

26 August 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 the 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.

We believe that an expanding annuity market, driven by demand from an aging Australian population and an appropriate regulatory framework, will allow life offices to make a significant contribution to addressing the challenges and priority issues identified by the FSI in its Interim Report.

Executive Summary

Our submission is organised into three sections responding to specific information requests within the following chapters of the Interim Report:

1. Chapter 8 (Retirement Income) within the Emerging Trends section;
2. Chapter 5 (Stability) within the Post-GFC Regulatory Response section; and
3. Chapters 3 (Funding) and 4 (Superannuation) within the Growth and Consolidation section.

In *Emerging trends: Retirement incomes*, we compare international pension systems to identify options to improve the performance and fiscal sustainability of Australia's post-retirement arrangements. We propose changes including the removal of impediments to allow the provision of cost effective solutions including DLAs, and default arrangements for those who do not make an alternative choice, using combinations of guaranteed lifetime annuities and ABPs. To implement these changes we discuss the government's policy options for changing the behaviour of retirees, addressing the options raised by the FSI ranging from defaults, through to incentives and mandates.

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Post-GFC regulatory response: Stability reviews the post-GFC regulatory response and the unintended market distortions that have occurred. We focus on the Financial Claims Scheme and the less onerous capital standards that banks operate under compared to other prudentially regulated financial funding providers such as life offices. We argue that there is scope for further distortions if annuity social security treatments were allowed to be applied to products offered by institutions operating outside life company capital requirements. We also express our concerns that relabeling all general advice as “sales” may be to the detriment of consumer education outcomes.

In *Growth and consolidation* we consider the role that life offices can play in funding infrastructure, and in supporting the development of an Australian corporate bond market. We also examine the SME lending and consider the role that life offices and other non-bank financial institutions can play.

Our submission has nine attachments, six of which are completely new material.

- Attachment A: Patricia Pascuzzo. *“An International Comparison of Pension Systems Performance in Delivering Adequate Retirement Income”*
- Attachment B: Prof Hazel Bateman UNSW, *“Retirement Planning Course and Curriculum”*
- Attachment D: NATSEM, *“Fiscal and Household Impact of Excluding Complying Assets from the Pension Asset Test”*
- Attachment G: Towers Watson, *“Comparing Retirement Income Strategies”*
- Attachment H: independenteconomics. *“Economic Impacts of Reforming the Financial Claims Scheme”*
- Attachment I: Ernst & Young, *“Comparability of capital requirements across different regulatory regimes”*

An additional three were attachments to Challenger’s previous submissions to the Henry Review which contain costings, economic analysis and actuarial investigations not previously provided to the FSI:

- Attachment C: Access Economics, *“Retirement Incomes Policy: Annuities Simulations Paper”*
- Attachment E: Rawlinson and Cater, *“Retirees’ Longevity Risk”*
- Attachment F: Access Economics, *“Public and private pension provision in Australia”*

We refer throughout this submission to the attachments made to Challenger’s previous FSI submission.

In reflecting upon our original submission and this one, we have examined the list of overarching issues under the themes identified by the FSI in its Interim Report and map out below the contribution which life offices and annuities can make.

Contribution of life offices and annuities to FSI's overarching issues under identified themes

FSI priority issues	Large scale annuitisation contributions
Emerging trends	
Retirement income and ageing	Guaranteed income for life protecting against market risk, inflation risk and longevity risk Strongest foundation for default product requirements in retirement Reduced reliance on Age Pension improves fiscal sustainability Safe financial solution for cognitive decline
Technology	Adviser tools can optimise complex retirement solutions
Post-GFC regulatory response	
Stability	Retirees do not exit annuities in a crisis
Consumer outcomes	Improved advice around retirement risks
Regulatory architecture	Annuities inside the prudential perimeter Annuities outside FCS but need to reduce distortions
Growth and consolidation	
Competition and contestability	Superior performance relative to other defensive assets
Funding economic activity	Increased demand for infrastructure assets Support development of corporate bond market Contribution to SME lending
Superannuation efficiency	Annuities provide most efficient and effective longevity cover

Table of Contents

FSI information request	Challenger submission section
Emerging trends: Retirement income	
A spectrum of options to achieve the objectives of the retirement income system and position Australia to manage the challenges of having an aging population.	1
Maintain the status quo with improved provision of financial advice and removal of impediments to product development.	2
Provide policy incentives to encourage retirees to purchase retirement income products that help manage longevity and other risks; Introduce a default option for how individuals take their retirement benefits; Mandate the use of particular retirement income products (in full or in part, or for later stages of retirement).	3
No change to current arrangements	4
Take a more flexible, principles-based approach to determining the eligibility of retirement income products for tax concessions and their treatment by the Age Pension means-test	5
For product providers, streamline administrative arrangements for assessing the eligibility for tax concessions and Age Pension means-tests treatment of retirement income products	6
Issue longer-dated Government bonds, including inflation-linked bonds, to support the development of retirement income products	7
Would deferred lifetime annuities or group self-annuitisation be useful products for Australian retirees? Are there examples of other potentially suitable products?	8
If part of retiree's superannuation benefits were to default into an income stream product, which product(s) would be appropriate?	9
Will the private sector be able to manage longevity risk if there is a large increase in the use of longevity-protected products? How could this be achieved?	10
Should Government increase its provision of longevity insurance? How would institutional arrangements be established to ensure they were stable and not subject to political interference?	11
What are some appropriate ways to assess and compare retirement income products? Is 'income' efficiency a useful measure?	12
Post-GFC regulatory response: Stability	
Modify the FCS, possibly including simplification, lowering the insured threshold or introducing an ex ante fee. What measures could be taken to simplify the FCS with minimal burden on industry, while still ensuring the effectiveness of the scheme? What is an appropriate threshold for the FCS guarantee of deposits?	13
Maintain the current calibration of Australia's prudential framework.	14
Rename general advice as 'sales' or 'product information' and mandate that the term 'advice' can only be used in relation to personal advice.	15

FSI information request	Challenger submission section
Growth and consolidation	
Funding	16
What are the impediments to the development of liquid, tradeable claims on infrastructure projects?	16.1
As a greater share of the population enters retirement, would the demand for fixed income products increase in the absence of regulation or other incentives? Would the development of annuity-style retirement income investment products encourage the growth of fixed income markets?	16.2
What are the best options to narrow the informational gaps between lenders and SME borrowers? What are the prospects for a market for securitised SME loans developing? What are the main barriers to greater broker activity in SME finance? Are these barriers transitional or structural in nature?	16.3
Consider additional mechanisms to MySuper to achieve better results for members, including auctions for default fund status.	17.1
Replace the three-day portability rule: <ul style="list-style-type: none"> • With a longer maximum time period or a staged transfer of members' balances between funds, including expanding the regulator's power to extend the maximum time period to the entire industry in times of stress. • By moving from the current prescription-based approach for portability of superannuation benefits to a principles-based approach. 	17.2

Emerging trends: Retirement income

The submission presents an international comparison of pension systems to identify possible parametric changes which could improve the performance and fiscal sustainability of Australia's post-retirement arrangements. We consider the characteristics of products currently used in Australia to deliver retirement income and their relative efficacy for managing the principal post-retirement risks (longevity, investment and inflation risk). We focus particularly on the impediments to the provision of DLAs as a cost effective component of retirement solutions and consider some of the difficulties and risks associated with GSAs. We propose default arrangements for those who do not make an alternative choice, using combinations of guaranteed lifetime annuities and ABPs to provide optimal retirement income solutions which will provide reliable lifetime income with enough flexibility to be acceptable to retirees. We show how retirees with inadequate retirement savings can make a significant addition to their household wealth by accessing mortality credits through a lifetime annuity. We discuss the government's policy options for changing the behaviour of retirees, addressing the FSIs questions as a continuum covering defaults, incentives and mandates. We present a new GOFI (goodness of fit) index for evaluating the relative performance of retirement products and product combinations for inclusion in defaults.

FSI information request	Challenger submission section
A spectrum of options to achieve the objectives of the retirement income system and position Australia to manage the challenges of having an aging population.	1
Maintain the status quo with improved provision of financial advice and removal of impediments to product development.	2
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1. Spectrum of options

Challenger commissioned a report 'An International Comparison of Pension Systems Performance in Delivering Adequate Retirement Incomes' by Patricia Pascuzzo (of Superannuation Advisory) to consider exemplars of international good and poor practice in both pension system performance and fiscal sustainability. The report is Attachment A to this submission and the executive summary follows:

"The purpose of this paper is twofold: First, to examine the outcomes produced by the Australian retirement income system compared with pension systems in comparable countries overseas. The scope of retirement systems for this purpose includes both public pension and mandatory private savings systems (so called Pillar 1 and 2). The outcomes of interest for the purpose of this study are income adequacy and fiscal sustainability. Adequacy relates to the benefits that are currently provided by the system while fiscal sustainability focuses on the likelihood that the current system will be capable of delivering these benefits into the future. Second, to compare pension systems designs across the same group of countries, particularly focusing on exemplary systems, with a view to identifying suitable reform options.

Given the recognized robustness of the Australian retirement income framework, including both its universal means tested pension and compulsory complementary superannuation system, this paper is not considering broad structural reforms. Rather its focus is to identify significant parameters in the system that could be altered to deliver enhanced retirement outcomes for Australians.

In general terms, adequacy implies that people in retirement should enjoy a living standard that is comparable to the one they experienced during their working lives. This thinking leads to pension replacement rates as a meaningful measure of adequacy. Australia's relative performance in terms of this measure depends to a large extent on the basis of the analysis. Projections of replacement rates that assume the current design of the pension and superannuation systems has been in operation for the full working life of the retired population provide an unrealistically positive perspective on the Australian system's design. This shows Australia ranks highly (5th) in terms of net replacement rates for people on 50% of average wage, but less highly for those on 100% average weekly earnings (11th) and 150% of average weekly earnings (14th).

These results, however, provide little insight on retirement outcomes today or even within the medium term. Evidence on actual (rather than projected) replacement rates in the late 2000s presents a different picture. According to OECD estimates, Australia's replacement rate for over 65s at that time was the lowest among 34 OECD countries (69% of national mean income compared with an OECD average of 86.2%). Retirees over 75 years received an even lower replacement rate of 60% over the same period.

Another important indicator of adequacy is the rate of poverty. Given the difficulties in identifying absolute poverty levels across countries, relative poverty thresholds that are proportional to average or median incomes are normally used. A common poverty threshold is the proportion of over 65s with incomes below 50% of the median equalised income. Using this measure, the OECD estimates that Australia (35%) had one of the highest poverty rates in the OECD region (average of 12.8%) during the late 2000s, second only to Korea (47%). While the living standards of the aged across the world are generally lower than those of the broader population, the evidence suggests that this disparity is greater in Australia than in almost all OECD countries.

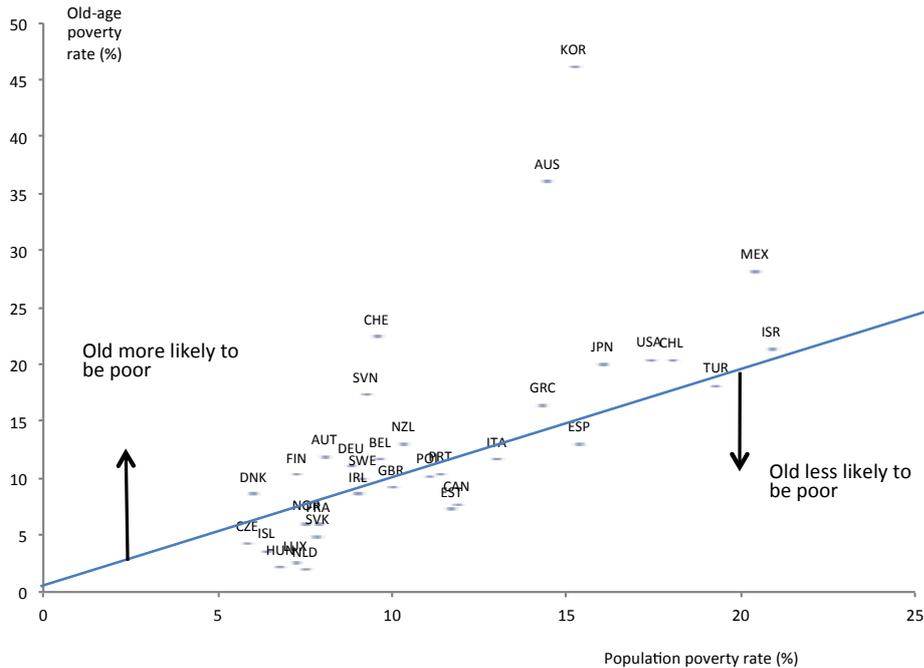
Measures of financial income however provide only part of the story. Non-cash factors have an important bearing on living standards, including housing wealth and publicly provided in-kind services. While Australian retirees have a rate of home ownership of 85%, higher than the OECD34 average of 76%, a high proportion of these homeowner retirees had mortgages on their homes. Moreover, evidence from Australian Housing and Urban Research Institute (AHURI) indicates that the burden of mortgage costs is greater on low-income households than it is on high-income households.

While publicly provided services are estimated to enhance elderly incomes for Australian retirees by 35%, this rate is lower than the OECD average benefit of 40%. Taking into account in kind benefits of housing and publicly provided services therefore does not change the overall conclusion that retirees in Australia are relatively less well off than their OECD counterparts.

The differences between Australia's partially favourable projected retirement income versus unfavourable actual retirement income performance during the late 2000s can be explained, to some extent, by the lack of maturity of the compulsory superannuation system. It will be some decades before all retirees have been through the compulsory superannuation system so that its full impact will be felt on retirement outcomes.

