

Dear panel members,

Thank you for this opportunity to provide a submission to the Financial Services Inquiry. I would like to comment on section '8: Retirement Income', subsection 'Retirement income products'.

In particular I would like to highlight the potential for 'Group self-annuitisation' on a deferred basis (GSA-DB) as a potential solution for allowing individuals to successfully manage longevity risk with respect to their retirement.

Longevity risk describes the problem of individuals needing to 'over save' for their retirement as well as 'underspend' during their early 'active' retirement years out of fear of outlasting their savings.

Why GSA-DB assists with longevity risk?

A GSA-DB which pays an annuity from a certain date provides individuals with the ability to manage the financial impact of surviving past an expected age.

Potential for attractive pricing

To manage longevity risk, it is possible to create an attractively priced¹ GSA-DB products using the following parameters:

- opportunity to purchase entry into the product between the ages of 60-70 with better pricing for those who purchase earlier in this range;
- no amounts payable if death before the age the annuity starts to become payable (i.e age 85 or a certain minimum number of years from purchase date);
- income payable from the age the annuity starts and continues for the individual's lifetime.

Those who survive past the age the annuity starts are funded by:

- their purchase price (capital) and investment returns on that capital;
- the purchase price and investments returns on that capital of those who have not survived or only survive for a shorter period of time after the annuity commences

By purchasing entry into the GSA-DB from age 60 up to a certain age, both the impact of investments compounding as well as the risk that the individual doesn't survive to annuity payment age, can result in significant longevity risk protection for the pool of participants at a reasonable cost. It is effectively a bet by the individual that they survive past the age at which the annuity starts to pay.

Informational imbalance – GSA-DB product manufacturers and intermediaries able to generate super normal profits

For consumers and the Commonwealth Government, a significant risk for such a GSA-DB is the likely informational imbalance between the consumers purchasing the GSA-DB and the manufacturers and sellers of the GSA-DB. It would difficult for consumers to determine what might be a fair price to pay for such a product.

If left to the market, this type of informational imbalance will almost certainly lead to super normal profits for manufacturers and intermediaries at the expense of consumers and ultimately, the tax payer (in the form of higher than necessary age pension expenditures).

¹ <http://www.theaustralian.com.au/business/wealth/deferred-lifetime-annuity-a-big-step-towards-addressing-increasing-longevity/story-e6frgac6-1226613610520>

Further, a GSA-DB would require significant government regulation and oversight as per superannuation funds and Australian banks. It would also risk the need of a government bailout if a provider failed.

It is unlikely the information imbalance could be solved by financial advisors etc due to issues of vertical integration by financial institutions² and 'poor advice'³⁴ that has been recognised as an ongoing problem in the Australian system.

To demonstrate the informational imbalance, consider the financial education and experience require to make an 'informed decision' regarding a privately provided GSA-DB. For example, the United States has set up 'Qualifying Longevity Annuity Contracts (QLACs)' which are somewhat similar to a GSA-DB. What chance do normal consumers have in making informed decisions given the complexity described with respect to these products. See this extract below:

"Benefit Projections

What would a \$75,000 QLAC buy? Based on a current estimate, a 65-year-old woman who buys this annuity today, with payments to begin in 20 years, would at age 85 begin receiving monthly payments of about \$3,190. That adds up to \$38,280 annually. In simple terms, you could say the annuity would "pay for itself" if she lives at least until age 87. Of course, that calculation fails to account for the opportunity cost — what could have been earned on that \$75,000 over the course of the next 20 years.

If you assume a conservative 4 percent average annual return, it would not quite double, and end up at \$164,000. If beginning at age 65, a modest 10 percent of that amount were withdrawn and spent by the retiree each year, that would only equal \$16,400 a year—considerably less than the \$38,280 annual annuity payout. Even at a more aggressive 15 percent annual withdrawal rate, the annual cash flow would be \$24,600, not quite two-thirds of the annuity payout.

On the other hand, if the retiree who bought the annuity died at age 87, nothing would be left to heirs, whereas had she not purchased the annuity, a sizable chunk of the \$164,000 would be available for heirs. But that's the gamble one takes with insurance, and the price one pays for peace of mind."

<http://www.wsrp.com/longevity-annuity-now-an-option-for-your-401k>

How did you go with that? At the Perth public forum for the Financial Services Inquiry, I believe I remember one Financial Services Inquiry panel member indicating that research showed many people have trouble with understanding basic financial concepts such as simple interest, let alone compound interest⁵. Read the extract above again with this in mind!

