over the course of the fund member's working life. If the fund member had an appetite for risk which indicated a 30% allocation to defensive assets adopting the better performing annuity strategy had the same effect on the balance at retirement as a 1.7% increase in the SG. If the fund member had an appetite for risk which indicated a 50% allocation to defensive assets the annuity strategy had the same effect on the balance at retirement as a 2.6% increase in the SG. Lower allocations to growth in accumulation could be expected to result in a lower balance at retirement than higher allocations to growth for both annuity and non-annuity portfolios, so adopting an annuity strategy is more important to achieving a better outcome when fund members have a lower risk appetite. (The report is at Attachment 4).

1.2.4.2 Lifetime annuities in pension phase

Watson Wyatt investigated the use of lifetime annuities as the defensive component of an asset allocation in pension phase and compared it with the expected performance of an allocated pension with no annuity. This submission has already discussed Towers Perrin's investigation of the age at which allocated pensions can be expected to fail. Because there is no age at which lifetime annuities are expected to fail a direct comparison between the performance of annuity strategies and no annuity strategies was done by Watson Wyatt investigating the relative percentage of income streams that would fall below the ASFA adequate pension benchmark by the age of 90 years from a starting balance of \$500,000 drawing the ASFA comfortable benchmark of \$37,000 including social security entitlements. The results were tabulated for all outcomes and adverse outcomes. With the no annuity strategy incomes fell below adequacy in 42% of cases and 71% of those cases with adverse events. In contrast with annuity strategies only 4% of income streams fell below adequacy and 5% with an adverse event. Similarly the outcome ranges showed annuity strategies could be expected to be better performing than non-annuity strategies. (The report is at Attachment 5).

1.2.4.3 Partial annuitisation can help achieve estate planning objectives

Actuarial investigations were also done by Watson Wyatt on the effects of partial annuitisation on bequests. The same starting balance of \$500,000 and drawdown of \$37,000 were assumed. The income stream was continued at the same level regardless of failure of the allocated pension. A reverse mortgage metric was used to calculate negative superannuation balances where there was insufficient superannuation money to cover the income stream. Again the outcome ranges showed annuity strategies could be expected to be better performing than non-annuity strategies. The conclusion that can be drawn from this is that partial annuitisation will help a retiree achieve their estate planning objectives because they will not have to consume as much of their non-superannuation assets to maintain a given living standard. (The report is at Attachment 5).

1.2.5 Henry Review Strategic Issues Paper and Longevity

The Henry Review issued a Retirement Income Strategic Issues Paper which dealt with longevity in some detail, it said:

In developing proposals relating to longevity insurance, it will be necessary to consider whether (or to what extent) the insurance:

- 1. is mandatory or voluntary;*
- 2. provides guaranteed or non-guaranteed income; and*
- 3. is provided by the public or private sector.*

There was considerable opposition to compulsion from within the industry and having given it consideration the Henry Review recommended against it and we are not advocating these. The discussion around it was, however, illuminating on the subjects of adverse selection and community rating.

Annuitisation is widespread in some other jurisdictions (see Attachment 6) and removes adverse selection. Adverse selection is an insurance concept which occurs where people who have good reason to believe they will live a long time choose to buy an annuity knowing it represents good value for them. Alternatively people who have reason to believe they will live shorter lives choose not to buy an annuity. These decisions to buy an annuity or not to buy an annuity will reduce the rate a life office can offer annuitants, which could trigger even greater adverse selection.

The Strategic Issues Paper pointed out that compulsion would be detrimental to those groups with higher mortality, including sick, poor and indigenous people to the extent that their higher mortality may not be reflected in the price of the annuities they purchase. Challenger commissioned actuarial investigations by Watson Wyatt on the effect of known unhealthy lives on annuity pricing. (The report is at Attachment 7). Based on experience of actual lives the investigation found that pre-existing health conditions, like diabetes and cardiac disease, were not good markers for offering higher annuity rates. However a multi-factor socio-demographic model using UK post codes as a proxy indicated mortality differences providing a basis for a 10% difference in annuity pricing between the lowest and highest socio-demographic deciles. On an equity basis this is an argument against community rating because in a competitive market retirees in demographics with higher mortality can expect to receive better annuity rates than retirees in demographics with lower mortality.

A related issue is the relative pricing of annuities for males and females. Men get better rates because, on average, they have shorter lives, although that mortality gap appears to be shrinking. The European Union has recently decreed that life offices cannot have pricing which discriminates on the basis of gender. Where annuitisation is voluntary, rational behaviour would result in more women than men buying annuities resulting in annuity rates falling as men decline to join annuity pools because they do not represent fair value for them.

1.2.5.1 Guaranteed or not guaranteed

There has been recent academic interest in GSA (group self annuitisation) where a superannuation fund pools the idiosyncratic longevity risk of its members. The difference between a GSA and a life office is that life offices commit shareholder capital to guarantee an outcome for policy holders, including against systemic mortality improvements. This is something a superannuation fund running a GSA cannot do.

Proponents of GSA argue that life offices' capital requirements are too onerous and better rates can be offered without it. That may be true in some circumstances but it ignores the fact that one of

the roles of the capital requirements set by the prudential regulator is to ensure longevity risk is properly priced including the population component of longevity risk. With GSA, all but the idiosyncratic longevity risk remains with the superannuation fund member. Because of the group annuitisation, a member may be restricted in moving his investment to another fund. Adverse investment events and general improvements in mortality may result in reductions in promised benefits. There is also a risk of intergenerational transfers of wealth from new members to old.

Australia has very little experience with these non-guaranteed longevity products and this limited experience has not been good from a member stand-point. Lifetime annuities offer a trade-off; if the retiree agrees to put capital into a longevity pool the life office guarantees the return. On the other hand, under GSA, the superannuation fund asks the member to commit their capital to a longevity pool but the superannuation fund cannot guarantee a return. As a result, the member has retained a significant risk, one which they are not well placed to understand or quantify when comparing with a fully guaranteed product.

On the question of whether longevity insurance should be guaranteed or non-guaranteed at page 124 of its Final Report the Henry Review said:

“The government should also consider removing other legislation constraints that may inhibit the development of longevity products. However, this should not be at the cost of necessary prudential or consumer protection. Given the nature of these products, they should only be provided by prudentially regulated entities. Products that provide a guaranteed income should follow consistent prudential requirements to reduce the risk that a provider is unable to meet their obligations as they fall due.”

1.2.5.2 Government provision

Two sets of arguments were put by various parties to the Henry Review favouring government provision of annuities. One was that the government had a lower cost of capital and could therefore provide better rates. The second was that the government's balance sheet was needed to provide certainty to annuity holders.