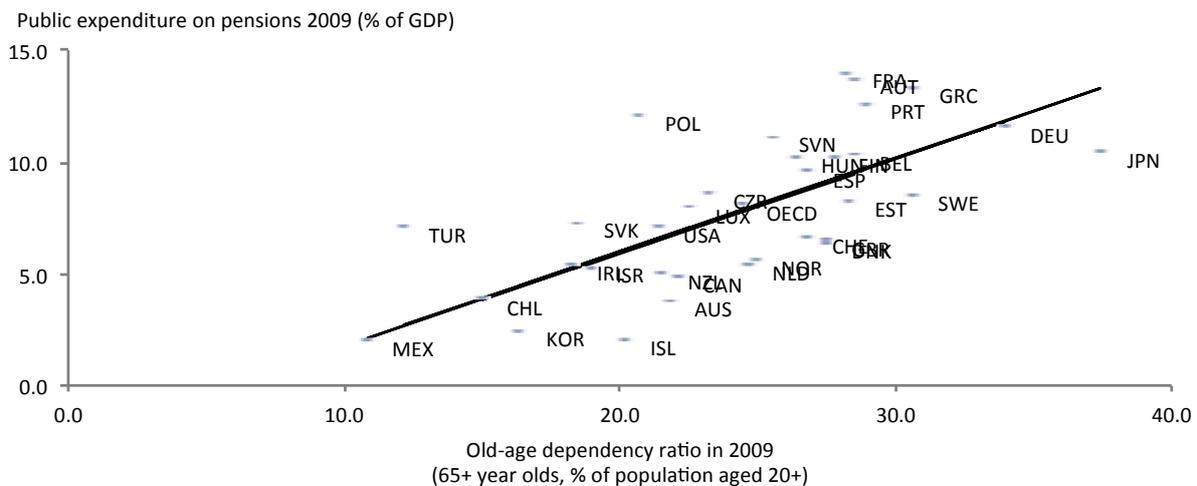
In summary, while the living standards of the aged across the world are generally lower than those of the broader population, the evidence suggests that this disparity is greater in Australia than in almost all OECD countries (Figure 1). Based on fiscal sustainability, however, Australia rates highly among OECD countries as indicated by Figure 2. On the basis of the combined performance of three financial sustainability indicators (including pension and pension reserve fund assets as a percentage of GDP, public pension expenditures and the permanent budgetary adjustment required to ensure the sustainability in public finances) Australia ranks second among its peer group.

Figure 1: Income poverty rates by age in OECD Countries



Source: OECD (2013)

Figure 2: Demographic pressures and public pension expenditure



Source: OECD Social Expenditures Database (SOCX); United Nations, World Population Prospects – The 2012 Revision.

Increasing the adequacy of retirement incomes without consideration of budgetary consequences is clearly not an option given fiscal pressures. The priority is therefore to identify measures that would improve the level of retirement income adequacy without compromising greatly on fiscal sustainability. For this purpose, this paper examines pension systems whose performance could be considered exemplary (ie performing well against both adequacy and sustainability criteria) from which policy lessons could be drawn.

The pension system performances of a sample of 33 OECD countries were evaluated using six indicators of adequacy and fiscal sustainability. Scores were assigned to each country on the basis of their performance against each indicator. These scores were then aggregated to allow best overall performers to be identified and ranked. (See Appendix A for the scoring method). It is acknowledged that inclusion of other criteria, such as market integrity, would no doubt have resulted in a different set of rankings. However this was not considered essential given the focus of this study on retirement outcomes. Figure 3 provides the summary results for each of the countries included in the analysis together with their scores against each of the criteria and final country rankings.

Figure 3: Summary of Pension System Evaluation

Adequacy Score		Sustainability Score		Total Score		Ranked Order	
Score	Rank	Score	Rank	Score	Rank	Score	Rank
France	29	1 Switzerland	25	1 Norway	44	1	
Norway	28	2 Australia	24	2 Netherlands	41	2	
Slovak Repub	27	3 Canada	21	3 Canada	39	3	
Czech Repub	26	4 United Kingd	21	4 Denmark	39	3	
Estonia	24	5 Chile	20	4 Estonia	39	3	
Denmark	23	6 Netherlands	20	6 Iceland	39	3	
Finland	22	7 Iceland	19	6 New Zealand	39	3	
Hungary	22	7 United State:	19	8 Slovak Repub	39	3	
Italy	22	7 Mexico	18	9 United Kingd	39	3	
New Zealand	22	7 New Zealand	17	10 Czech Repub	36	10	
Sweden	22	11 Denmark	16	11 Finland	36	11	
Netherlands	21	12 Ireland	16	12 Sweden	36	12	
Belgium	20	13 Norway	16	13 Australia	35	13	
Iceland	20	13 Estonia	15	14 France	32	14	
Luxembourg	20	13 Israel	15	15 Ireland	32	15	
Canada	18	16 Finland	14	16 Switzerland	32	16	
United Kingd	18	16 Sweden	14	17 Hungary	30	17	
Poland	17	18 Poland	12	18 Poland	29	18	
Portugal	17	19 Slovak Repub	12	19 United State:	29	19	
Germany	16	20 Czech Repub	10	20 Mexico	28	20	
Ireland	16	21 Turkey	10	21 Chile	27	21	
Austria	15	22 Japan	9	22 Belgium	25	22	
Spain	15	23 Hungary	8	23 Israel	25	23	
Greece	12	24 Portugal	8	24 Italy	25	24	
Australia	11	25 Spain	8	25 Luxembourg	25	25	
Israel	10	26 Germany	6	26 Portugal	25	26	
Mexico	10	27 Belgium	5	27 Spain	23	27	
Slovenia	10	28 Luxembourg	5	28 Germany	22	28	
Turkey	10	29 Slovenia	4	29 Turkey	20	29	
United State:	10	30 Austria	3	30 Austria	18	30	
Japan	9	31 France	3	31 Japan	18	31	
Chile	7	32 Italy	3	32 Slovenia	14	32	
Switzerland	7	33 Greece	-1	33 Greece	11	33	

The results highlight the trade-off between the objectives of income adequacy and fiscal sustainability given that countries that perform well against one objective tend to perform poorly against the other. Looking at scheme type, countries in the sample tend to be either predominantly defined contribution or predominantly defined benefit/hybrids. The results also indicate that DC funds are more likely to perform well against both adequacy and sustainability criteria.

On the basis of a review of the top performing and bottom performing systems, a number of parameters were identified as having a significant bearing on retirement outcomes in Australia. These parametric reforms and their relative merits are discussed below and summarized in Figure 4.

Figure 4: Comparison of Parametric Reforms

Reform Options	Fiscal Impact	Incentives to Work/Save	Effect on Adequacy	Impact	Retiree post retirement risk management		
					Investment Risk	Longevity Risk	Inflation Risk
Increase Age Pension Level	Negative	Negative	Immediate	Full	Yes	Yes	Yes
Increase Pension Age	Positive	Positive	Delayed	Partial	No	No	No
Increase Preservation Age	Positive	Positive	Delayed	Partial	No	No	No
Increase Contribution Rate	Positive	Negative	Delayed	Full	No	No	No
Remove Impediments to DLA	LT positive	Positive	Immediate	Partial	Yes	Yes	Yes
Provide Incentives for DLAs.	ST Negative LT Positive	Positive	Immediate	Full	Yes	Yes	Yes
Limit Lump Sum Benefits	Positive	Positive	Immediate	Full	Yes	Potentially	Potentially
Lifetime Annuity Default Option	Positive	Positive	Immediate	Full	Yes	Yes	Yes
Mandate Lifetime Annuities (full, partial, later stages)	Positive	Positive	Immediate	Full	Yes	Yes	Yes

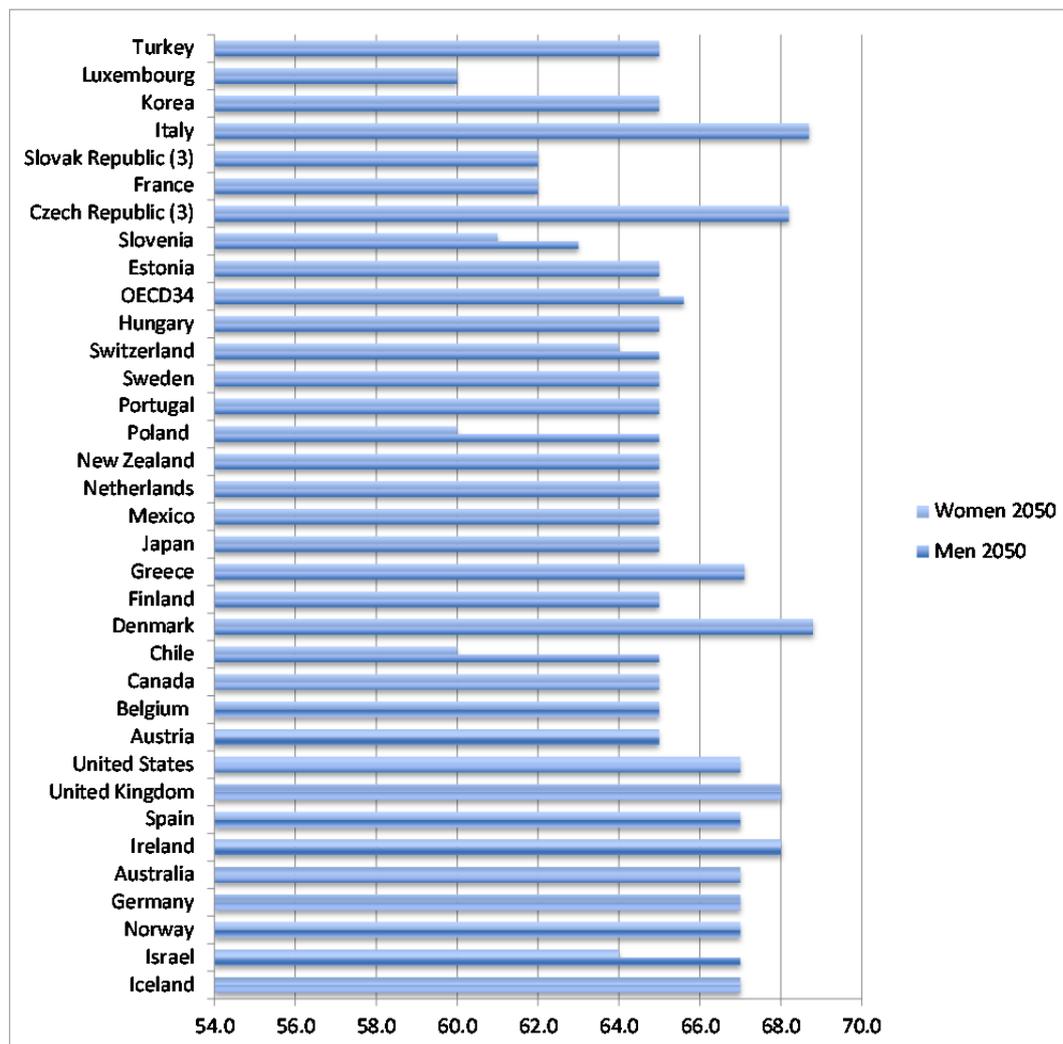
Age Pension Rate

Depending on the size of the increase, increasing the aged pension rate could have a significant impact on retirement outcomes, with associated budgetary costs. It would also help manage retirees' longevity risk but only by shifting more of this risk back to government. A pension rate increase would also affect incentives for voluntary savings adversely and encourage greater risk-taking in superannuation investment.

Entitlement Ages

One of the most visible and politically contested pension system reforms has been raising the retirement age. Pension ages have increased in most OECD countries and a retirement age of 67 is now becoming more common as indicated in Figure 5 (OECD 2013). Some countries have gone even further, moving to 68 or 69 years, while the Czech Republic has introduced an open-ended increase of the pension age by two months per year.

Figure 5: Pensionable age in OECD countries, 2050



Source: OECD (2013)

Pension entitlement age in Australia is comparable to that of other retirement systems in the OECD although a number of the exemplars (Iceland and Norway) have higher pension entitlement ages, as noted above, that are equalized for men and women. Whether increasing the pension age positively affects adequacy levels depends, however, on the ability of the aged to continue working. While contributions are essential to building future pension entitlements, increasing pension age alone will not suffice. A holistic approach to ageing is needed to ensure people remain effective in the labour market. Given its relative level, raising the preservation age is likely to be more effective than further increasing the pension age in addressing adequacy particularly for older retirees (75 years plus).

Contribution Rate

Increasing the contribution rate would have a positive long-term effect on living standards in retirement with a positive budgetary effect through lower pension outlays. On the other hand, higher post retirement living standards come at the expense of pre-retirement expenditures that in many cases may contribute to financial hardship or potentially crowding out other more life changing expenditures such as education. On its own, a higher contribution may do little to help retirees manage longevity risk unless it is supported by other measures.

Form of Retirement Benefits

There is increasing recognition that the outcomes of the Australian superannuation system could be enhanced by introducing a requirement that part of the retirement benefit must be taken as an income stream (Mercer, 2013). The World Bank's conclusions in relation to annuitisation are noteworthy. First, it notes the need to ensure that retiring workers opt for an adequate level of annuitisation, without forcing an excessive level of annuitisation. Second, given the shortcomings of all types of retirement products, a combination of products should be favoured covering different payout options over time (Rocha and Vittas 2010).

Cross-country comparisons of the form in which benefits are paid at retirement are summarized in Figure 6. This figure is broadly arranged from the least restrictive requirement of the left hand side, through to most restrictive requirements on the right. A number of conclusions are evident from these results.

First, 60% of the 30+ OECD countries included in the survey apply some form of limitation on lump sum payments at retirement. These limitations range from tax penalties, limits based on years of service or size of accrued benefits through to outright prohibitions.

Second, many of the retirement systems that were identified above as high performing, in terms of both adequacy and fiscal sustainability, place a heavy reliance on income streams including requirements for total lifetime annuitisation (eg Norway, Netherlands and Denmark). Third, and conversely, many of the least well performing systems (eg Slovenia, Spain, and Luxembourg) place a heavy reliance on lump sum benefits.

There are various options for encouraging greater reliance on post retirement income streams. The key advantage of these options compared with all other parametric reforms (apart from increasing the pension level) is that they allow retirees to manage key risks, namely longevity, investment and potentially even inflation risk. Further advantages are that their effect on living standards is immediate and they positively influence incentives to work and save.

Compared with options involving some form of compulsion, the use of incentives (through the exclusion of all or part of income stream payments from pension means testing) provides the least distortionary means of increasing post retirement incomes although this comes at a budgetary cost. Currently all new sales of assets are included in the assets test for the aged pension. It would be expected that removing, or partially removing, lifetime annuities income streams from the aged pension asset test would encourage stronger take-up this solution. NATSEM has modelled the household and fiscal impact of such a policy change for a range of scenarios. Its median growth scenario shows around 17,765 families taking up lifetime annuities, with an increase in pension outlays of around \$149M over the budget forward estimates period (Phillips 2014).

Considering all the parametric reform options, encouraging a greater take up of income streams offers scope to enhance retirement incomes while allowing retirees to better manage their post retirement longevity, investment and inflation risk.

It needs to be recognized that trade-offs and synergies exist between objectives. For example, increasing the adequacy of pension incomes by increasing the generosity of the pension promise is likely to affect fiscal sustainability adversely. On the other hand, encouraging accumulated assets to be converted to income streams at retirement eases the pressure on the public budget to provide a pension, manages longevity risk and improves the adequacy of retirement incomes”.