How to solve the imbalance – Public provision of a GSA-DB

To deal with the informational imbalance, it would seem appropriate for the Commonwealth Government to offer a GSA-DB to individuals. The Commonwealth would need to ensure that the investments and capital were only available for the purposes of providing a benefit to the members.

² <http://riskinfo.com.au/news/2014/07/03/serious-conflict-posed-by-vertical-integration/>

³ [https://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/Advice_Report.pdf/\\$file/Advice_Report.pdf](https://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/Advice_Report.pdf/$file/Advice_Report.pdf)

⁴ <http://www.yourmortgage.com.au/article/97-of-financial-planners-fail-the-asic-test-121928.aspx>

⁵ ASIC – Report 230: Financial literacy and behavioural change

<http://www.financialliteracy.gov.au/media/218309/financial-literacy-and-behavioural-change.pdf>

The Commonwealth could contract in the best specialists in Australia and the world to work out the most appropriate design for the Australian context with affordability and sustainability as key elements.

Potentially, the Commonwealth could use an insurer or panel of insurers to provide the administration of applications to join and payments to members of the GSA-DB. (Or alternatively, use the existing Centrelink administrative capabilities to deliver the administrative needs of such a product).

The Commonwealth is able to ensure economies of scale in the administration of product, contract in the appropriate specialists to ensure affordability and sustainability of design and has the incentive to ensure the product is prudently managed and appropriately priced.

Prudent management by the Commonwealth allows the certainty of a 'government guarantee'⁶, lower Commonwealth expenditure on the Age pension and appropriate pricing to ensure that the assets and income are fairly distributed to participants to ensure the ongoing sustainability of the GSA-DB.

Commonwealth experience with significant investment pools

The Commonwealth already manages significant pools of investments via the Future Fund Board of Guardians with support of the Future Fund Management Agency⁷. The only difference with the pool of money in the GSA-DB is that these are the pooled private savings of Australians which the Commonwealth is managing and investing for the sole purpose of reducing these Australian's longevity risk.

The long term nature of such a pool of investments and the lower need for liquidity could lend the pool towards longer investments without needing to focus on short term return on investment timelines⁸.

Voluntary or compulsory

Such a GSA-DB could be made on a default 'opt-out' basis for all Australians. This opt out provision could use the current superannuation data so that:

- any Australian;
- with a certain minimum superannuation account balance⁹;
- at a certain age;
- is sent a communication that indicates that unless instructed otherwise;
 - a certain default amount of their superannuation will be withdrawn from a nominated superannuation fund/s to pay for entry to the GSA-DB¹⁰.

⁶ Guarantee in this context is from failure due to fraud or mismanagement, rather than some guarantee as to the amount of income payable in the future.

⁷ <http://www.futurefund.gov.au/>

⁸ <http://www.oecd.org/daf/fin/private-pensions/TrendsInLargePensionFundInvestmentInInfrastructure.pdf>

⁹ Through mandatory reporting (Member Contribution Statements) the Australian Tax Office is provided with the information to determine every super fund member's total account balance. Given this information, the Commonwealth is able to make an assessment that if a person's superannuation saving are under a certain amount, it would be inappropriate to direct those savings into a GSA-DB.

¹⁰ The Government could make an assessment as to the 'safety net' default payment to a GSA-DB to enable a reasonable 'default' response to manage the longevity risk.

Australians would be able to choose not to participate, or potentially choose a higher or lower amount (subject to appropriate parameters). An 'opt out' approach means that those who don't feel confident making a decision are effectively swept into the system through inaction but at a minimum 'default' level which the Government specialists have calculated as appropriate.

A compulsory approach to a GSA-DB should be avoided. A proportion of members in a compulsory system would almost be guaranteed to die before any benefit was payable¹¹. It also means those who are unwilling to purchase the GSA-DB to manage the longevity risk or have the financial capability to manage longevity risk are afforded the choice to do so.

Summary

It is likely that a voluntary, GSA-DB product administered by the Commonwealth would allow Australians to manage their longevity risk. Due to the information imbalance described above, the Commonwealth government should offer the GSA-DB. This will ensure that individual's savings are not transferred to product manufacturers and intermediaries as super normal profits.

A Commonwealth provided GSA-DB allows individuals to manage their longevity risk in retirement by saving enough super to fund a defined number of years of their retirement with a modest amount used to purchase the GSA-DB.

¹¹ Australian Bureau of Statistics, 3302.0 – Death, Australia, 2012
<http://www.abs.gov.au/ausstats/abs@.nsf/Latestproducts/3302.0Main%20Features32012?opendocument&tabname=Summary&prodno=3302.0&issue=2012&num=&view=>