In addressing these arguments Challenger commissioned Access Economics to prepare a report addressing the claim that because government has a lower cost of capital it can provide annuities at a better rate. (The report is at Attachment 8). The report shows that paying a return to annuitants of higher than the government bond rate would involve a taxpayer subsidy. If done on a sufficiently large scale, the additional longevity risk and effect of any subsidy implicit in the price would eventually impact the government's own cost of funding.

On the second point Challenger commissioned Chris Dalton, a former Australian Country Head of S&P to prepare a report on how ratings agencies would view the Australian Government becoming a provider of annuities. (The report is at Attachment 9). In short, ratings agencies would not look favourably upon a government which became a retailer of annuities.

It is important to note that public provision of pensions inevitably results in a long term deterioration of a country's fiscal position. The cause of this is the political process. The value of the promised pension inevitably becomes divorced from the mechanism to fund it, a situation which cannot continue long in a commercial environment.

Government provision of annuities makes no more sense than government ownership of banks. Government should not be a provider of any retail financial product apart from Commonwealth Government Securities.

The Henry Review was also asked to contemplate the Department of Social Security offering a purchased annuity up to a specified limit. There was no discussion of the resources required, the sheer complexity, or the risks associated with turning the Department of Social Services into a provider of financial advice. The Henry Review said the government should only do this if there was a private supply side failure. The government response to this recommendation was to rule out the government being a provider of annuities.

1.2.6 Deferred Lifetime Annuities

Challenger put a proposal to the Henry Review to remove the effective prohibition on providing DLAs (deferred lifetime annuities). DLAs are a non-commutable lifetime annuity which is purchased on a single date or over time and begins to pay a benefit at a later date provided the policy holder survives to that later date. The DLA continues paying benefits until the death of the policy holder. The size of the benefit is large relative to alternative defensive products due to both the compound interest on the premium during the deferral period and the “mortality credits” generated by the possibility of receiving fewer payments because of a shorter life. As pure longevity insurance, bought on retirement and not paying until the policy holder’s age cohort life expectancy, a DLA will pay a benefit as an indexed pension that is comparatively large in real terms relative to the original premium. This use of pooling of longevity risk would allow retirees to cover their income needs late in life for a significantly smaller amount than they would need to save to provide the same income from an allocated pension. The DLA transfers all of the associated risks to a life office which is not only able to manage them but provides a prudentially regulated guarantee backed by shareholders’ capital.

The availability of DLAs will make the job of financial advisers and superannuation trustees much easier. Instead of having to deal with longevity risk the adviser or trustee can focus on the strategy necessary to make retirement savings last the known period until the DLA begins to provide an income stream. Of course the retiree remains exposed to the market, which may perform better or worse than is necessary to deliver the objectives of that strategy. It is likely that when advisers go through the arguments for use of DLAs, which will introduce the benefits of pooling at a relatively low price, many of their clients will see the logic of buying immediate lifetime annuities and the take-up of these will increase.

The Final Report of the Henry Review supported DLAs:

- *“The Review has also identified the role that deferred annuities can play in an ageing society. These products commence from a specified age and are a type of insurance against running out of income in retirement.” (page 543)*
- *“Products are not available in the market to cover the broad range of preferences of retirees in achieving security of income. This is a structural weakness in the Australian retirement income system. The main product on the market that does achieve this security of income is a guaranteed income for life...Given the diverse preferences of retirees, a single product is unlikely to satisfy all people who wish to manage their longevity risk. This suggests a need for product innovation within the Australian market.” (page 118)*
- *“The increasing life expectancies of Australians will require a greater choice of retirement income products that can cater for the different needs of individuals in retirement. There are not enough products that guarantee an income for the whole of a person’s retirement.” (page 120)*

- *“Deferred annuities (overseas), which provide an income from a certain age, are also becoming more prevalent. These annuities allow a person to lock in part of their retirement savings to generate an income when they are entering the latter stages of their retirement. This provides a person with more certainty in how they manage the rest of their assets before the commencement of the deferred annuity.” (page 123)*
- *“many people prefer to have the security of knowing they will always have an income above the Age Pension” (page 118).*
- *“given the unique nature of deferred annuities, there is a case that they should only be means tested when they start to pay an income, unless a person can access the capital before this time.” (page 126)*
- *“the rule requiring a minimum payment to be made from a pension every year does not cater for deferred annuities.” (page 119)*

There was nothing in the government response to the Henry Review on these findings and recommendations. Challenger subsequently had the opportunity to raise the subject of DLAs at the Tax Forum in 2011 (see Attachment 10) and pointed to the need for the following reforms:

Consistent with the recommendations of AFTS and a detailed examination of the tax and regulatory impediments to the provision of DLAs by KPMG and Lander and Roger (see Attachment 11) and provided to government by Challenger, the following matters require policy reform:

1. Amend the SIS definition of a superannuation pension to include deferred lifetime annuities so they will be eligible for the Benefits Tax exemption for persons over 60 years.
2. Clarify the Earnings Tax treatment of non-commutable deferred lifetime annuities during the deferral period to explicitly recognise that they are risk products.
3. Clarify the accruals tax treatment of non-commutable deferred lifetime annuities to ensure that they can be bought either by an individual or by the trustee of a superannuation fund.
4. Amend the APRA prudential standard on minimum surrender values so that non-commutable deferred lifetime annuities are not treated as investment products during the deferral period.
5. Exempt non-commutable deferred lifetime annuities from social security and aged care assets tests during the deferral period, as proposed by AFTS.
6. Exempt non-commutable deferred lifetime annuities from the minimum drawdown rules during the deferral period, as discussed by AFTS.

The then Treasurer and then Minister for Superannuation included the need for more work on DLAs in their concluding remarks to the Tax Forum and indicated a willingness to work with the industry on post-retirement issues.

Subsequently, in its April 2013 superannuation statement and the 2013 Budget, the previous government announced a policy measure to remove the effective prohibition on superannuation DLAs. As from July 2014 DLAs would be given the same tax treatment as other superannuation pensions and exempted from the minimum draw down rules during the deferral period.

The government’s policy announcement had no fiscal impact in the forward estimates period, so from the absence of any revenue impact it can be inferred that:

1. The measure related to DLAs bought with superannuation money;
2. It was specifically focussed on longevity insurance bought at retirement;
3. There was no Assets Test Exemption, which would have had some fiscal impact; and
4. DLAs will not be commutable to an individual or their estate and are therefore a risk product. If they were not a risk product, which also requires pooling, other pension structures would be likely to characterise accumulation as deferral which would have a significant impact on revenue).