Figure 6: Overview of Pension Benefit Systems

Country	No limits on lump sums	Benefits determined by Plan	Voluntary Lifetime annuity	Preferential tax treatment*	Minimum years of service	Minimum accrued benefit or assets	Minimum pension level	Limits on lump sums	Lump sums prohibited	Compulsory annuities	Other
Income Stream Requirements											
Australia	X			Draw down products							
Austria						< EUR9,900					
Belgium	X										
Canada				Min Withdrawal amount			DB: <2-4% of max pensionable earnings				3 types of income streams
Chile									4 types of income streams		
Czech Republic									3 types of annuities		
Denmark				X				X			Pure lump sums rare
Estonia				Benefits up to EUR 321 per month tax exempt			>25% national pension rate (NPR) (1)	If <25% NPR, withdrawal limited to 25% of NPR			
Finland									X	X	
France	PAYG scheme										
Germany		X									
Greece											
Hungary						<15 yrs				4 options	
Iceland										X	40 yrs = 56% of lifetime average salary
Ireland		DB						DC: 1.5 times final salary			
Israel		X					X				
Italy				>66% of capital (2)				50% of capital			
Japan					>20 yrs pension or lump sum; <20 yrs lump sum						
Luxembourg	X										
Mexico					> 24 years programmed benefits or life annuity						
Netherlands										X	
New Zealand		Some DB plans provide lump sums									
Norway									X		
Poland										X	
Portugal		X					>10% of minimum wage (3)	<33% of capital (4); 100% of capital if <10% of MW			Benefits normally paid as pensions.
Slovak Republic								Part of accumulated capital			
Slovenia	X										
Spain	X										
Sweden		X						X		Life or fixed term	Benefits normally paid as pensions.
Switzerland							>10% of minimum pension	25% capital			Benefits normally paid as pensions (5)
Turkey											
United Kingdom				X						75% capital: annuity or income drawdown	
United States		DC plans	DB Plans								

Notes

"X" denotes feature applies.

1. Capital in excess of amount required to fund annuity of 3 x the NPR may be withdrawn gradually
2. Lump sum > 33% of capital are taxed twice on investment income component.
3. Conditions apply – requires agreement of pension fund manager, sponsor and retiree.
4. If the retiree requests it and the plan allows for it.
5. Tax rate on lump sums often less than pensions.

2. Status quo plus improved financial advice and removal of impediments

2.1 Improved financial advice

Challenger agrees with the FSI on the need for improved financial advice in the area of retirement income. Improvements in advisor training and competence will be important parts of the solution in this regard.

In its first submission to the FSI Challenger included a discussion of its partnership with the School of Risk and Actuarial Studies UNSW to develop specific curriculum covering an identified gap in professional education for financial advisers and superannuation trustees in managing post-retirement risk.

Following a request from FSI panel member Carolyn Hewson, on 15 July at the launch of the Interim Report, Professor Hazel Bateman from the School of Risk and Actuarial Studies at UNSW has provided the following update on this project. This update, together with the course outline and detailed curriculum are Attachment B to this submission

2.1.1 ACTL5401 Retirement Planning – update

Background

In 2014 UNSW Business School introduced the course ACTL5401 Retirement Planning. This is an elective course offered in the Certificate, Diploma and Master of Financial Planning programs and may be taken as an elective in other postgraduate coursework degrees offered by UNSW Business School. It is designed to supplement the existing suite of courses required under RG146 by providing specific training in retirement planning, and specifically retirement risk management.

The course may also be taken on a 'non award' basis, and as such is specifically targeted to existing financial planners.

Overview

This course imparts the knowledge necessary to provide effective financial advice for retirement planning in the context of increasingly complex financial products and government policies. A novel feature of the course is the integration of key retirement risks in retirement planning as well as consideration of behavioural biases which may influence advisor and client perceptions and behaviour.

The course covers the presentation, evaluation and implications of retirement risks including longevity risk, inflation risk, interest rate risk, adequacy (replacement) risk, contingency risk and political risk; the design and features of superannuation and retirement income policies and products; the public age pension and other publically provided benefits and their interaction with superannuation and other retirement benefit products; residential options for older Australians; financing health, aged and long term care; estate planning; understanding consumer behaviour; and designing a 'retirement plan'.

The official UNSW Course Outline and a more detailed outline are included as Attachment B.

Experience to date

A pilot version of the course was run in intensive format over 6 days in June 2014. The 8 participants included actual financial planners, Master of Financial Planning Students, and technical/professional staff from the financial services industry. The course was positively received. A full session face to face version of the course is being offered in Session 2, 2014 and if demand warrants, will be offered each session (ie, twice a year) thereafter.

Simultaneously, a fully online version of the course is being developed with the assistance of Smart Sparrow (e-learning specialists). The on-line version of the course covers exactly the same content as the face to face version. The on-line version will be ready to pilot by late September 2014 and then go live shortly thereafter. This version will be specifically targeted to existing financial planners.

This course sets a benchmark for education and training of advisers in managing risk in post-retirement.

Take-up of this and other courses like it will be driven by demand from individual advisers wishing to specialise in this area and by Australian Financial Services Licensees' requirements for their employees but most importantly by regulatory requirements.

If this issue is left to ASIC more detailed requirements on post-retirement need to be incorporated into a revised RG 146 than are contained in the current ASIC consultation paper. More generally, the content of the UNSW Retirement Planning course demonstrates what needs to be done to encourage the use of new retirement income products that can manage longevity, market and inflation risk in retirement and more generally to improve the professionalism of the financial advice industry.

2.2 Removal of product development impediments

In removing impediments to product development it is important to provide integrity measures to not only ensure that the new products actually work providing longevity protection but importantly that they cannot be used for mischief such as tax deferral and estate planning. With annuity products that make lifetime payments this can be achieved by requiring all of 3 integrity measures:

1. The income stream is not commutable.
2. There is adequate pooling of longevity risk.
3. The income stream is guaranteed and the guarantee is regulated by APRA under the Life Insurance Act 1995 with the same prudential standards, supervision and capital requirements that apply to a life office.

This does not necessarily preclude payment of death benefits or allowing policy holders to reclaim their premium in an initial period, which may be necessary to overcome behavioural biases in a choice environment or to facilitate provision of longevity insurance in default pension products if trustees were unwilling to make irreversible decisions on behalf of members, but such arrangements would need to be restricted so that they could not be mis-used for tax deferral or estate planning purposes.

Challenger's primary interest and expertise is in ILAs (immediate lifetime annuities) and DLAs (deferred lifetime annuities)¹. ILAs are permitted in Australia and, after almost disappearing from

¹ Refer to Section 8 for product descriptions

the retirement market, have enjoyed a resurgence, with sales last financial year exceeding the previous pre-Superannuation Guarantee (1992) industry peak. It is important to note that these sales, in a choice environment, are almost entirely of types that have a death benefit and capacity for an initial period for policy holders to reclaim a known quantity of capital.

This section of our submission begins with a discussion of the incompatibility of the current minimum drawdown rules with the provision of ILAs to late age retirees and indexed ILAs in extremely low interest rate environments such as exists currently.

A major focus of our submission to the FSI and to Treasury's Review of retirement income regulation is removal of the impediments to DLAs which collectively constitute an effective prohibition on their provision in the Australian market. A full set of legislative solutions to these issues were provided to the FSI as Attachment 11 to Challenger's first submission to the FSI. One of the two authors of these advices is no longer available to Challenger, but as the new Chief Tax Counsel at the Australian Taxation Office he is probably available to the FSI.

For completeness, this section of our submission concludes with a discussion of the impediments to RCLAs (ruin-contingent lifetime annuities) which appear in academic literature, and seem to have potential as a useful product but which we have not costed or evaluated in detail. We will leave others to argue the merits of removing impediments to GSAs (group self annuitisation) and exotic hybrids, though in other sections of this submission sets we set out our reservations about these products.

2.2.1 ILA impediments

In the current low real interest rate environment the minimum drawdown settings are incompatible with ILAs, particularly those that are indexed to provide protection against inflation risk. Consider an ABP comprised entirely of inflation linked commonwealth government bonds. Yields on these bonds are currently approximately 1.5%. Even allowing for gradual return of capital, this is an inadequate return to generate ABP payments sufficient to meet minimum drawdowns. The only ways to meet minimum drawdown requirements are either to withdraw in such a fashion that it is highly likely the ABP will run out prematurely or increase investment risk. This problem is exacerbated for older retirees with higher mandatory drawdowns.

ILAs are bought as the defensive component of an asset allocation but are required to meet the same drawdown requirement as an ABP with a substantial weighting to growth assets.

With the integrity measures discussed above there is no scope for tax deferral or estate planning mischief using immediate lifetime annuities. Provided death benefits and any commutation value are restricted to the nominal value of the premium with an eligibility period of no more than 15 years, immediate lifetime annuities (ILAs) should not be subject to the minimum drawdown rules. Use of lifetime annuities for tax deferral is already precluded by Taxation Ruling No. IT 2492, Income Tax: Eligible Annuities and Eligible Policies – Unreasonable Deferral of Annuity Income, dated 28 July 1988, and its Addendum dated 28 January 1993.

This policy change would facilitate provision of inflation risk protection to retirees buying lifetime annuities in low interest rate environments, as well as provision of protection against longevity risk, investment risk and inflation risk by those wishing to buy a guaranteed income stream late in retirement.

2.2.2 DLA impediments

DLAs face a number of impediments which render them unattractive to retirees, uneconomic to provide and preclude their provision. Specifically, DLAs:

- a) Are not eligible for either an Earnings Tax or Benefits Tax exemption in pension phase and after age 60.
- b) Are not treated as a risk product even if they are non-commutable.
- c) May be subject to accruals tax if purchased by a superannuation trustee.
- d) Could be required to offer a minimum surrender value, which would undermine pricing by precluding the availability of mortality credits inherent in the pooling arrangement².
- e) Are incompatible with the minimum drawdown rules, as discussed by AFTS.
- f) Are not contemplated by the means test arrangements for the Age Pension and aged care during the deferral period.

2.2.2.1 *Removing DLA impediments – solutions*

- a) Define a DLA as a SIS pension from payment of the premium. This would exempt DLAs from both Earnings and Benefits Tax. This was the essence of the unimplemented DLA measure of 2013. It would be preferable to treat non-commutable DLAs as a risk product, whenever they are bought but if there are insurmountable fiscal constraints provide this treatment from age 60.
- b) Ensure no conflict of laws between this treatment under the SIS Act and general provisions pertaining to accruals tax. This should ensure that DLAs receive the same tax treatment whether they are bought directly by an individual or by a superannuation trustee.
- c) APRA needs to amend the prudential standard on paid up and minimum surrender values to explicitly exempt non-commutable DLAs from having a surrender value.
- d) Exempt non-commutable DLAs from the minimum drawdown rules during the deferral period, as discussed by AFTS and provided in the unimplemented DLA measure of 2013.
- e) Exempt non-commutable DLAs from the Age Pension and aged care means tests during the deferral period, consistent with the treatment of other risk products. If there are insurmountable fiscal constraints set the asset value at the purchase price.

2.2.3 Impediments to other product development

2.2.3.1 *Longevity insurance for private health insurance, aged care and accommodation bonds*

The FSI Interim Report identified managing longevity risk as a gap in Australia's financial system. Longevity risk manifests in the drivers of the costs of ageing, principally health care, aged care and retirement incomes. These costs are shared between individuals and government, that is other tax payers, by the following mechanisms:

- Gap fees, co-payments, private health insurance premiums, private health insurance benefits, tax rebates, the Pharmaceutical Benefits Scheme, Medicare benefits and public hospitals.
- Individuals' contributions to their aged care costs, accommodation bonds, means tested government support for aged care.
- Income from non-superannuation assets, income from superannuation assets, tax expenditures in pension phase after age 60, tax expenditures in accumulation and before age 60, the Low Income Superannuation Contribution, means tested Age Pension.

Longevity risk is also shared by these mechanisms. Managing longevity risk for both individuals and government for retirement incomes is dealt with elsewhere in this submission.

² Refer to section 8.3.1 for a discussion on mortality credits.

Footnote 5 on page 1-8 of the FSI Interim Report says:

“For the purposes of this Inquiry, the Committee considers private health insurance to be out of scope. Private health insurance is closely linked to the operation of the health system and government plays a significant role in approving products and premiums. In addition, it does not pose a systemic risk to the financial system.”

This is a correct decision as to scope as most of the regulation of private health insurance is focussed on maintaining the system of community rating, regulating premium increases and targeting rebates to legitimate health services.

Similarly regulation of aged care fees and accommodation bonds is focussed on ensuring that government subsidies are only paid in respect of legitimate aged care services and that those subsidies are means tested so that they are provided equitably and on the basis of need.

With the exception of the lifetime cap on aged care fees, neither the private health insurance or aged care regimes have contemplated managing either the individual's or the government's longevity risk in respect of those costs.

There is significant scope to enhance the welfare of individuals who will choose private health insurance or use aged care by transferring the associated longevity risk to a private life office that is better able to manage it. Allowing pooling of these longevity risks will make them more affordable resulting in more retirees maintaining private health insurance cover and the frail aged having greater capacity to pay for and therefore choose the aged care which they need. State governments will achieve savings by having fewer public patients and, as a result of means testing, Australian Government outlays on aged care will be reduced. Current legislation and means testing arrangements do not contemplate longevity protection for these purposes.

For private health insurance this longevity protection would be provided using immediate lifetime annuities (in the case of a single premium) or deferred lifetime annuities (in the case of multiple premiums) to fund a stream of payments sufficient to provide private health insurance cover for life. The premiums for this longevity protection would be based on the expected escalating annual cost of private health insurance, the age and sex of the insured, and appropriate mortality assumptions. This longevity protection would be provided or underwritten by a life office with a registered private health insurance company providing the health insurance component. There are impediments to offering these two conceptually different products together as a package because the private health insurance rules designed to regulate price increases and protect community rating are incompatible with the provision of efficient longevity protection. The most obvious, but not the only conflict, is the need to have pricing which discriminates on the basis of age and gender when providing longevity protection.

Other matters including the treatment of the longevity protection for the purposes of the private health insurance rebate would also have to be settled by government.

In the case of longevity cover for aged care fees a single or multi-premium deferred annuity could be used, priced on the likelihood of needing care and the duration of care, subject to the lifetime cap on aged care fees. Challenger has also proposed a single premium lifetime loan product to assist the frail aged to cover the cost of accommodation bonds for a fraction of the face value of the bond. These potential products were covered in some detail in Challenger's submission to the Productivity Commission Inquiry into Caring for Older Australians, which is Attachment 14 to Challenger's first submission to the FSI.

Resolving these detailed issues is out of scope for an inquiry as broad ranging as the FSI. However, as managing individuals' and governments' longevity risk is a systemic issue, and that these are major drivers of the long term fiscal gap resulting from the ageing population, it would be worth considering recommending that the Government establish a process led by appropriate government agencies, not dissimilar to the current Treasury Review of retirement income regulation, to consider and if possible remove the impediments to longevity protection products for private health insurance and aged care.

This matter was discussed with FSI panel members Mr Dunn and Ms Hewson, at the Sydney consultation on insurance at the Grace Hotel on July 17, with Mr Dunn suggesting this was an appropriate issue for consideration under retirement.

2.2.3.2 RCLA impediments

RCLAs³ (ruin contingent lifetime annuities) are a non-commutable product similar to a DLA bought with an upfront premium which distinguishes them from VAs (variable annuities) which are fully commutable and where protection against longevity risk and investment risk are paid for with an annual fee. Payments from an RCLA are contingent on both survival and the failure of a specific non-guaranteed income stream. They have been a point of discussion in academic circles but Challenger has not costed them so they are not explored further in this submission. There would be similar impediments bringing them to market as presently exist for DLAs and we presume the solutions would also be similar to those needed for DLAs.

3. Incentive, Default, Mandate

3.1 Fiscal considerations

This section responds to the FSI's identified challenge, *Fiscal pressure from an ageing population* on page xvi of the Interim Report.

An independent actuarial investigation conducted by Towers Perrin, commissioned by Challenger for its submission to the Henry Review in 2009 used stochastic modelling and the then ASFA benchmarks⁴ for a single retiree living modestly and comfortably to estimate the age at which superannuation assets could be expected to be drawn down to the point where the retiree would receive a full Age Pension. The report is Attachment 2 to Challenger's first submission to the FSI. The table shows that retirees with above average starting balances becoming eligible for a full Age Pension, so there are fiscal benefits if the performance of post retirement products and strategies can be improved.

³ Refer to Section 8 for product descriptions and a discussion on mortality credits.

⁴ ASFA benchmarks for "modest" and "comfortable" retirement income were \$19,399 and \$37,452 respectively.

Table 1: Average age at which a retiree first becomes eligible for a full age pension

Starting Account Balance	ASFA Benchmark Income	Aged 65 Retiree
\$500,000	Modest	104
	Comfortable	84
\$300,000	Modest	86
	Comfortable	79
\$150,000	Modest	65
	Comfortable	71
\$50,000	Modest	65
	Comfortable	67

Towers then investigated the age at which those retirees' superannuation assets would be exhausted and they would become completely dependent on the Age Pension.

Table 2: Average age at which account based pension is exhausted

Starting Account Balance	ASFA Benchmark Income	Aged 65 Retiree
\$500,000	Modest	na
	Comfortable	89
\$300,000	Modest	na
	Comfortable	80
\$150,000	Modest	na
	Comfortable	71
\$50,000	Modest	81
	Comfortable	67

If a retiree lives according to the ASFA modest standard an ABP can be expected to last a long time. Even retirees with only \$50,000 can expect it to last into their early 80s, and retirees with higher balances can expect an ABP to last for life. However if a retiree tries to live according to the ASFA comfortable benchmark, even starting with a balance of \$500,000 that is well above average, they cannot expect an ABP to last until age cohort life expectancy. This means that average retirees cannot sustain a comfortable living standard. Some retirees will respond to this risk of becoming totally dependent on the Age Pension by living more frugally than necessary, others will spend too much, have bad investment experience or live longer than they expected and their living standard will fall to one that can be supported by the Age Pension.

Challenger has commissioned two reports showing how higher living standards in retirement can be sustained either by partial annuitisation or by buying longevity insurance in the form of a DLA and that if annuitisation occurs on a large scale there will be significant fiscal savings as Australia's population ages. The first report was prepared by Access Economics and provided to the Henry Review in 2009. It is Attachment C to this submission. It showed that if retirees were required to annuitise 30% of their superannuation balance and the payments were deferred 10 years, the savings as a result of the Age Pension means test would be 0.2% of GDP in 2040.

The second report was commissioned by Challenger and released at the Tax Forum in 2011. It is Attachment 13 to Challenger's first submission to the FSI. It was prepared by Deloitte Access Economics and shows that if the average take-up of DLAs was \$10,000 per person, savings as a result of the Age Pension and aged care means tests would be 3% of combined Age Pension and aged care government outlays in 2050.

3.2 Incentive

Since 1 July 2007, when the full Earnings Tax and Benefits Tax exemptions for persons over 60 years commenced, there have been substantial tax incentives for Australian retirees to take an income stream that qualifies as a pension under the SIS rules.

On 20 September 2007, the Age Pension 50% ATE (Assets Test Exemption) was removed for *complying income streams* commencing after this date. *Complying income streams* are lifetime annuities, FTAs (fixed term annuities) to at least life expectancy and TAPs (term allocated pensions) which are an allocated pension with both minimum and maximum drawdown requirements. All three of these complying income stream types are required to be non-commutable with a 5-year claw back of social security benefits received in the event of commutation. This incentive drove substantial sales of complying income streams among the particular demographic that they targeted – lower middle income households including a pensioner with some superannuation assets. The incentive was not effective for retirees with more assets who would not receive a pension uplift from it.

The ATE was introduced on 20 September, 1998 at a rate of 100% for lifetime and fixed term annuities; reduced to 50% and extended to TAPs on 20 September, 2004; and abolished for new pensions on 20 September, 2007. To date, the ATE is the only government incentive which targeted longevity, although only partially in the case of FTAs and TAPs.

Currently there is no shortage of incentives for retirees to take an income stream, but the incentives that are available have not been effective in influencing two very significant groups of behaviours:

- a) Behaviour A: the tendency of retirees with small account balances, who have received relatively little in the form of tax incentives during accumulation, to take their benefits in the form of a lump sum; and
- b) Behaviour B: the tendency of retirees to take a superannuation pension but not one that manages the principal risks in retirement, longevity risk, investment risk (including sequencing risk) and inflation risk.

The current tax exemptions for pension phase earnings and benefits are less effective in targeting Behaviour A because of the existence of SATO (the Senior Australians Tax Offset) and the free area under the Age Pension means test. In any event not enough is known about the range of behaviours associated with taking lump sums and their implications for retirees' living standards later in life to know whether further incentives targeted at reducing this behaviour would be justified from welfare and fiscal perspectives. In any event, an incentive targeted directly at Behaviour A would also flow to a large proportion of those who have already chosen a superannuation pension and who are receiving the exemption from Earnings Tax and Benefits Tax. Any new incentive that flowed to this group would have a high cost but no further beneficial influence on behaviour, although it would be welfare enhancing for some part-pensioners.

We do know that the tax exemptions for pension phase earnings and benefits are not effective in targeting Behaviour B because less than 1% of the superannuation monies rolling over from accumulation to pension phase are going into products which provide longevity insurance.

Absent introducing a tax so that an exemption can be granted to target behaviour Group B the only proven option is to re-introduce an ATE.

An ATE could target Behaviour B encouraging individuals to use products which manage the principal risks in retirement. For both efficacy and fiscal reasons, it would be appropriate to constrain eligibility for an ATE in a more targeted fashion than was the case under the 1998-2007 arrangements. That would mean restricting eligibility to lifetime annuities subject to appropriate integrity measures (non-commutable, pooling and full regulation by APRA under the Life Insurance Act 1995 including capital standards). If fiscal or equity considerations were an overriding consideration, the value of the ATE could be capped. As these products are not account based there would be no interaction with the deeming arrangements.

Even a partial ATE might elicit a significant behavioural response. The availability of an ATE targeting Behaviour B would also elicit some behavioural responses in relation to Behaviour A. A cap on the amount of ATE available would signal to retirees that the product and the ATE are valuable. Behavioural economists have found that regulatory settings influence behaviour not just as a constraint but as a guide to appropriate behaviour.

An incentive could be effective by itself in a choice environment or operate in combination with a default or compulsion.

Challenger did not raise incentives in its submissions to the Henry Review, the Cooper Review, or the Tax Forum. However, as the FSI has raised this issue, we thought it was appropriate to ensure the debate was informed about the short-term costs of an ATE for lifetime annuities based on current sales in a choice environment. Challenger commissioned NATSEM (the National Centre for Social and Economic Modelling at the University of Canberra) to do this work and their report is at Attachment D to this submission. NATSEM estimated the fiscal cost of a 50% ATE on \$600 million of sales of immediate lifetime annuities in 2013-14 at \$9 million. The report shows the fiscal costs and benefits to families over the Forward Estimates period for a range of ATE rates and growth projections. The long term fiscal benefits of large scale annuitisation are dealt with elsewhere in this submission.

Australian lifetime annuity sales fell to extremely low levels after the introduction of the Superannuation Guarantee in 1992. In one year only 14 lifetime annuity policies were sold. In the last 4 years there has been a revival of this market segment but it still accounts for less than 1% of the flows out of superannuation accumulation. There are two implications for future policy:

1. An ATE for lifetime annuities managing longevity risk, investment risk and inflation risk would be effective and appropriately targeted to the overwhelming majority of retirees who are not addressing these risks; and
2. In fiscal terms, the cost of any retrospective benefit conferred on existing holders of lifetime annuity policies would be comparatively small.

3.3 Default

Many retirees are disengaged from the superannuation system; they lack sufficient financial literacy and the experience necessary to make good choices themselves; they cannot afford, will not seek or do not trust financial advice; and they have behavioural biases that impair their decision making. This would be no different to the challenges that faced superannuation fund members in accumulation and led to the development of MySuper default products, except that retirement is different and retirees face a complex array of uncertainties and additional risks.

The first uncertainty is that they do not know how long they are going to live and therefore how large an income it is safe to draw from their accumulated retirement savings. In addition to the investment risks they faced during their working lives as superannuation contributors, they face sequencing risk around the time they retire. This is the risk that they suffer a major adverse event

when they are close to retirement. Investment performance, combined income and growth, must also be strong enough to maintain purchasing power over a period that could span a number of decades.

The ABPs (asset backed pensions) used by a majority of Australian retirees today do not by themselves have the capacity to manage these risks. Most individuals by themselves are even less capable of doing so. The maxim that “equities perform better than fixed interest in the long term, you are retired for a long time, therefore you should have a high exposure to the market”, does not provide an acceptable solution because the critical dates when individuals enter and leave the retirement income market are randomly distributed and largely beyond their control. Therefore if a retiree is impacted by a significant market correction and is now consuming (not adding to) the capital from their retirement savings, their capital base may begin to erode beyond a level which will provide a sustainable income for their lifetime. What individuals need is products with a combination of features or a combination of products that provide them with exposure to the market and a component of protection against longevity risk, investment risk and inflation risk.

Currently the superannuation system is structured so that most retirees default into a lump sum if they meet a condition of release (retirement, disability or death) and they must make an active decision to rollover into a superannuation pension product. The first objective of a default would be to have retirees move seamlessly into an income stream. MySuper default accumulation superfund providers should be permitted to offer a MyPension default pension with appropriate features to manage the principal retirement risks. This is currently prohibited for MySuper funds. One way of encouraging uptake of the MySuper default retirement option would be to ensure that, as with SMSFs, the move from accumulation to pension is not a Capital Gains Tax event.

Default pension offerings would presumably operate within the current choice model and be available for use by dis-engaged retirees who did not want to make a choice themselves or did not feel they were capable of making an informed choice. In developing a default model policy makers should have regard to the cost of the products. However the objective should be for funds to provide defaults that are not only fit for purpose but also of a quality that a retiree making a choice could reasonably be expected to choose.

Default pension offerings could replace the need for complete personal advice with a fit for purpose product, effectively embedded advice. Use of these default solutions could be supported with intra-fund advice, limited advice or general advice.

With something as complex as post-retirement superannuation solutions policy makers also need to consider how prescriptive the default settings are. If the settings are too prescriptive there will be no scope for innovation and retirees choices will be defined in terms of providers and price rather than product features which may be very relevant to an individual.

There are three possible models for providing defaults with varying degrees of prescription:

- a) The default must address longevity risk, investment risk and inflation risk but how it does that is a matter for the trustee;
- b) The default must include use of particular products, (eg an ABP in combination with at least one type of lifetime annuity); or
- c) The default could require a stipulated choice of products and product combinations as is the case with the Chilean post-retirement model for conversion of compulsory contributions into income streams, which gives a choice between three alternatives (a lifetime annuity, a lifetime annuity and an ABP, and a temporary allowance (ABP) with a DLA).

It is significant who sets the defaults. Recommendations are implicit in the selected policy default. In a study of default organ donor selections where the default was reversed, McKenzie, Liersch and Finkelstein, found their results indicated that default effects occur in part because policymakers' attitudes can be revealed through their choice of default, and people perceive the default as indicating the recommended course of action. Policymakers need to be aware of the implicit messages conveyed by their choice of default.

Since the FSI's Interim report was released there has been much discussion within Australia's financial services industry about the Chilean model of auctioning accumulation default funds on the basis of fees. Amongst the arguments put against this model are that fees are neither an indicator of future performance nor an indicator of relative value of fund performance.

Chile also has a type of auction system, called consultations, where life offices bid for intending retirees annuity business. As annuities have no fees and the pension amount is stipulated at commencement in the life policy (annuity contract) with the life office not the retiree taking the risk, an auction providing competition only on the annuity rate to be paid would be both viable and fair.

3.4 Mandate

The Henry Review conducted an extensive public debate on the merits of compulsory annuitisation before recommending against it. This debate covered a number of important issues, these were summarised in Challenger's first submission to the FSI and it is worth reiterating here that government should not mandate either any system of community rating or unisex pricing of lifetime annuities.

The Henry Review Strategic Issues Paper on retirement incomes said that while compulsion would reduce adverse selection in the lifetime annuity market it would do so at the expense of poor, sick and indigenous people with shorter life expectancies. Challenger has already provided an actuarial investigation (as Attachment 7 to Challenger's first submission to the FSI) using multi-factor demographics which not only confirm that but also demonstrate that pricing markers such as postcodes could be used to provide higher annuity rates to disadvantaged retirees. This is a rare situation where the financial system can provide a system for redistributing income which is generally progressive. This is a sound argument against community rating of longevity risk insurance.

Similarly the European Union's recent ban on discriminating annuity pricing on the basis of gender in a voluntary system will result in adverse selection and reduce annuity rates.

The UK is in the process of abandoning a system that required people to heavily annuitise at age 75. Because the UK's move to abandon compulsory annuitisation has been assumed by some to call into question the efficacy of lifetime annuities it is worth examining here. Indeed the FSI panel had these views expressed to it quite widely on its study tour, which included the UK, and FSI panel member Carolyn Hewson has asked us directly to address this.