Consistent with the Henry Review findings, it seems likely that, for the purposes of prudential and consumer protection, the entities providing DLAs would be subject to prudential regulation and the same capital standards as other longevity products. Challenger discussed the measure in some detail in a paper delivered to the UNSW Colloquium of Superannuation Researchers in July 2013 (which is at Attachment 12).

This policy measure remained unlegislated when the government changed and the new Assistant Treasurer subsequently announced that there would be a review of post-retirement products.

The benefits of opening the market to deferred lifetime annuities are material. Removing the impediments to DLAs should be an immediate policy priority

1.2.6.1 DLAs a risk product

The appropriate benchmark for non-commutable DLAs is that they are a risk or insurance product. Policy holders pay a premium and the receipt of the income stream is conditional on survival with no death benefit payable to either the policy holder or their estate. Other risk products are not subject to accruals tax or any tax on earnings on the premium. It should be noted that life offices issuing risk products are subject to the full company tax rate on changes in the difference between assets and liabilities in their statutory funds. Risk products are not subject to means tests unless a benefit is actually paid.

In public policy terms one of the desirable characteristics of DLAs is that they must be non-commutable to provide the mortality credits that underpin the attractive pricing. In the past there have been many products which have been described as non-commutable, such as deferred annuities which provided a lump sum, but in the case of the DLA described here the economics for the life office require that it be non-commutable to be deliverable. For the purposes of public policy, including reducing the call on future outlays for the Age Pension, it must deliver the promised lifetime income stream.

Restricting the product to purchase on or after age 60 limits the circumstances in which a DLA can be provided. Retirees will want to have the choice to:

- Buy deferred lifetime annuities when capital market conditions are favourable before they reach preservation age to better manage the risk associated with the timing of their retirement;
- Buy longevity insurance by instalments over the latter part of their working lives to average in its costs; and
- Use the DLA structure to gradually contribute to what is effectively a private, indexed DB pension with part of their SG contributions from early in their working lives.

If non-commutable lifetime DLAs are treated as a risk product there should be no impediment to providing them in these circumstances. Consistent risk product treatment would also facilitate the provision of LTCI (long term care insurance) for aged care and lifetime private health insurance.

1.2.6.2 Minimum deferral period

Treasury has raised as a question of possible policy whether it would be appropriate to impose a minimum deferral period on DLAs. This is not only unnecessary it would be inadvisable:

1. It would stop people nearing retirement using a DLA to better manage the interest rate risk associated with the timing of their retirement. For example a short deferral period timed to coincide with the date of retirement for what otherwise would have been an immediate lifetime annuity purchased on that date.
2. We currently know little about how people's decision to purchase a DLA will be affected by the length of the deferral period. If some arbitrary minimum deferral period is imposed it may well curtail take up of the product.
3. It would impact the ability of advisers and superannuation funds to use DLAs to optimise retirement solutions.

1.2.6.3 Indicative pricing

Current indicative pricing for a \$10,000 initial investment in a DLA today (27 March 2014) by a male who is exactly 65 years old, with no death benefit during the deferral period, no tax during the deferral period, a 26 year deferral period (that is to age cohort life expectancy for a male voluntary annuity buyer), with CPI indexed payments made monthly, and mortality assumed for a functioning market, the annual payment would be \$4,651 a year in today's dollars (real terms). If the deferral period was for 20 years, that is to age 85, the annual payment under the same assumptions would be \$2,390 a year in real terms.

1.2.6.4 Purchase of lifetime annuities with non-superannuation money

The Henry Review considered making it easier to purchase lifetime annuities late in life:

- *"There should be no restrictions on people wanting to purchase longevity insurance from a prudentially regulated entity. This would be an important element in making it easier for people to purchase these products." (AFTS page 116)*
- *"People should be able to purchase these products with superannuation as well as non-superannuation money." (AFTS page 126)*
- *"The restriction on people aged 75 and over making contributions should be removed. However, a work test should still apply for people aged 65 and over. There should be no restrictions on people wanting to purchase longevity insurance products from a prudentially regulated entity. (AFTS Recommendation 20)*
- *"In many cases, people may choose not to purchase longevity insurance at their retirement age. As they grow older they may be in a better position to judge their potential longevity. However, after a person retires they may be unable to make further contributions into a superannuation fund due to the work test rules. These restrictions should not apply to contributions made to a prudentially regulated superannuation fund or life insurance company for the purposes of purchasing a longevity product." (AFTS page 126)*

Some people will choose to annuitise later in retirement. A major purpose of Henry Review Recommendation 20 would be to allow retirees to transfer non-superannuation assets to a superannuation income stream of a kind where there could be no tax deferral or estate planning mischief. It would also help people securely manage their wealth through the period where they experience cognitive decline. This Henry Review recommendation was not pursued by the previous government.

1.3 Reducing Government exposure to longevity risk

The Productivity Commission research paper, *An Ageing Australia: Preparing for the Future*, which was released late last year sets out the major drivers of budgetary pressure over the next 50 years.

Table 1: Australian Government Budget Pressures grow over the next 50 years

	2011-12 Share of GDP%	2059-60 Share of GDP%	Change Share of GDP%
Health care	4.1	7.0	2.9
Age pension	2.7	3.7	1.0
Aged care	0.9	2.6	1.8
Education	1.9	1.7	-0.2
Other (including disability)	11.2	10.2	-1.0
Sum	20.7	25.1	4.5

Table 2: State and Territory Governments Budget Pressures grow over the next 50 years

Health care	2.4	3.8	1.4
Education	3.5	3.2	-0.3
Disability	0.2	0.5	0.3
Sum	6.1	7.5	1.4

Source: An Ageing Australia: Preparing for the Future, Productivity Commission, November 2013

The Government's response to these pressures should include encouraging greater self-provision by individuals in the areas of retirement income, aged care and health care. A critical component of encouraging self-provision is to facilitate arrangements which provide for the pooling of longevity risk. This is a financially efficient means of self-provision for individuals. Pooled longevity products are less costly than self-provision since, without pooling, provision would need to be made for significantly outliving one's life expectancy. Pooling within life offices is supported by Australia's prudential regulatory regime which provides those wishing to participate in pooled products assurance that the promises made to them by regulated institutions will be met.

Given that retirement incomes, aged care and health are all subject to social safety nets, the alternative is that the government bears much more of these costs through means test arrangements and outlays on public hospitals as the population ages.

Challenger commissioned Access Economics to estimate the long term fiscal benefits of a modest take-up of DLAs. This report, which is at Attachment 13, was released at the Tax Forum. It showed that with an average take-up of a \$10,000 DLA premium, that as a result of the Age Pension and aged care means tests, there would be fiscal savings in 2050 of 0.18% of GDP.