While the UK system was apparently highly unpopular, it had a logical and rational basis. Rawlinson and Cater (2008) see Attachment E showed that, depending on an individual's appetite or aversion for risk, it is rational to annuitise at some point in retirement. They developed the concept of an SRP (survivor risk premium) to measure the annual economic cost of electing not to invest in a lifetime annuity. By making a decision to invest in an allocated pension a retiree is also making a decision to self-insure longevity risk.

The pricing of a lifetime annuity is such that a lifetime annuitant who survives a year implicitly derives a financial benefit from the death of those lifetime annuitants who are expected to die

during the course of that year. It should be noted that because the annuity is guaranteed by the life office, and the life office has priced on that basis, it is immaterial to the annuitant whether others in the pool die according to the expected schedule. By contrast, the self-insurance characteristic of an allocated pension means that an allocated pension retiree will not derive the same benefit. The SRP is a measure of this benefit foregone by an allocated pension retiree. Put another way, the SRP is the marginal, risk-adjusted cost each year of deferring a decision to convert from an allocated pension to a lifetime annuity.

It may be economically rational to continue an allocated pension for as long as the expected additional (after fees) returns from it exceed the SRP. That does not mean that the outcome from the allocated pension will actually exceed the guaranteed returns from the lifetime annuity but it does mean that there is a rational basis for expecting that to be the case.

The SRP can be measured against the PRP (portfolio risk premium) which is an equivalent measure of the additional investment return that the allocated pension is expected to earn (in excess of risk free rates), after adjusting for the difference in fees between an allocated pension and a lifetime annuity. The PRP is determined in part by the weighting of growth and defensive assets in the allocated pension portfolio. These weightings are determined in part by the retiree's risk tolerance. A retiree with a lower tolerance for risk will commonly have a lower PRP than a retiree with a higher appetite for risk, because the retiree with the lower risk tolerance will tend to invest in an allocated pension with a larger weighting to defensive assets and therefore a lower expected portfolio rate of return.

The SRP rises as the retiree ages and will exceed the PRP at different ages depending on the retiree's appetite for risk and hence their resulting allocation to growth assets. The lower the retiree's appetite for risk the younger it may be rational to annuitise. On their analysis Rawlinson and Cater found it was rational for a person with a low risk appetite to annuitise very early in retirement. They also found that for a retiree with a high risk appetite it was rational to annuitise well short of normal life expectancy.

It is reasonable to conclude from the Rawlinson and Cater (2008) analysis that the UK system of compulsory annuitisation had rational motivations that could have been theoretically expected to deliver appropriate retiree outcomes. It is therefore important to understand why a decision has been taken to end it. Several observations are instructive in this regard:

- The move will have short-term fiscal advantages for the UK government, which is projecting future tax savings in the order of 1.2 billion pounds in 2018/19. Under the new regime, lump sums, other than small ones, are to be taxed at marginal rates if more than 25% is withdrawn. Annuities will still be concessionally taxed.
- More generally, from a short term budget and economic management viewpoint, the increased lump sums could be expected to have a mild stimulus effect.
- The UK system required 75% annuitisation of wealth at age 75 in order to meet the secure income test (ie GBP 20,000 a year in DB, state pension or annuity), which is not being contemplated in Australia. The sequestering of 75% of wealth prevented retirees responding to a change in circumstances or from pursuing broader financial objectives such as leaving a bequest. The removal of compulsion created choice and flexibility which did not previously exist. Perhaps if compulsion had applied to only a portion of savings, attitudes would have been different.
- Because the UK system had no structured accumulation until 2012 when auto-enrolment was introduced, structured decumulation was seen as an inconsistent and jarring measure that arbitrarily removed freedom of choice. The converse applies in Australia, where Australia has had compulsory super saving since 1992 and the absence of structured decumulation is regarded as inconsistent policy.

- A typical UK annuity does not provide for any liquidity of capital. Some annuities are offered with a maximum of a 5-year income guarantee (ie it will pay for 5 years even if you die) but they typically do not have guaranteed periods during which capital can be withdrawn or a death benefit paid. So the product retirees were being forced to buy still suffers from the key investor behaviour objection to annuities: the irrational 'run over by a bus' response to the rational option to annuitise.
- Consumers may have confused the low interest rates driven by global monetary policies with poor value for money. Annuities, which are regulated to be risk free, pay modest margins above government bond rates. These returns can seem low especially when equity markets are performing strongly driven by the same monetary policy which drives yields lower.
- A perceived lack of competitiveness in the industry may have exacerbated the feelings of poor value for money. Various Financial Conduct Authority reports into the UK annuities market suggest these concerns were not without basis.

Importantly, none of these observations need apply to the Australian annuities market.

Pension strategies can be devised to meet particular objectives which they will do with varying degrees of efficacy. They can be devised by pension providers and sold to retirees in a choice environment as we have in Australia; they can be offered as defaults or choices amongst defaults with more or less prescription for the disengaged; and use of particular products in full, or in part, or in combinations with other components can be mandatory. The response of retirees will be affected by both their view of their choices and any incentives that come with them. In terms of influencing behaviour, choice, defaults, and incentives will be partially effective. Incentives have a fiscal cost and they will also improve outcomes. Compulsion can be almost fully effective as it is in accumulation in Australia and made much more acceptable by being accompanied by incentives. Compulsion could also be used by itself, and be almost fully effective in changing behaviour, with almost no fiscal cost but a loss of acceptability.

FSI information request	Challenger submission section
No change to current arrangements	4
Take a more flexible, principles-based approach to determining the eligibility of retirement income products for tax concessions and their treatment by the Age Pension means-test	5
For product providers, streamline administrative arrangements for assessing the eligibility for tax concessions and Age Pension means-tests treatment of retirement income products	6
Issue longer-dated Government bonds, including inflation-linked bonds, to support the development of retirement income products	7

4. No change to current arrangements

Challenger takes the position that the principal policy objective of the superannuation system is to provide a higher level of retirement income to Australians than they would obtain if they had to rely entirely upon the Age Pension. Australians have behavioural biases which limit the amount they will voluntarily save for retirement so it is Government policy to provide a combination of compulsion (the Superannuation Guarantee levy) and tax incentives to increase accumulation, as well as additional tax incentives to encourage the use of private pensions in retirement.

These tax incentives and the means tested safety net Age Pension have significant implications for fiscal sustainability, given Australia's ageing population, and therefore must be targeted and controlled. The mechanisms for doing this are:

- Superannuation concessional and non-concessional contribution limits;
- LISC (low income superannuation contribution);
- Age pension means test:
 - Income test
 - Assets test;
- Pension rules under the SIS Act (in particular s105 and s106) which maintain the boundary between accumulation and pension phase and determine eligibility for the Earnings and Benefits Tax exemptions;
- Minimum drawdown rules which ensure that superannuation assets in pension phase are converted into an income stream;
- Taxation Ruling IT 2492, Income Tax: Eligible annuities and eligible policies – unreasonable deferral of annuity income, issued on 28 July 1988 and its Addendum issued on 28 January 1993, that protect the taxpayer from the misuse of annuities for tax deferral; and
- Taxation of death benefits paid to persons other than superannuation dependents.

This submission is fully cognisant of the role of these requirements and the need to have regard to competitive neutrality across superannuation and risk products.

5. Take a more flexible, principles-based approach to determining the eligibility of retirement income products for tax concessions and their treatment by the Age Pension means-tests.

Guiding principles for defining policy objectives are desirable and appropriate but unless they are dealing with very simple concepts, and superannuation is not simple, they are unlikely to stand the test of assault from persons who will inevitably seek to test the boundaries of tax arrangements or use superannuation structures for tax deferral or estate planning.

6. For product providers, streamline administrative arrangements for assessing the eligibility for tax concessions and Age Pension means-tests treatment of retirement income products.

Providers of VAs (variable annuities) recognise their products' complexity and frequently express a strong desire for a process to co-ordinate and streamline approvals between APRA, ASIC and the ATO.

7. Issue longer-dated Government bonds, including inflation-linked bonds, to support the development of retirement income products.

Life offices have successfully managed annuity books for centuries without having access to very long dated Government bonds and inflation linked bonds. That is not to say that availability of very long dated risk free fixed rate and indexed paper would not be useful for pricing other long dated securities. It would be desirable for the Government to issue very long term bonds to assist the market with pricing long term risk, but it needs to also be recognised that government securities are issued to raise public debt cheaply and efficiently and issuing very long term debt may not always be in the public interest. In the current low interest rate environment debt is relatively cheap and it would be economic to do so. Canada, which is a highly comparable jurisdiction to Australia, has twice in the last year issued Government bonds with 50 year tenors.

FSI information request	Challenger submission section
Would deferred lifetime annuities or group self-annuitisation be useful products for Australian retirees? Are there examples of other potentially suitable products?	8
If part of retiree's superannuation benefits were to default into an income stream product, which product(s) would be appropriate?	9
Will the private sector be able to manage longevity risk if there is a large increase in the use of longevity-protected products? How could this be achieved?	10
Should Government increase its provision of longevity insurance? How would institutional arrangements be established to ensure they were stable and not subject to political interference?	11
What are some appropriate ways to assess and compare retirement income products? Is 'income' efficiency a useful measure?	12

8. Would deferred lifetime annuities or group self-annuitisation be useful products for Australian retirees? Are there examples of other potentially suitable products?

Leaving aside exotic hybrids there are 8 income stream types which could be used by an Australian retiree. GSA's and DLAs are two of the three that are not currently available because they are not contemplated by the SIS Act, taxation law, or the social security and aged care means test arrangements. The third kind of income stream that is not contemplated by the law is an RCLA (ruin contingent lifetime annuity).

DLAs and RCLAs, if they were available, would be regulated by APRA under the Life Insurance Act 1995, with prudential standards, supervision, powers of intervention, and onerous capital requirements (see Section 13), GSA's would not.

8.1 DLA (deferred lifetime annuity)

A DLA will provide an income stream for life commencing at a specified later date, conditional only on survival. DLAs will provide full protection against longevity risk and investment risk later in retirement. A DLA will provide either a guarantee against inflation risk, or a very high nominal rate. DLAs can remove the uncertainty about how long other components of a retirement solution must provide income. There may be a gap if a market linked component of the total retirement solution fails earlier than anticipated. Because DLAs pool longevity risk they are non-commutable. DLAs are an intense promise regulated by APRA with strict prudential standards, supervision, powers of regulatory intervention, substantial capital requirements and guaranteed income.

8.2 GSA (group self annuitisation)

GSAs have yet to be offered in Australia. They are an account-based product requiring pension fund members to commit their assets to a non-commutable pool, with the superannuation fund endeavouring to provide a target income for life. However, there is no guarantee (prudentially regulated or otherwise). Instead, the pension amounts paid may be adjusted up or down, or may cease, depending on actual market returns and mortality outcomes within the pool. Investment risk (including sequencing risk) is not mitigated at all, while longevity risk is only partially mitigated. Provided the pool is large enough, a GSA can deal with idiosyncratic longevity risk (the variation of the length of individual lives in the pool), but not with broader mortality experience outcomes (deviation in average longevity outcomes of the pool as a whole from what was expected).

While simple in concept, GSAs would be complex to operate. In order to achieve their sole objective of mitigating idiosyncratic longevity risk, GSAs must be non-commutable. One particularly difficult challenge with an open pool is how to achieve certainty that a later cohort of entrants is not subsidising one or all earlier cohorts. Depending on market movements, inflation movements, or pool mortality movements, situations may emerge where either too little or too much income (in retrospect) has been drawn from the pool. Depending on how such products are administered actuarially, there is significant scope not only for mistakes but also conflicts of interest and wrongdoing.

The risk of mis-selling is significant. For example, use of the word “annuity” (or derivatives thereof) in describing a GSA to consumers creates the risk that consumers confuse GSA schemes with guaranteed annuities issued by prudentially regulated life offices operating under rigorous capital requirements. The risk of such confusion is significant given growing consumer awareness on the benefits of annuities driven by advertising and education initiatives. Independently conducted quantitative surveys now report that 62% of consumers claim to have heard of annuities, while 45% of advisers claim to have received consumer enquiry regarding annuities in the last six months. GSA providers may be inclined to highlight the higher returns that the lack of a prudentially regulated guarantee affords, but less inclined to highlight the lack of the guarantee itself.

Many fund members may have difficulty understanding the conditionality of the promised or targeted income when they join, or are defaulted, into a GSA. They may be unaware that they are accepting all investment, inflation and systemic longevity risk and are committing their own funds to share only idiosyncratic longevity risk.

A GSA where the fund has underestimated longevity risk or overestimated returns will offer a higher target income and is therefore likely to attract more members than a fund that anticipates longevity risk and returns more accurately. Ultimately the fund that miscalculates will have to reduce the pensions it is paying and its members will collectively be worse off than those of a fund that made more accurate forecasts.

In summary, while the GSA concept would be a step forward in that it seeks to address idiosyncratic longevity risk, there are many practical issues that might make the model unworkable or at least requiring a significant degree of additional regulation and supervision by APRA and ASIC.

If superannuation funds do offer GSAs, they should do so in combination with an ILA (immediate lifetime annuity), DLA (deferred lifetime annuity) or RCLA (ruin contingent lifetime annuity) to provide guaranteed protection against investment risk and longevity risk. Where a GSA is offered in conjunction with longevity insurance that is non-commutable and has a deferral period, there should be no minimum drawdown requirement in respect of the longevity insurance component.

Without an annuity, a GSA has no guaranteed return, however retirees may not fully understand the degree to which their future payments are at risk, which may result in a future regulatory issue when adverse market events may require a reduction in GSA payments to the funds’ members.

8.3 Other products

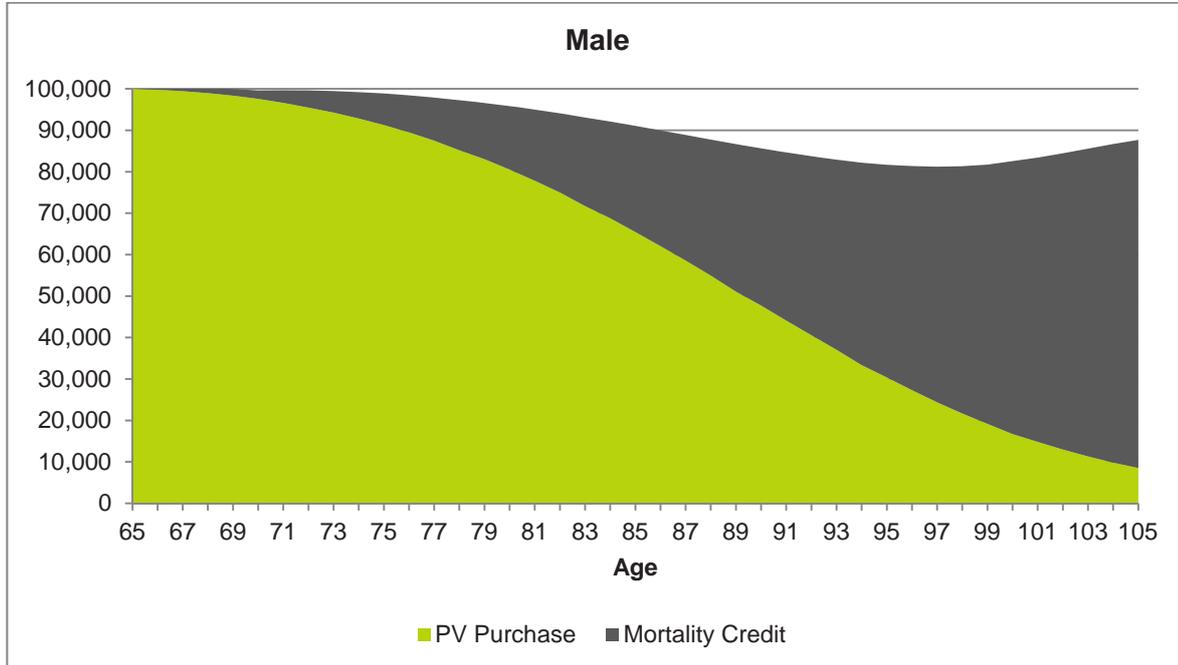
8.3.1 ILA (immediate lifetime annuity)

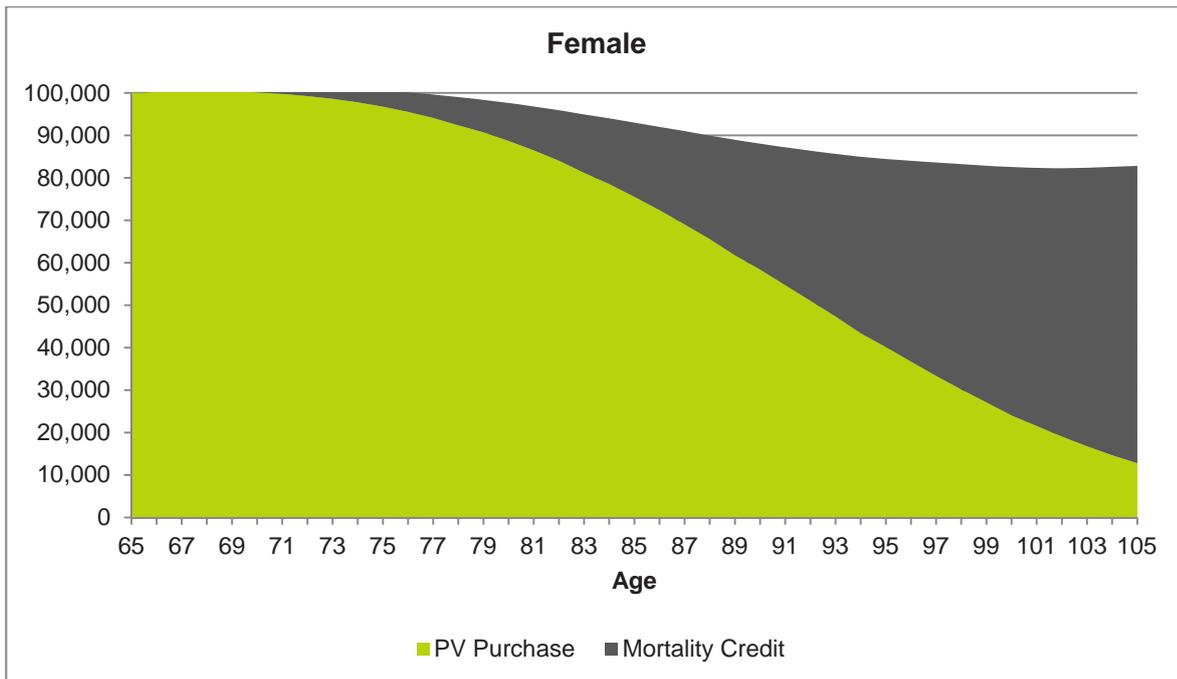
An ILA is a conventional lifetime annuity providing an income stream for life commencing immediately on payment of a premium. It transfers all investment risk and longevity risk to the product provider. Most lifetime annuities sold in Australia also provide protection against inflation risk.

As with other products that pool longevity risk such as DLAs and GSAs, the attractiveness of ILAs is enhanced by “mortality credits”. A mortality credit is an increase in annuity benefit payment arising from the expectation that premiums paid by those annuitants in a pool who die earlier than expected contribute to pool assets. The time value of money means that these expected contributions are worth more than the corresponding ultimate drain on pool assets caused by those annuitants who die later than expected absent the increase in benefit payments.

The value of mortality credits to an annuitant can be shown graphically. The graphs below show the value of an annuity purchased at age 65 through time as the policy holder ages (age being the x-axis). The value comprises two parts: 1) the present value of future payments originally expected at the time of purchase, and 2) the present value of future increased expected payments (reflecting higher probabilities of future payments by virtue of survival corresponding to an age on the x-axis). This second component represents a net addition to household wealth over time from mortality credits.

Figure 7: Value of ILA through time including mortality credits





Mortality credits can make a significant contribution to retirement income adequacy. If a retiree does not have sufficient savings to meet adequacy, and by virtue of retirement has diminished human capital, an ILA delivers an extra return from living longer.

Because ILAs pool longevity risk, they are generally non-commutable. That is, it isn't possible to exchange the net present value of all remaining payments for a single lump sum. However, to overcome well-documented behavioural biases, most ILAs sold in Australia are offered with a 10 or 15 year period during which a death benefit will be paid and/or some access to nominal capital will be provided.

The behavioural biases include pessimism, loss aversion (ie the estate "losing" the annuity premium on early death), resistance to making irrevocable investment decisions and a desire for all investments to be liquid "in case of emergency". These concerns may be felt most strongly by recently retired people, who are still growing accustomed to relying on income derived from wealth and welfare rather than personal exertion. They may also underweight the probability of a long life and overweight the likelihood of early death, thereby viewing the purchase of an annuity as an unattractive bet against an insurance company where the premium far exceeds the payoff. Further to the issue of chronic underestimation of longevity, several quantitative studies including those by Susan Thorp from UTS and the National Seniors Association and Challenger, indicate that younger retirees are more likely than older retirees to significantly underestimate their own life expectancies.

Not every purchaser values the peace of mind provided by these liquidity features more than the peace of mind provided by higher lifetime income payments. Hence these liquidity options are not always selected because they come at the cost of lower income payments and reduced, or no, inflation indexation.

With the assistance of these behaviour-targeted product features, and sustained, high levels of loss aversion following the global financial crisis, lifetime annuity sales in Australia have grown from a total of 14 policies issued across Australia in FY2011 to \$613 million in sales by Challenger in FY2014. This is more than the entire annuity industry has sold in Australia in any previous year.

ILAs are an intense promise regulated by APRA with strict prudential standards, supervision, powers of regulatory intervention, substantial capital requirements and guaranteed income.

8.3.2 FTA (fixed term annuity)

An FTA provides a guaranteed income stream for a term of certain duration. FTAs pay a fixed rate, a fixed annual rate of increase up to 5%, or are indexed by the CPI. Indexation by an ABS wage index is permitted under the SIS pension rules but is not feasible due to a lack of available hedging. As an annuity the income stream can include return of all of the capital, part of the capital or none of the capital; 0%-100% RCV (residual capital value). FTAs are available with tenors of 1 to 50 years. FTAs provide guaranteed protection against market risk. FTAs can also provide protection against inflation risk but most FTAs are short term fixed rate.

An FTA with a very long tenor could be used to partially address longevity risk but are less efficient than an immediate lifetime annuity for doing so because an immediate lifetime annuity will provide continuing income in the event that life exceeds the term of the FTA and an ILA should provide a higher rate than an FTA as early deaths are worth more to the pool of lives than the cost of long lives.

Non-commutable nil RCV FTAs with tenors at least to life expectancy purchased before 20 September, 2007 are complying income streams for the purposes of a social security ATE (assets test exemption), which falls short of full longevity risk protection as half the population exceed life expectancy. The ATE was removed for complying income streams bought after that date. On death the remaining value of an FTA is paid to the estate of the policy holder. FTAs are an intense promise regulated by APRA with strict prudential standards, supervision, powers of regulatory intervention, substantial capital requirements and guaranteed income.

8.3.3 ABP (account based pension)

ABPs are allocated pension products or accounts and are required to meet the minimum drawdown rules each year. They are fully commutable. The fund member carries all investment risk and longevity risk. There is no intense promise, the income stream has no capital backing and there is no guarantee.

8.3.4 TAP (term allocated pension)

TAPs are a non-commutable allocated pension product with both a minimum and maximum rate of drawdown. Fund members can choose an income within the range of minimum and maximum drawdown. Non-commutability and the limit on the pension taken are intended to ensure that the income stream lasts for an extended period. The fund member carries all investment risk, longevity risk and inflation risk. TAPs are complying income streams for the purposes of a social security ATE (assets test exemption) grandfathered for those bought before 2007. On death the remaining value of the TAP is paid as a death benefit or to the account holder's estate. There is no intense promise, the income stream has no capital backing and there is no guarantee.

8.3.5 VA (variable annuity)

VAs are hybrids combining an account based product with a guarantee typically to pay a fixed percentage of the starting balance for life. These products provide guaranteed income, exposure to the upside of the market and access to capital. The level of guaranteed income has the potential to ratchet up if the market outperforms. Guaranteed income reduces if the retiree takes a lump sum. VAs offer specified protection against both longevity risk and investment risk provided the retiree does not choose to drawdown their capital. The guarantee is typically in nominal terms

with the retiree needing sufficient market performance to deal with inflation risk. Longevity risk is transferred to a life office and investment risk may be hedged by the provider on its own account or transferred to another institution. VAs are fully commutable at which point any guaranteed income ceases. VAs offer a less intense promise with the longevity risk and investment risk protection they provide being paid for by the retiree by way of fees. The fees have a significant impact on net performance.

8.3.6 RCLA (ruin contingent lifetime annuity)

An RCLA is a type of income stream currently found only in academic literature. An RCLA would provide an income stream for life commencing at a later date, conditional on both survival and failure of a specified income stream. RCLAs could be based either on a real portfolio of assets or a notional drawdown against a market index. They could provide protection against investment risk and longevity risk throughout retirement. They could also provide a guarantee against inflation risk. There may be basis risk (a potential income gap) if the retiree invests in assets that differ from those on which the RCLA is based. Because RCLAs pool longevity risk they would have to be non-commutable. RCLAs would involve an intense promise regulated by APRA with strict prudential standards, supervision, powers of regulatory intervention, substantial capital requirements and guaranteed income.

9. If part of retirees' superannuation benefits were to default into an income stream product, which product(s) would be appropriate?

There are a number of characteristics or criteria that would be desirable in a default product:

- i. An extremely high probability that the income stream will not fail, that is it should produce significant private income to the end of life with an income profile that meets the members' needs.
- ii. The product must recognise that retirement is different to accumulation and address the principal retirement risks:
 - longevity risk;
 - investment risk and in particular sequencing risk; and
 - inflation risk.
- iii. The product must be acceptable to retirees, that is:
 - sufficiently flexible in terms of some access to capital;
 - recognise that the retiree may have bequest objectives; and
 - if possible provide money to assist with aged care costs.

Those criteria lead to default solutions which are part account based and part lifetime annuity. The combinations can come from ABPs and TAP like products on the account based side; and ILAs and DLAs on the guaranteed side.

Combinations of these products will maintain exposure to the market with a robust layer of guaranteed income.

A robust layer of guaranteed income means:

- a significant component, though not necessarily a majority of the income stream is guaranteed for life;
- there is pooling of longevity risk to reduce the cost of longevity protection;
- the guaranteed component is APRA regulated under the Life Insurance Act 1995 with prudential standards, supervision and life office capital standards; and
- the longevity protection component is non-commutable and attached to the life of the retiree, so the income guarantee to end of life is effective and providers are not faced with additional adverse selection risks.

The characteristics of product types make them more or less effective in meeting income or risk management objectives which may be the basis of more refined criteria for default products, for example:

- Immediate lifetime annuities will provide income while mitigating sequencing risk; While DLAs do not provide income during the deferral period they remove part of the retirement balance from exposure to sequencing risk and provide cost efficient longevity, investment and inflation risk protection late in life, as well as defining the timeframe over which the account based component must provide income; and
- RCLAs (which have not been priced in the current Australian context) would match guaranteed income with the point of ruin for the account based component.

Relevant to this is Attachment 5 to Challenger's first submission to the FSI, which is a Watson Wyatt actuarial investigation using stochastic modelling, which found that the expected outcome from an ABP with an annuity is better (both higher minimum and maximum outcomes) than an ABP with no annuity. Using a reverse mortgage metric to maintain target income, partial annuitisation was also found to assist retirees in achieving more of their estate planning objectives by consuming less of their non-super assets if their ABP failed.

The inclusion of VAs as a default would need to be carefully thought through. They are complex products which generally carry significant fees. There is a high risk that consumers will not fully understand the product or appreciate the risks. For example, common implementations provide low levels of guaranteed non-inflation indexed income. Inflation therefore erodes the effectiveness of these products for longevity protection. VAs are fully commutable.

GSAs, in theory, look like a good default product, particularly with a seamless transition from accumulation, but they present significant challenges:

- No guarantee (prudentially regulated or otherwise);
- Target income may be reduced or cease in light of actual investment and mortality experience;
- If they are not completely non-commutable there are major selection risks down the track;
- Only manage idiosyncratic longevity risk of the pool, not systemic longevity risk of the population; which may be more important;
- There are significant challenges maintaining equity between different cohorts of entrants; and
- The members ultimately carry all of the risk, including the additional scope for mistakes and conflicts of interest of the provider.

If GSAs are to be permitted as part of a default pension it would need to be within a portfolio including a component of guaranteed income. However the amount of guaranteed income required could be lower than that required in the case of an ABP/annuity combination because the idiosyncratic longevity risk component, as opposed to the systemic longevity risk component, should already be covered by the GSA, assuming a sufficient pool of lives.

9.1 How should the default be administered?

Commencement of a default income stream has to be triggered by an individual actively taking a decision to retire and not make another choice. Contributions ceasing after preservation age is not a reliable indicator of retirement because the fund member may have changed employment and default superannuation provider, exercised choice for new contributions without consolidating, or have taken a decision to use income from other super or non-super assets while leaving the fund no longer receiving contributions to accumulate.