Some argue that because the government has the largest balance sheet and the lowest cost of capital, it is therefore best placed to manage these liabilities. These risks may be aggregated by government but that does not remove them or mean that they will necessarily be properly managed. There are a number of prominent examples of countries which have demonstrated that the burden of not properly managing these risks ultimately falls on the community. Government provision in this area is problematic because of the political separation that occurs between acceptance of liabilities and the means of paying for them. This problem cannot persist for long in a commercial environment.

Longevity risks can be transferred to private APRA regulated balance sheets where it will be appropriately capitalised and properly managed. This transfer of longevity risk to the private sector

happens through the uptake by individuals of products which reduce their likelihood of relying on public safety nets. Immediate and deferred annuities are the most obvious and important of these products. There are other product opportunities in areas of aged care and private health insurance which could see further longevity risk transferred off the government's balance sheet. Adjustments to regulatory settings are required to facilitate their development.

In the area of aged care, Challenger's submission to the Productivity Commission Inquiry into Caring for Older Australians (see Attachment 14) proposed the government allow provision of risk products, with either single or periodic premiums to provide payments to cover aged care costs as a form of LTCI (long term care insurance). The products would be in the form of a non-commutable deferred lifetime annuity with known real return priced on the risk of needing care (survivorship and age of needing care), and longevity (the expected length of time in care). Such products would be more affordable for retirees because of the lifetime cap on aged care fees under the new aged care regime.

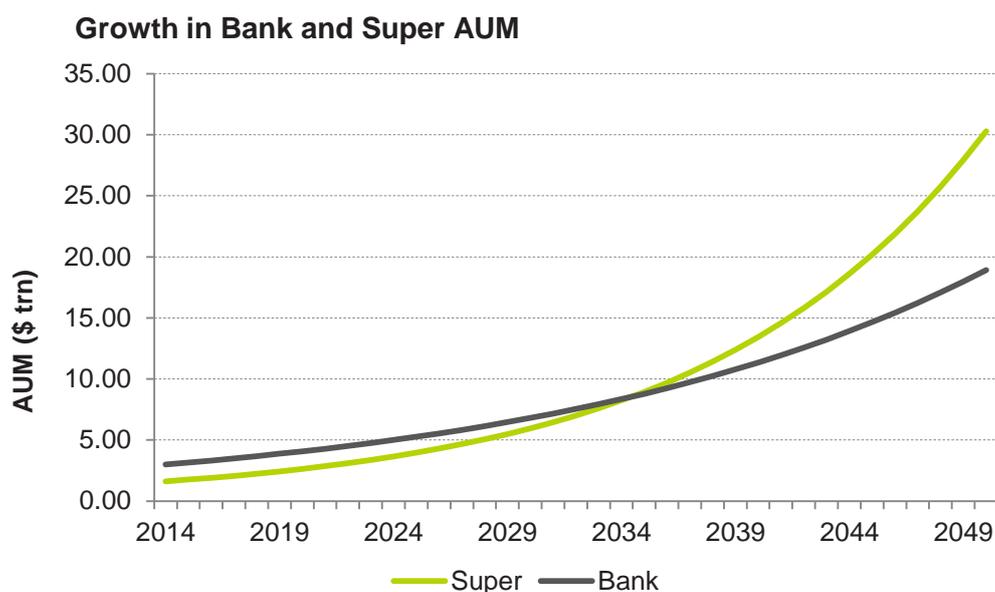
Rather than liquidating their house and other assets to fund an accommodation bond, or not being able to find a place in suitable care, a proportion of frail aged do seek appropriate financial products, in the form of either conventional loans or reverse mortgages. Life offices could offer a single premium loan product to pay the nursing home accommodation bond at a fraction of the upfront cost of the bond to the resident. This is dealt with in more detail in Attachment 14.

In the area of private health insurance, a deferred or immediate lifetime annuity structure could also be used to fund lifetime health insurance cover for retirees. An additional premium could be attached to regular private health insurance payments over a lengthy period during the insured's working life or a large single premium could be used on retirement to provide lifetime health cover commencing from a date on or after retirement.

1.4 Life offices a source of long-term funding

Providers of lifetime annuities invest with a considerably longer investment horizon than superannuation funds. The need for liquidity on the part of super funds restricts their ability to adopt a longer term horizon. Banks also adopt shorter investment horizons than annuity providers. A greater role for annuity providers in the retirement income system will result in more funding available for infrastructure projects and other long duration investments. This is consistent with the broad public policy objective of funding Australia's future.

Superannuation assets are expected to grow considerably more quickly than bank balance sheets. From a base of domestic bank asset of \$3 trillion and superannuation assets of a little more than half this, total superannuation assets will overtake bank assets in around 20 years (*Deloitte, 2013, Maddock 2014, Challenger 2014*).



The ageing of the population and the move of baby boomers to the retirement phase will see a significant growth in post-retirement assets with this rate picking up after the next decade or so as new retirees (early Gen X retirees) enter the retirement phase with higher accumulated savings. By 2030, post-retirement savings will reach a projected \$800 billion out of a total superannuation savings pool of some \$5.8 trillion (*Deloitte, 2013*).

There is currently much public debate about who can and should finance nation building and capital deepening projects. What is the capacity and appetite of governments, the banking sector, superannuation funds, life offices, other non-bank financial market participants, and households to meet the funding requirements for Australia’s economic growth? In his scene setting paper “Funding Australia’s Future: From where do we begin?” Prof Kevin Davis focused on several significant issues:

“If banks face a declining share of new savings, how will the supply of new financial assets (securities) available for super fund investment be created? Will super funds take on, in some way, a larger role as creators of financial assets?”

“An important issue in this regard is the extent to which super funds currently feel constrained to limit investments in illiquid assets to allow for potential future changes in asset allocation (or member withdrawal)” (Davis, Page 6).

“... it is apparent that the Australian financial system has not fully adapted to the interaction of demographic trends and the growth of the superannuation system. Population growth and technological change are driving a need for significant infrastructure investment which governments are unwilling to fund on-budget, while bank lending is heavily focused on households and, arguably, constrained by deposit supply. Superannuation funds appear averse to the risk and illiquidity of large positions in individual infrastructure projects, and taking on project risk of “greenfields projects” (Page44).

The question of where superannuation funds should be invested must ultimately be answered by superannuation trustees according to their duty which is defined by the sole purpose test. The primary question of public policy is whether superannuation funds are unduly constrained by liquidity requirements, which limit their investments in suitable assets that would provide their members with illiquidity premia and better retirement outcomes. The factors driving these liquidity

constraints are member choice (the ability to switch between internal investment options or to another fund) and a competitive dynamic that focuses on short term measures of performance. Regulatory settings also have an impact. In situations of financial stress, regulators will focus on liquidity requirements to ensure the equitable treatment of all members at a time when many of them are seeking to reallocate to more defensive assets.

As Philip Lowe, Deputy Governor of the RBA noted in his recent speech Opportunities and Challenges for Market-based Financing (25 March 2014):

“Given that balances in superannuation funds are essentially ‘at call’ and can be moved at short notice, these funds need to ensure that they remain quite liquid at all times. This inevitably reduces the attractiveness of relatively illiquid assets like corporate bonds. From one perspective it seems slightly curious that long-term retirement savings can be moved at short notice. Over time, there may be a benefit in exploring other arrangements that are more conducive to investments in illiquid assets.”

To the extent that retirees choose annuities as the defensive component of their portfolio life offices will solve part of that superannuation liquidity problem. Long term and lifetime annuities perform better as the defensive component of a retirement portfolio. Life offices achieve those outcomes by sharing with policy holders the illiquidity premia the life office obtains by making long term investments, not just in fixed income securities but also mature infrastructure assets and property.

Growth in annuities will also sponsor development of a more vibrant corporate bond market in Australia. In his speech, “Opportunities and challenges for market based financing”, RBA Deputy Governor, Philip Lowe, put particular focus on Australia’s underdeveloped domestic corporate bond market:

“By international standards, the Australian corporate sector makes relatively little use of the bond market, especially the domestic bond market. Since the mid-2000s, the available internationally comparable data suggest that average annual bond issuance by Australian corporations has been the equivalent of just under 1 per cent of GDP , with around two-thirds of total issuance taking place offshore..”

“So as things have turned out, superannuation funds, rather than financing the corporate sector directly, have helped finance the banks, which in turn have financed the corporate sector. In effect, we have seen a lengthening of the chain of financial intermediation – from savers to superannuation funds to banks to borrowers. This is not quite the financial disintermediation that some had expected a decade and a half ago.”

Life companies invest heavily in corporate credit assets. Challenger, for example is a major participant in the public and private debt markets in Australia. Growth in annuities will drive a corresponding growth in the domestic corporate bond market. Credit creation through a broader set of channels than just banks is healthy and will lead to more efficient allocations across the economy.

1.5 Annuity provider capital standards

It has been argued above that a greater role for annuity providers in the provision of retirement incomes within the Australian financial system provides desirable public policy outcomes. In this context it is relevant to consider the capital standards surrounding annuity providers (life insurance companies) with two (slightly competing) questions in mind: first, are the current capital settings conducive to the growth of a vibrant industry; and second, is it necessary to layer additional policy

holder protection such as government guarantees on top of the capital requirements and prudential regulatory arrangements more generally?

1.5.1 Overview of current standards

Life insurance capital requirements, as set out in prudential standards issued by APRA, target a 99.5% probability of sufficiency. That is, a prescribed capital amount is set such that:

“if a fund was to start the year with a capital base equal to the prescribed capital amount, and losses occurred at the 99.5 percent confidence level then the assets remaining would be at least sufficient to provide for the adjusted policy liabilities and ‘other liabilities’ of the fund at the end of the year.”

This level of sufficiency represents a “hard floor”, that is the point below which the life office would be in breach of the Life Insurance Act 1995 (the Act). The Act requires that the life office satisfies prudential standards at all times. A prudent life office will therefore hold capital over and above this hard floor in order to ensure that there is a low probability that it will be in breach of its regulatory requirements. Indeed, APRA has set out that, through its “ladder of supervisory intensity”, it will be engaging with life offices regarding their capital levels well before any breach of regulatory requirements occurs.

The combination of a hard floor set at 99.5% probability of sufficiency, along with expectations of significant capital buffers over and above the regulatory minimum, results in extremely high probabilities of sufficiency.

Overly conservative capital requirements are detrimental in that it results in one or both of the following outcomes:

- Policy owners and prospective policy owners must pay a higher price for an equivalent benefit.

If investors in the life insurance industry are to maintain an appropriate return on capital, increased capital requirements must be financed through an increase in prices, or decrease in return to policy owners. This will make life insurance products less attractive to policy owners and prospective policy owners and reduce the size of the market.

In particular, as the amount of capital held increases, it provides diminishing improvements in security, while the cost of holding that capital increases proportionally. This leads to a point at which the marginal cost of holding further capital exceeds the marginal benefit in reduction in expected loss.

- Reductions in returns to policy owners and prospective policy owners will exacerbate existing problems that are already widely identified:
 - the level of under insurance in respect of death and disability cover; and
 - the overexposure of retirees to market risk, longevity risk and CPI risk.
- Investors in the life insurance industry must receive a lower return on capital if investors in the market cannot earn an appropriate return for the capital that they provide to the industry, they will seek to withdraw that capital in order to invest it into other areas that provide better returns.

Given that the best protection for policy owners is that a life office has access to additional capital should the need arise, and that investors will not be willing to provide additional capital if it is uneconomic to do so, such a result would be detrimental even to existing policy owner interests.

In this context, we note that section 3(1) of the Act states that:

“The principal object of this Act is to protect the interests of the owners and prospective owners of life insurance policies in a manner consistent with the continued development of a viable, competitive and innovative life insurance industry.”

While onerous capital requirements may marginally reduce the probability of loss for a policy owner:

- They impose a real on-going cost on policy owners through lower returns, and are therefore overall contrary to the interests of owners and prospective owners of life insurance policies; and
- The reduction in the value proposition available to prospective policy owners, and the further deterioration of competitive neutrality between similar product offerings of banks and life insurers, are inconsistent with the continued development of a viable, competitive and innovative life insurance industry.

We further note that the basis on which APRA has the power under section 230A of the Act to determine standards in relation to prudential matters is *“in order to protect the interests of policy owners or prospective policy owners of the life companies that are to comply with the standards”*. It could be argued that a focus solely on probability of default is an unreasonably narrow interpretation of the interests of policy owners and prospective policy owners. An assessment of the interests of policy owners and prospective policy owners must take account of their ability to purchase products that provide real protection and an acceptable value proposition.

Further, Australia’s capital standards for life insurers are more conservative by international standards. While this arises due to a number of aspects of the respective standards, a particularly material impact arises from the discount rate assumed.

Under prudential standards, a life office in Australia issuing an annuity is required to recognise a liability equal to the present value of the future payments and expenses at a risk free discount rate. This risk free discount rate is determined based on a Commonwealth bond rate plus an illiquidity premium, which generally results in an overall discount rate below the swap rate.