The Government could be prescriptive about the options as they are in Chile where retirees have a choice which covers three pension options for their compulsory contribution segment, essentially a choice between stipulated defaults:

1. an immediate lifetime annuity;
2. a programmed withdrawal (account based pension) and an immediate lifetime annuity; and
3. a temporary allowance (account based pension with recognition it is likely to fail) and a deferred lifetime annuity.

It is more likely in Australia that we would leave responsibility for overseeing the development of default options to superannuation fund trustees. The simple way of doing that would be to legislate to require trustees to specifically consider longevity risk, investment risk and inflation risk when designing retirement income solutions. That would be done by amending section 52(f) of the SIS Act as recommended by the Cooper Review. Regulation of default settings need be no more prescriptive than requiring a non-commutable lifetime guaranteed component (immediate lifetime annuity, DLA or RCLA) with a minimum income objective.

10. Will the private sector be able to manage longevity risk if there is a large increase in the use of longevity-protected products? How could this be achieved?

Under APRA's capital standards, an amount up to 7 per cent of the total premium value would be required to be put aside to cover longevity risk for a lifetime annuity bought by a 65-year-old male (with real interest rates around 1.5 per cent per annum). That capital is provided, and put at risk, by the life company's shareholders.

The additional capital required across the industry to support growth in demand for lifetime annuities can be approximated as follows. An estimated \$72bn in superannuation funds will make the transition from accumulation to pension phase as people retire in FY15. If those retirees used 10 per cent of that capital to buy lifetime annuities (ie \$7.2 billion per annum in lifetime annuities), life companies would have had to find around \$500 million of new equity capital annually. On that basis, with the ageing population, if lifetime annuities (including deferred lifetime annuities) reached a 10 per cent share of the post-retirement market by 2020, the annual capital requirements for longevity risk for new business would be in the region of \$900 million a year. Challenger's announced capital raising of \$530m in August to fund future growth is noteworthy in this context.

11. Should Government increase its provision of longevity insurance? How would institutional arrangements be established to ensure they were stable and not subject to political interference?

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 3: Major drivers of the increase in the Budget cost of ageing over the next 50 years

	2011-12 Share of GDP %	2059-60 Share of GDP %	Change Share of GDP %
Health care (Aus govt)	4.1	7.0	2.9
Health care (States)	2.4	3.8	1.4
Age pension	2.7	3.7	1.0
Aged care	0.9	2.6	1.8
Sum	10.1	17.1	7.1

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

A substantial part of those pressures is the longevity risk carried by the government, not just through the mechanism of the Age Pension and its means test, but significantly through aged care and very particularly health costs. Government's over the next several decades will find it very challenging managing the longevity risk that they already carry on their balance sheets as a result of existing policy settings.

There are two ways in which government could provide longevity insurance. The first is by increasing the size and, through the mechanism of the means test, the extent of eligibility for the Age Pension. As Patricia Pascuzzo notes in her paper *An International Comparison of Pension Systems Performance in Delivering Adequate Retirement Incomes (2014)* that would have considerable negative budgetary implications, adversely affect incentives for voluntary savings and encourage greater risk-taking in superannuation investment.

The second way government could provide longevity insurance is as a provider of lifetime annuities. However this would be completely counterproductive to reducing the very large amount of longevity risk carried by the government. It would also be an extremely sub-optimal approach to dealing with individuals' longevity risk. If it were provided on budget, premiums as a receipt and benefits as an outlay, the fair basis for setting the rate would be the risk free rate (Commonwealth Government Securities). That would be low relative to the rate the prospective annuitant could obtain from a life office, which would commit shareholders' capital and invest in riskier assets. Government provision would therefore result in a reduction in the annuitant's living standard.

If the government tried to replicate the rate provided by the private life office it would have two choices. One, subsidise the rate at the expense of other taxpayers, many of whom would have too few financial resources to participate. Two, set up a government financial institution to provide annuities on a quasi-commercial basis using taxpayers funds as capital and investing in riskier assets. Some supporters of this concept have suggested that the government could do this at lower cost than a private life office because the government's cost of capital is lower. The cost capital is actually equal for the two modes of operation. The risks are the same. The difference is that in the case of the government operation the capital is paid for by taxpayers. Challenger commissioned Access Economics to prepare a report for the Henry Review which explains this, and it is Attachment F to this submission. Challenger also commissioned Chris Dalton, the former Australian country head of S&P to write a report setting out the implications for Australia's sovereign rating if the government became an annuity provider. The Rating of Australia and the

Proposal for Public Provision of Annuities is Attachment 9 to Challenger's first submission to the FSI.

Most of the proposals for public provision of annuities have been that it be done through Centrelink. This rather understates the complexity and responsibility that would go with that organisation becoming a provider of financial advice.

A fundamental risk with government providing funded pension arrangements is that economic decisions on pricing and benefits become separated in the political process causing large imbalances and economic losses to the government and taxpayers. This has previously occurred with public sector superannuation schemes in Australia and it has occurred most spectacularly with the social security system in the United States over many decades. It is something that cannot persist long in a commercial environment.

The Government's policy response 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 by private insurers. Government has a fiscal imperative to shift as much of this risk off its balance sheet as possible.

12. What are some appropriate ways to assess and compare retirement income products? Is 'income' efficiency a useful measure?

Challenger commissioned Towers Watson to investigate the performance of various types of income streams, alone (except for DLAs) and in combination, to determine which have the necessary characteristics in terms of capability to deliver target income with adequate reliability to be considered as candidates for use as a default post-retirement strategy. Towers Watson's report is Attachment G to this submission.

12.1 Strategies

The following strategies were evaluated:

- Strategy 1: 100% invested in an account based pension;
- Strategy 2: 30% invested in an immediate lifetime annuity and 70% invested in an account based pension;
- Strategy 3: 100% used to purchase an immediate lifetime annuity
- Strategy 4: 10% used to purchase a 20 year deferred lifetime annuity and 90% invested in an account based pension.
- Strategy 5: 50% invested in a group self-insured annuity (GSA) and 50% invested in an account based pension;
- Strategy 6: 100% invested in a GSA

In each strategy where an account based pension is included, the account is assumed to be invested in 70% 'growth assets' and 30% 'defensive assets', with annual rebalancing.

The income and account balance results in this report are expressed as a percentage of the initial superannuation account balance, with a notional account balance at retirement of \$400,000.

As the age pension is not included in the modelling, the results are substantially the same for any account size. Absence from the modelling of the Age Pension and means test provides a clearer evaluation of each strategy's relative performance.

12.2 GSA

GSAs are yet to be brought to market in Australia. There are a range of GSA designs possible. Towers Watson has developed the following relatively simple product specification:

- The retiree invests in a pooled group of assets with other participating members;
- As members of the pool die, their share of the pool is divided amongst the surviving members. This additional return to the surviving members is a 'mortality credit'.
- The GSA distributes mortality credits to surviving participants annually, as an additional lump sum, credit to the account. In all other respects, the GSA operates in the same way as an account based pension.
- The modelling assumes every participant in the pool (including the model retiree) is the same age, has the same initial account balance, invests in the same way and draws down the same dollar amount from the GSA each year, so that the exposure of each surviving participant in the GSA in any year is the same as the model retiree.

12.3 Target Income

The investigation uses a "target income" framework where the retiree endeavours to draw a specified level of retirement income each year until death, drawing upon all sources available under the strategy. To the extent that a strategy is unable to deliver target income in any year (for example, once an account based pension has been exhausted) the retiree draws the maximum amount available (which may be zero).

As the target income is the same across all strategies being assessed, a target income framework allows the use of metrics such as residual account balance at a given age to assist in comparing the success of each of the strategies at meeting this target over the retiree's lifetime.

In this investigation, target income is specified as a percentage of the initial superannuation account balance at retirement (e.g. an income of 7.5% of the initial account). The target income in each year is assumed to be indexed with CPI to maintain its purchasing power over retirement. A flat target income effectively assumes that the retiree's desired spending level remains constant in real terms over retirement. There are a number of alternative spending patterns that may be considered applicable to retirees. In order to investigate these, Towers Watson also modelled the following target incomes:

- "tapered" – the target income reduces when the retiree moves from the active to passive, stage of retirement and reduces again from the passive to frail stages of retirement. This shape reflects a reduced spending need as the retiree's level of activity declines.
- "U-shaped" – the target income reduces when the retiree moves from the active to passive stage of retirement, but increases when the retiree moves from the passive to frail stage of retirement. This shape reflects increased health costs incurred in the frail stage of retirement.

The modelling excludes any income provided by the government Age Pension, and uses:

- Investment returns generated using the Towers Watson Global Asset Model.
- Pricing of immediate and deferred lifetime annuities specified as a prescribed margin over prevailing swap rates.
- Account Based Pension, pension platform and administration fees in line with the FSC Superannuation Fees Report 2013 published by Rice Warner Actuaries for Retail retirement income products.

12.4 Probability of success

Given the objective of delivering target income through the retiree's lifetime, the natural metric to consider in this stochastic modelling framework is the probability of achieving "success" which in this context is achieving target income in all years of retirement up to the year of the retiree's death. The probability of success metric is defined as the proportion of all simulations that achieve success.

Probability of success is a useful summary metric for comparing different strategies. However, it does not distinguish between scenarios where the strategy just falls short of delivering a successful outcome, and where it fails comprehensively. This is addressed by the next metric.

12.5 Goodness of Fit (GOFI)

Towers Watson developed a "Goodness of Fit Index" (GOFI) metric which measures how well a given product or strategy delivers retirement income in line with a pre-determined "target" income. Hence, a pre-condition to measuring GOFI is an agreed target income for the retiree. The target income is specified in terms of the notional purchase price (e.g. an income of 7.5% of the initial capital, indexed with CPI, continuing until death). Clearly a range of target incomes could be selected, and the relative GOFI measures of different products will differ for different target incomes.

For a given strategy, the projected (real) cash flows and the shortfall of these cash flows relative to target income (shortfall) are determined for each projection year. Generally the projected cash flows will be dependent on a market variable. For example, income from an account-based pension will depend on market returns, and the income from an annuity will depend on the prevailing interest rates at the date(s) of purchase.

A set of simulated cash flows is derived stochastically, and the GOFI determined for each such simulation up to the simulated date of death. The GOFI for the product or strategy is then taken to be the weighted average of the GOFIs across all investment market simulations.

Features of the GOFI include:

- GOFI lies between 0 and 1; 1 indicates a perfect fit to the target income, 0 indicates no income (so that the shortfall equals the target income at all times).
- GOFI takes into account how well the "shape" of income produced by a product/strategy matches target income. For example, an income producing product would have a higher GOFI than a lump sum of the same value. Other than reflecting shortfalls up to date of death only, the GOFI metric does not assume a preference for "earlier" rather than "later" cash flows, in the way a discounted cash flow metric may.
- GOFI factors in the extent to which income produced by a product or strategy falls short of delivering the target income over a lifetime. Hence a term annuity which may cease prior to an individual's death would have a lower GOFI than a life time annuity at the same income level.
- Intuitively, the GOFI can be regarded as the "average" proportion of target income delivered allowing for downside (but not upside) differences.
- GOFI reflects presumed relative risk aversion of retirees on a year by year basis. That is, a product or strategy which results in a large shortfall in a single year produces a lower GOFI than a strategy that delivers a smaller shortfall across a number of years, even if the aggregate shortfall is the same for each.

- GOFI is not a simple measure (it requires a stochastic framework for it to be calculated for most strategies) and (as noted above) the GOFI measure depends among other things on a prescribed target income. However in our view it captures and summarises different product design aspects in a way that measures like probability of success cannot, and therefore is a valuable tool in comparing different retirement income strategies.

Table 4: Core results – 7.5% of initial balance

Strategy	Age at which available assets fall to zero		Available assets at age 85*			Probability of success	GOFI
	Median	5th Percentile	5th percentile	Median	95th percentile		
St 1 - Account Based Pension (ABP)	86	78	0%	14%	150%	49%	73%
St 2 - ABP + Lifetime Annuity	88	79	0%	13%	106%	51%	83%
St 3 - Lifetime Annuity	65	65	0%	0%	0%	66%	99%
St 4 - ABP + Deferred Annuity from 85	84	77	0%	0%	115%	47%	80%
St 5 - ABP + GSA	87	78	0%	6%	67%	59%	78%
St 6 – GSA	65	65	0%	0%	0%	65%	81%

* Available assets expressed as a percentage of the Initial retirement account balance
Source: Towers Watson Report: Comparing Retirement Income Strategies, August 2014

The table above illustrates the trade-offs associated with the various strategies. For example, investing all of the retirement account in a lifetime annuity or GSA leaves no available assets on death immediately from the date of purchase. Conversely, strategies which leave part of the capital in an account based pension are more likely to keep assets available upon the retiree's death (e.g. for bequest purposes).

A GSA strategy generally improves outcomes relative to an account based pension, on account of mortality credits. However, a GSA strategy leaves reduced (or no) assets on death as these are shared with remaining participants.

Probability of success is in the range 40% – 70% across all strategies, illustrating the difficulty in achieving “success” across all market conditions. However, the GOFI metric, which captures not only whether a strategy falls short of success but the extent of the shortfall, indicates more positive results of between 70% and 100%.

The following tables isolate the trade-off between exhausting assets available on death compared to the ability to achieve the best fit for target income. Towers Watson looked at this trade-off for various sensitivities.

The following table isolates the trade-off between exhausting assets available on death compared to the ability to achieve the best fit for target income.

Strategies involving account based pensions produce lower GOFIs, relative to the corresponding probability of success. This follows from the fact that where an account based pension falls short of target income, this indicates the account has run out and hence income falls to zero. If annuity strategies, on the other hand, fall short of target they still produce income, improving the GOFI score relative to ABPs. In the remaining tables of this section, only median ‘age available assets exhausted’ and GOFI are presented in order to compare the strategies using different underlying assumptions.

Table 5: Impact of Target Income Level

Target Income (% of initial balance)	7.5%		6.5%		8.5%	
	Age at which available assets fall to zero - Median	GOFI	Age at which available assets fall to zero - Median	GOFI	Age at which available assets fall to zero - Median	GOFI
St 1 - Account Based Pension (ABP)	86	73%	94	84%	82	63%
St 2 - ABP + Lifetime Annuity	88	83%	101	93%	82	71%
St 3 - Lifetime Annuity	65	99%	65	100%	65	92%
St 4 - ABP + Deferred Annuity from 85	84	80%	105	90%	80	68%
St 5 - ABP + GSA	87	78%	94	88%	83	66%
St 6 – GSA	65	81%	65	91%	65	70%

Source: Towers Watson Report: Comparing Retirement Income Strategies, August 2014

Where the target income is lower, all strategies naturally perform well, as evidenced in particular by GOFI scores of above 80% under all strategies for the low target income (6.5%). As target income increases, probability of success and GOFI scores fall fairly uniformly for all strategies except the GOFI for the 100% lifetime annuity, which falls at a lower rate than other strategies due to the fact that GOFI better captures the continuation of the annuity income stream throughout retirement even where the annuity level falls short of target.