By contrast, under Solvency II, the directive that harmonises European Union capital regulation, a life company discounts future payments at a discount rate which includes a “matching adjustment”, which is a margin which reflects the spread within the assets backing the annuity liability. The intention is to prevent changes in the value of assets, caused by spread movements, from flowing through to a life office’s balance sheet for portfolios where companies have fully or partially mitigated the impact of these movements. This recognises the difference between losses arising from real defaults, and those arising from credit spread movements, and seeks to avoid life companies becoming forced sellers of assets where they intend to hold the assets to maturity.

Overall, this results in lower capital requirements for life offices complying with Solvency II compared with Australian capital standards.

Australian capital standards which are conservative relative to international equivalents can be detrimental to the interests of Australian consumers and place Australian life insurers at a disadvantage.

They can lead to:

- higher costs and reduced product choice for consumers; and
- a competitive disadvantage to local entities and encourage the transfer of risk to jurisdictions with lower capital imposts.

1.5.2 Capital Harmony with ADIs

In order to provide competitive neutrality (a key tenet of any efficient and developed financial market), regulatory treatment including capital requirements should be the same for products and portfolios that have similar economic risks regardless of whether they are written by ADIs, life insurers or non-life insurers.

Term certain annuities issued by life insurers have the same risk profile as term deposits issued by ADIs, and yet the capital imposts on term certain annuities are materially higher than those of term deposits even where those liabilities are backed by the same assets. This results in significant competitive advantages to ADIs over life insurers in a market where their products are close substitutes.

This capital disadvantage imposed on life insurers versus ADIs is despite the fact that ADIs have a higher target probability of sufficiency than life insurers, at 99.9% over 12 months versus 99.5% over 12 months, and despite the fact that:

- ADIs represent a greater systemic risk than do life insurers.
- ADIs enjoy the additional government support of implicit and explicit government guarantees, and the support of the RBA acting as a lender of last resort.

A major component of this capital disadvantage is the method used to determine the liability that a company must recognise for capital purposes. An ADI issuing a term deposit recognises the face value of the liability for capital purposes, whereas a life office issuing a term certain annuity with identical cash flows is required to hold the present value of the future payments and expenses at a risk free discount rate.

To illustrate:

- If an ADI were to issue a five year term deposit of \$100,000 paying a rate of 100bps over the swap rate, it would be required to recognise a liability of \$100,000.
- By contrast, a life office issuing an identical term certain annuity would be required to discount future payments and expenses at a discount rate based on the Commonwealth bond rate plus an illiquidity premium. Assuming the discount rate equated to around swap minus 20bps, and expenses of around 50bps, a life office would be required to recognise a liability of around \$108,000.

As a result, a life office is required to provide capital support equal to 8% of its liabilities, in addition to any capital required to support the assets backing those liabilities, whereas the ADI is not required to hold any liability capital. This represents a significant additional capital impost on a life company compared with an ADI and therefore decreases competitive neutrality. Further because the impact arises from the discount rate, there is an increasing level of disharmony as the term of the deposit/annuity increases.

1.5.3 Implications

Both by world standards and relative to banks, Australian life offices have very conservative capital standards and are well supervised by the regulator. This provides a very high level of protection for policy holders. It is unnecessary to contemplate an additional layer of policy holder protection, such as in the form of a government guarantee. These conservative capital standards come at a cost to consumers in terms of product choice and price. In its ongoing role of setting capital standards, there may be opportunities for the regulator to rebalance the partially competing objectives of policy holder protection and industry development.

Theme 2 – Trustee and Adviser Management of Post-Retirement Risk

2.1 Development of post-retirement curriculum

Several years ago Challenger recognised the need for specific curriculum development in the area of managing post-retirement risk and entered into a partnership with the University of New South Wales to provide it. Challenger has funded this work and will provide access to its state of the art post-retirement adviser tool described below. The UNSW Australian School of Business has full academic control of the course content and on 23 of May 2013 the ASB (Australian School of Business) Postgraduate Coursework Education Committee approved the course, ACTL5401 Retirement Planning, for teaching in the ASB's postgraduate programs. It will be primarily delivered in the postgraduate suite of ASB programs in Financial Planning. The course will be offered on a stand-alone basis or as an option in the suite of Financial Planning programs: the Graduate Certificate in Financial Planning (7273), the Graduate Diploma in Financial Planning (5273) and the Master of Financial Planning (9273).

At the conclusion of this course, students should be able to:

- Understand the changing demographics of the Australian population, particularly in relation to increasing life expectancies.
- Understand the key features of the available publicly provided and privately provided retirement income products, including the Age Pension, other publicly provided benefits, superannuation benefits, and the interaction between these.
- Understand the risks faced in retirement including longevity risk, inflation risk, interest rate risk, adequacy risk, contingency risk and political risk.
- Critically assess the available publicly provided and privately provided retirement income products against the risks faced in retirement.
- Understand and critically assess alternative residential options, aged care and health expenses in retirement, as well as implications for estate planning.
- Formulate and evaluate alternative financial plans for and in retirement.
- Understand and appreciate factors influencing consumer behaviour, including behavioural biases, skills and expectations.

The teaching program has commenced. Both Challenger and UNSW will pursue opportunities to make this teaching program widely available through other institutions, including Challenger's own Retirement Incomes Academy which it established to provide professional development for advisers working for the major wealth managers and independent dealer groups.

With the baby boomers beginning to retire, advice for older Australians and in particular advice on post-retirement planning and risk management will be the largest growth area for advice.

2.2 Review of RG 146

Retirement is different and financial advice for retirees must have a specific focus on managing the principal post-retirement risks; longevity risk, inflation risk and market risk, particularly sequencing risk for those approaching retirement. Most curriculums for training financial advisers have an inadequate focus on managing these risks. With the baby boomers already moving \$72 billion a year from accumulation to pension phase it is essential that this deficiency is addressed in ASIC's current review of RG 146.

Current adviser training is deficient in the area of post retirement planning. Existing curriculum does not cover managing longevity risk; how long an individual can expect to live, how long they may live, the principal retirement risks (longevity, inflation and market risk), the implications of sequencing risk, particularly early in pension phase or approaching pension phase, and the use of longevity insurance and other lifetime products to manage risk and deliver income.

Advisers need the ability to talk to their clients about their life expectancy, that is how long they can expect to live, how long they may live and how long they will need to remain in the labour force. As retirement planning will be a major focus of almost every long term financial planning relationship this is a discussion which needs to be started as early as possible. This is necessary to ensure that clients can set realistic retirement savings targets which reflect both their life expectancy and available human capital.

There should be a specific topic covering sequencing risk, that is the difference in total return outcome for an individual between long-term average returns and actual returns as determined by the dates at which a client invests and exits their investments. Training in portfolio theory appears to miss this distinction between average returns and individual investor outcomes, determined by the timing of the individual's investment relative to adverse events. The implications of this for a consumer's actual investment experience justify a specific focus in this area.

For the purpose of revising RG146 the following specifics should be included in the regulatory guidance:

- An ability to explain to a client in general terms how long a man or a woman can expect to live and how long they may live. This requires a general understanding of the difference between average life expectancy and age cohort life expectancy, as well as an awareness of ongoing mortality improvement;
- An ability to explain to a client in general terms the principal financial risks in retirement, in particular; longevity, market and inflation risk;
- A general understanding of sequencing risk, that the order of returns can be more important than the average return, and the particular implications of adverse market events close to (before, at or after) retirement;
- A general understanding of post-retirement product types and the extent to which their features manage, or do not manage, the principal retirement risks;
- A general understanding of the difference between account based products, annuities and other defined benefit pensions, the relevant regulatory arrangements including capital standards, and the respective risks carried by the retiree and product provider with each;
- A general understanding of how lifetime annuities work including the availability of mortality credits; and,

- A general understanding of the expected costs of health and aged care and the choices available to retirees to provide for these or, alternatively, to rely entirely on government provided safety nets.

2.3 Superannuation trustees' duties on post-retirement

Superannuation trustees should have specific obligations in relation to post-retirement. The Cooper Review dealt with this matter in its recommendation 7.4:

“Trustees must devise a separate investment strategy for post-retirement members in MySuper products which has regard to the factors as set out in section 52(2)(f) of the SIS Act as well as inflation and longevity risk.”

This recommendation was never enacted by the previous government and should apply to post-retirement products generally.

2.4 State of the art post-retirement adviser tools

Challenger responded to these deficiencies by developing a state of the art tool or calculator to assist financial advisers to analyse the key post-retirement risks, develop solutions, and illustrate and explain to their clients the choices available to them to manage those risks. The adviser tool has:

- Full social security functionality using a retiree's own personal income and assets to project their Age Pension entitlements;
- A stochastic engine (provided by Towers Watson) to;
 - Analyse the expected performance of allocated pensions,
 - demonstrate the effects of sequencing risk, including by reversing the order of returns, and by showing the outcomes of a portfolio in historical periods such as the Great Depression and 1987 stock market crash as well as in bull markets;
- The capacity to show how the Age Pension, fixed term and lifetime annuities, and allocated pensions can be combined or layered to meet the client's income objectives and reduce risk;
- Functionality using the stochastic model runs to calculate the probability that a selected allocated pension will last to a particular age at a given rate of drawdown; and
- The facility to provide age cohort life expectancies.

The Challenger calculator provides financial advisers with a means of working through with a client the difficult question of how much income they can afford to take in retirement. Properly addressing this question was a key element of the advice evaluated as excellent in ASIC's recent post-retirement Shadow Shopping Survey. Having had that kind of engagement with a client to establish the amount of annual income they can afford to take, the adviser then has a tool that can be used to ensure that income level is achieved with a minimum of risk.

Since its development more than two years ago this calculator has been made available free to advisers. The availability of this kind of technology can assist financial advisers providing post-retirement advice and superannuation trustees designing post-retirement products to produce optimised solutions that manage both risk and uncertainty.

Regulators should encourage the availability of these analytically powerful but simple calculators to improve the quality of advice and provide advisers with the capacity to document their decision making processes.

Theme 3 – Minimising bank deposit guarantee distortions

As a result of government action during the GFC there has been a marked movement away from depositor preference to both explicit and implicit government guarantees on ADI liabilities.

3.1 Deposit guarantee

The FCS guarantee on deposits is the explicit guarantee. It provides banks with a competitive advantage over all other entities regardless of their relative credit strength. This sits at odds with the principle of competitive neutrality, one of the benchmark recommendations of the Wallis Inquiry and an important input to the proper functioning of a market economy in allocating capital.

During the GFC as an emergency financial stability measure the Australian Government announced it would guarantee bank deposits. The guarantee was capped at \$1 million per person per ADI. At the time the Government had draft legislation for an FCS (Financial Claims Scheme) to provide a much smaller deposit guarantee and this mechanism was legislated with the revised cap. The FCS was subsequently reviewed and the cap on the government guarantee was reduced from \$1 million to \$250,000 per person per institution. The FCS is to be funded ex-post, first from the proceeds of winding up the failed ADI and then from a levy on surviving ADIs. The economic justification for the FCS is as a financial stability measure to avoid loss of confidence by depositors who might otherwise drive a bank run. The problem with having a high cap on the government guarantee, and providing the cap on a per person per institution basis (affording an individual multiple access to the guarantee by spreading cash around a number of ADIs) is that it has become a defacto guarantee on investments and is significantly impacting retail investment strategies. To the extent that a large component of savings are directed to ADIs motivated by the FCS the moral hazard and taxpayer backed contingent liability is unnecessarily amplified.

As a result, rather than retail investors considering the risk return trade-off across the spectrum of potential investments available to them, many retail investors happily accept what might be seen as a generous fixed term deposit rate given the comfort of an explicit government guarantee. This has resulted in a significant distortion of retail investments at the expense of investments in institutions and funds that are not ADIs, and this has flow on effects limiting the availability of finance to households and businesses which otherwise would have been funded by NBFIs (non-bank financial institutions). An independent report for Challenger Limited by Prof Kevin Davis and Martin Jenkinson of the ACFS which discusses these distortions and which concludes that the FCS needs to be reviewed, can be found at Attachment 15.

Treasury's estimate of the government liability in a worst case scenario with a \$250,000 cap is \$688.2 billion or around 45% of GDP as at 31 March 2013 (Budget Statement No 8). This is an excessive misuse of the Australian Government's balance sheet and demands a reduction in the cap to a level commensurate with the original purpose of the scheme to provide affected households with a minimum level of liquidity during a bank workout. That means a range of \$50,000 to \$100,000, which is more consistent but still exceeding annual payments to households under the Social Security safety net, and would substantially reduce the government's contingent liability.

A recent RBA review "*Depositor Preference in Australia*", *RBA Bulletin, December Quarter, 2011* includes a survey of arrangements for comparable jurisdictions with the deposit caps equivalent to roughly A\$100,000 in local currency terms. Only the US offers equivalent coverage to that applying in Australia.

Whatever cap is chosen, to remove the distortion of the scheme being used to provide an effectively unlimited government guarantee on personal investments it should be applied on a per person basis and not a per person per institution basis.

The previous government announced that it would support continuation of the FCS and would move to establish an “ex-ante” fund to contribute to any future claim under the scheme:

“The Government will progress a recommendation from the Council of Financial Regulators, which includes the Reserve Bank of Australia and the Australian Prudential Regulation Authority, to establish a dedicated Financial Stability Fund to help meet any future cost of the Financial Claims Scheme (FCS), as well as the cost of other resolution activities that protect depositors. The dedicated Fund will build gradually over time to a target size of 0.5 per cent of total deposits protected by the FCS. Establishing the Fund is expected to have a net positive impact on the budget of \$733 million over the forward estimates, from 1 January 2016.” (Economic Statement, August 2013)

In the absence of risk based funding, the FCS is not compliant with the Core Principles for Effective Deposit Insurance System, the international standard for deposit insurance set by the International Association of Deposit Insurers. The new government has yet to clarify its position on a fee.

The projected costs of the scheme appear to assume a low expected loss given a failure, with potential costs limited by the existing and so far completely adequate depositor preference regime. The budget estimates are based on a fee of 5 bps with a pool of funds accumulated over 25 years equivalent to less than 0.5 per cent of covered deposits (Council of Financial Regulators FOI). The target 0.5 per cent of covered deposits (see Economic Statement, 2013 above) and the 25 year accumulation period are at the lower end of international efforts.

A fee of a handful of basis points will do nothing in terms of addressing the distortion or the moral hazard. The public policy conundrum is that to be effective in reducing the distortion and the moral hazard the fee would need to be market referenced (e.g. credit default swap) and the result would be an unacceptable burden on the interest income of household savers. Therefore the most effective means of reducing the market distortion, moral hazard and the government’s contingent liability is a substantial reduction in the cap and narrowing of application of the FCS.

The deposit guarantee should be limited to coverage of at-call transaction accounts rather than including less liquid investment products such as term deposits. The cap should be reduced to between \$50,000 and \$100,000, and applied on a per person basis not per person per institution as is the case currently. If individuals feel they have a particular need for a guarantee above a modest cap they should be free to purchase deposit insurance from a private provider other than the institution where their deposit is held.

3.2 Too big to fail

There is an implicit government guarantee extending to the big four DSIBs (domestic systemically important banks). This implicit guarantee exists because these institutions are regarded as too big to fail and provides the institutions which have it with a significant competitive advantage. The value of this is reflected in the credit ratings agency up-lift factor of two for the big 4 banks and one for Macquarie Bank and the regional banks.

There are two widely accepted methods of measuring the advantage offered by the implicit guarantee.

3.2.1 Credit agency ratings uplift factor

Standard and Poor's regard the Australian authorities as unlikely to move in any decisive way to address the size of the implicit guarantee:

"Our current view is that the Australian government is one of 12 governments globally of the 86 banking systems where we assign bank ratings that is "highly supportive" to its domestic banking sector. The potential move by the Australian government toward an alternate resolution regime that embraces a concept of senior creditor bail-in could sit uncomfortably with our "highly supportive" designation. This could result in changing our views concerning government support, which, in turn, would likely be accompanied by downgrades of Australian banks that we currently view as "systemically important." Absent greater clarity concerning the government's appetite for a change in crisis management, we note the government's strong track record of support to the banking sector in both ordinary and extraordinary times, including via the current depositor-protection scheme (the Financial Claims Scheme, or FCS) and via the repo-eligibility of Australian mortgages and other collateral. With four large Australian retail commercial banks controlling about 80% of banking assets--and the remaining 20% of system assets shared between more than 160 other prudentially supervised institutions--and with the Australian banking sector reliant upon bond and other senior unsecured domestic and offshore funding sources, we believe that the Australian government is likely to have significant incentives to continue to support domestic systemically important banks and would likely carefully consider any change in crisis management given the structural underpinnings of the economy and banking sector".

3.2.2 Yield spread differential/Credit Default Swaps

This is the standard, market-based measure. It is less preferred by authorities because of influences which may reflect "general shifts in risk appetite unrelated to individual institutions". It does, however, provide another metric and confirms the advantages enjoyed by the SIBs in raising debt at concessional rates.

According to the OECD:

"Implicit guarantees imply very significant funding cost advantages for the banks that benefit from them. They thus create distortions to competition and an invitation to use them and, perhaps, take on too much risk.....The preliminary discussions by the OECD's Committee on Financial Markets on the issue suggest that there is no unanimity as regards to what the policy response should be. Should the implicit guarantee be made explicit and a user fee charged in turn? Delegates were rather sceptical regarding this suggestion. That said, some delegates were open to the idea of charging user fees for government guarantees, thus effectively transforming implicit guarantees into explicit ones. Many others suggested however that the focus should be on reducing guarantees through indirect charges in the form of higher capital and other requirements, so as to incentivise banks to become smaller, less complex and interconnected, and hence, more resolvable." (OECD "Implicit Guarantees for Bank Debt: Where Do We Stand?" OECD Journal of Financial Market Trends, Volume 2112 – Issue 1).

3.3 Economic impacts

3.3.1 Explicit guarantees

The change from relying predominantly on depositor preference to explicit and implicit guarantees has had an effect on competitive neutrality. Challenger has asked Chris Murphy at Independent Economics to model the economic costs associated with this disturbance to allocative efficiency of the explicit guarantee of bank deposits through the Financial Claims Scheme. Challenger will make this report available to the Financial System Inquiry as soon as it is available.

3.3.2 Implicit guarantees

DSIB status confers considerable advantage when it comes to debt raising and the cost of debt. According to the IMF:

“The four large banks are estimated to have a wholesale funding cost advantage of about 80 basis points prior to the global financial crisis (GFC) and 120 basis points in 2009, during the GFC”. (FSAP Australia “Addressing Systemic Risk Through Higher Loss Absorbency” Technical Note, November 2012, IMF)

The latest Global Financial Stability Report issued this month presents the IMF's estimates of the increases in capital requirements for Australian D-SIBs. To achieve a one-year-ahead probability of 99.9 percent of not defaulting on any payment would require additional Tier 1 capital of up to 2.8 percent of risk weighted assets. To achieve a 99.95 percent probability of not defaulting it would require additional Tier 1 capital of up to 5.2 percent of risk weighted assets.

Apart from nostalgia for reliance on depositor preference, Challenger does not have a solution to offer on the market distortions created by too big to fail.

Challenger hopes this submission and its supporting attachments are a useful contribution to the Inquiry's consideration of the management of post-retirement risk and removing distortions arising from the current settings of the Financial Claims Scheme. We appreciate the constructive engagement we have already had with you, other Inquiry panel members and the Secretariat. We look forward to making further contributions as your deliberations progress.

Yours sincerely

David Cox
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