Post-GFC regulatory response: Stability

The post GFC regulatory response has created and or exacerbated certain distortions in the credit creation process. Most noteworthy in this regard is the Financial Claims Scheme together with broader implicit government credit support of banks (as evidenced by GFC wholesale funding government guarantees for example). These credit support measures provide banks with a subsidised cost of funding relative to both other prudentially regulated financial institutions such as life offices and relative to other less regulated non-bank financial institutions. The less onerous capital standards that banks operate under compared to other prudentially regulated financial funding providers such as life offices is also distortionary. Together, these distortions result in a disproportionately large share of funding flows through the banking system.

The post GFC regulatory response has also included changes to laws and regulations covering advice. Care needs to be taken to avoid unintended consequences of such changes. In particular, relabeling all general advice as “sales” may be at the detriment of consumer education outcomes.

FSI information request	Challenger Submission Section
Modify the FCS, possibly including simplification, lowering the insured threshold or introducing an ex ante fee. What measures could be taken to simplify the FCS with minimal burden on industry, while still ensuring the effectiveness of the scheme? What is an appropriate threshold for the FCS guarantee of deposits?	13
Maintain the current calibration of Australia's prudential framework.	14
Rename general advice as ‘sales’ or ‘product information’ and mandate that the term ‘advice’ can only be used in relation to personal advice.	15

13. Financial Claims Scheme

Challenger’s first submission to the FSI focussed on the distortions created by the ADI deposit guarantee. These had been examined in an independent report for Challenger Limited by Prof Kevin Davis and Martin Jenkinson of the ACFS which discussed these distortions and which concluded that the FCS needs to be reviewed. That report was Attachment 15 to Challenger’s first submission to the FSI.

To reduce the distortions created by the ADI deposit guarantee Challenger proposed:

- a. Limiting coverage to at-call accounts rather than including less liquid investment products such as term deposits;
- b. Reducing the cap to between \$50,000 and \$100,000;
- c. Applying the cap on a per person basis instead of per person per institution; and
- d. If individuals have a need for a guarantee above the cap they should be able to purchase deposit insurance from a private provider.

For this submission, Challenger commissioned Chris Murphy of *independenteconomics* to model the effects on the Australian economy and households of the distortions created by the Financial Claims Scheme. His report *Economic impacts of reforming the Financial Claims Scheme (25 August 2014)* is Attachment H to this submission.

This is a significant micro-economic reform issue. For the purposes of comparison it is worth noting that the order of magnitude of the allocative efficiency distortion is not too dissimilar to the total annual cost reductions for business targeted by the Australian Government's current deregulation program. Challenger regards ex-ante fee as unlikely to change behaviour significantly enough to reduce the distortion created by the FCS. Challenger believes that the distortion must be directly addressed by reducing the cap to no higher than \$100,000 per person.

The following is a summary of Chris Murphy's analysis and the modelling results.

The report simulates the economic impacts of various FCS reform options using the Independent Computable General Equilibrium (CGE) model, which was extended for this report. The three broad finance industries found in Australian CGE models were disaggregated to 12 industries, so that ADIs are identified as a separate industry. Further, the structure of modelling consumer choices was enriched to take into account that ADI financial services are more closely substitutable for non-ADI financial services than is the case for other goods and services.

The model results are for the long-term, after the economy has fully adjusted to economic shocks. This is fitting for policy analysis because economic policies should be judged against their lasting effects on the economy, not just their effects in the first one or two years.

13.1 The FCS scenarios

The model was used to simulate seven policy scenarios. The design of each of these scenarios is summarised in Table A. Some of these scenarios focus on the areas in which the Interim Report of the FSI invited submissions on the costs and benefits of incremental change. Other scenarios are designed to assess the costs and benefits of each policy scenario.

The baseline scenario refers to the existing policy of the FCS in its current form. It provides the point of comparison for the other scenarios.

13.1.1 Lowering the insured amount

The next two scenarios lower the insured amount. The \$100k scenario reduces the coverage limit from \$250k to \$100k and applies it to each account holder once, after aggregating holdings across ADIs. The \$50k scenario reduces the coverage limit by more, from \$250k to \$50k, and also applies it to each account holder once. These coverage reductions reduce, but do not eliminate, the moral hazard and allocative inefficiency costs of the FCS.

Table A: Design of Policy Scenarios

Features	FCS (baseline)	\$100k limit	\$50k limit	apply premium	limit + premium	abolish FCS	costless scheme
Coverage limit	\$250k	\$100k	\$50k	\$250k	\$50k	na	na
Separate limit per ADI	yes	no	no	yes	yes	na	na
Premium	no	no	no	yes, risk-based	yes, risk-based	no	no
Severe bank runs	no	no	no	no	no	yes	no
moral hazard	yes	reduced	further reduced	no	no	no	no
Allocative inefficiency	yes	reduced	further reduced	further reduced	largest reduction	no	no
Insurance pool cost	no	no	no	yes	no	no	no

13.1.2 Introducing insurance premiums

The *apply premium* scenario introduces an ex ante premium and calibrates it to the risk of each bank. This is in keeping with a recent IMF (2012) recommendation for the FCS.

The authorities should re-evaluate the merits of ex-ante funding for the FCS with a view toward converting it to an ex-ante funded scheme... with an objective to implement risk-based assessments over time. (IMF, 2012).

In the modelling, risk-rated premiums remove the moral hazard cost and reduce the allocative inefficiency cost of the FCS, while introducing a new cost of maintaining a funding pool.

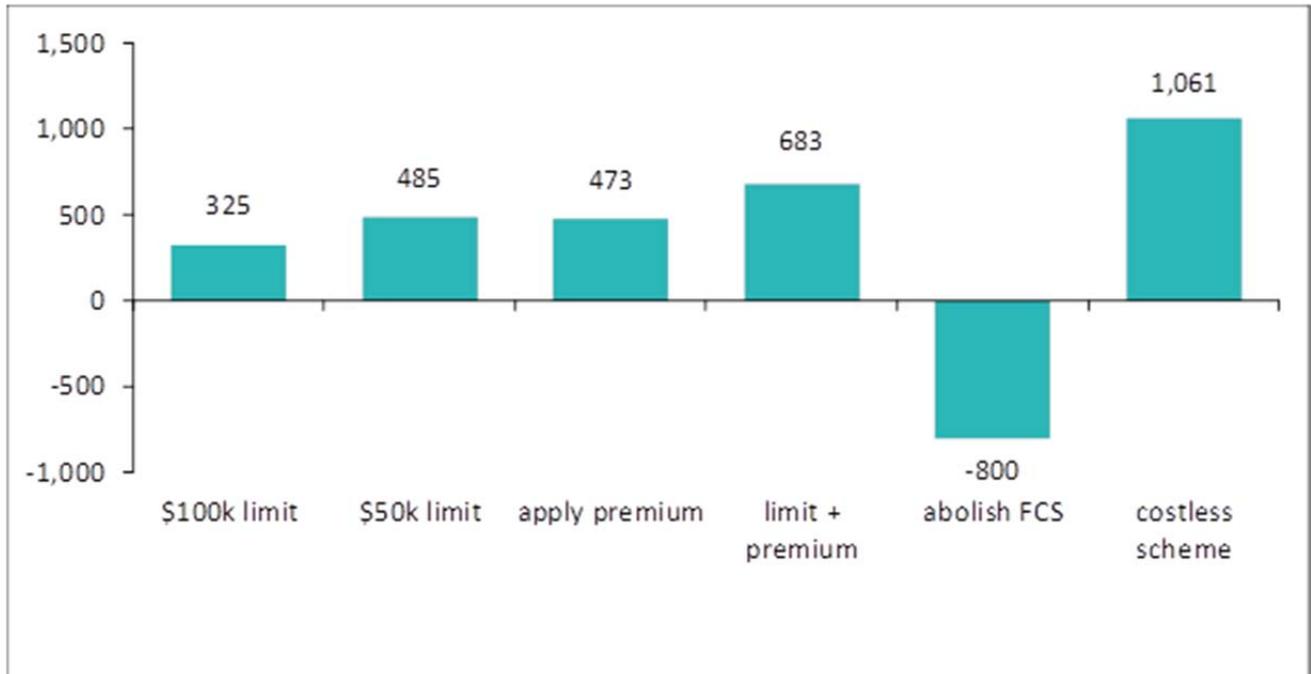
The *limit + premium* scenario combines the two ideas for improving the FCS i.e. it combines reducing the coverage limit from \$250k to \$50k with introducing risk-rated premiums.

13.1.3 Abolishing the FCS

The *abolish FCS* scenario simulates the abolition of the FCS. Its costs disappear, but so does its benefit of eliminating severe bank runs. The *costless scheme* scenario makes the hypothetical assumption that an ideal scheme could be devised that prevented severe bank runs while incurring no costs. It is designed to identify the costs of the FCS.

The comparative results from the scenarios are presented in Charts A to D. The results are expressed as deviations from the baseline scenario, which includes the FCS in its present form. Hence, they show the incremental economic impacts of alternative reforms to the FCS.

Chart A: Effects of FCS policies on Australian living standards (\$million, 2012-13 terms)



Source: Independent Extended CGE model

Chart B: Effects of FCS policies on real GDP (per cent)



Source: Independent Extended CGE model

13.2 Allocative inefficiency

Under the FCS, the availability of “free” insurance from ADIs can distort the choice of consumers in favour of investing with ADI rather than non-ADI financial institutions. This non-level playing field may lead to allocative inefficiency, with the ADI sector oversized and the rest of the financial sector undersized. This is consistent with the shift to insured deposits that was observed during the GFC.

13.3 Moral hazard

Insurance can create a “moral hazard” problem: by reducing the costs of risky behaviour, insurance may increase its prevalence. Because they are protected from bank failure, insured depositors choosing a bank may be less focussed on whether a bank lends prudently than uninsured depositors. This relaxation of market discipline from depositors may lead to excessively risky lending, making bank failure more likely. Thus, Barth et al. (2013) conclude that: “while instilling confidence in depositors that their funds are always safe, so as to prevent bank runs, deposit insurance simultaneously increases the likelihood of another serious banking problem in the form of moral hazard”.

Of course prudential regulation and supervision do aim to safeguard against excessively risky lending by banks. However, this task becomes more challenging when moral hazard from bank deposit insurance is introduced.

The existing design features of the FCS show more of a focus on depositor confidence than moral hazard. This is understandable in that the FCS was introduced in response to a potential crisis in depositor confidence from the GFC. However, the FSI provides an opportunity to review the FCS and make it a more balanced scheme. Other countries, including the USA since 1993 (Ellis, 2013), and Canada (CDIC, 2014), apply risk-based insurance premiums calibrated to the level of risk of each bank. “The advantage of risk-based premiums is that they potentially can be used to induce banks to avoid engaging in excessively risky activities” (Barth et al., 2013).

13.4 Abolishing the FCS

Abolishing the FCS removes both its benefits and costs. Losing the benefit of eliminating severe bank runs is only partly offset by the savings from eliminating the moral hazard and the allocative inefficiency costs of the FCS. Hence, abolishing the FCS results in a significant loss in living standards on an annual basis of \$800 million (Chart A). Similarly, there is a significant loss in GDP of 0.05 per cent (Chart B). Thus, the results suggest that the FCS should be retained rather than abolished.

13.5 Coverage

An effective way to reduce moral hazard would be to reduce the coverage of the FCS. The scope of the FCS in its present form is broader than for bank deposit insurance schemes in most other major jurisdictions, apart from the USA, which has similar scheme coverage. This broad scope has three dimensions.

First, the insured value is capped at \$250,000, whereas it is capped at the equivalent of around AUD 100,000 in most other high-income countries with deposit insurance (Demirgüç-Kunt, Kane and Laeven, 2014). As Barth et al. (2013) note: “the higher the limit the more protection is offered to individual depositors, but the higher the limit the greater the moral hazard”.

Second, the insured cap under the FCS is provided for each bank used by an account holder. This provides an incentive for account holders to open accounts at more banks to obtain more insurance cover. The cost of opening additional accounts in response to regulation represents a deadweight loss to the economy (Shy, Stenbacka and Yankov, 2014).

Third, the FCS has no coinsurance. Countries with coinsurance require that depositors bear up to 10 per cent of losses. Barth et al. (2013) find that in practice this relatively small percentage of coinsurance is enough to “help to curb moral hazard”.

Reducing the broad coverage of the FCS in any or all of the above three areas would help to improve the focus of the scheme on containing moral hazard for bank lending. In this report, one FCS reform option modelled is to reduce the insured cap from \$250,000 to either \$100,000 or \$50,000, while removing the incentive for account splitting by aggregating over accounts at different ADIs before applying the cap.

Reducing coverage, and the associated government backing of bank deposits, also reduces the allocative inefficiency problem. It reduces the extent of the favouritism from government backing of bank deposits when there is no similar government backing of household investments with non-bank financial institutions.

13.6 Lowering the insured amount

Reforming the FCS by lowering the insured threshold and closing the account splitting loophole lowers the moral hazard and allocative inefficiency costs of the FCS. This generates a sustained gain in consumer living standards on an annual basis of \$325 million under a reduction in the threshold to \$100k, or \$485 million under a larger reduction in the threshold to \$50k (Chart A). Similarly, reducing the insured threshold provides an ongoing boost to the level of GDP. This boost is 0.04 per cent or 0.05 per cent, depending on the extent of the reduction in the threshold (Chart B).

13.7 Introducing insurance premiums

Reforming the FCS by introducing insurance premiums and making them risk-rated removes the moral hazard problem while developing an insurance pool of funding that has an opportunity cost. This opportunity cost effect only partly offsets the benefits from reducing moral hazard, leaving a small gain in productivity for the ADI sector. Introducing premiums also reduces the existing allocative inefficiency resulting from “free” insurance. These two improvements combined with the productivity improvement to lead to a significant overall gain in living standards of \$473 million per annum (Chart A). Similarly, there is a significant gain in GDP of 0.05 per cent (Chart B).

14. Capital Standards

14.1 Annuities

APRA recently finalised LAGIC, its review of life and general insurance capital standards. In respect of those revised standards the FSI said in its Interim Report at page 4-30:

“Challenger’s submission notes that capital requirements for Australian life insurance companies offering annuities are high by international standards. This provides greater assurance to recipients against the failure of the provider. However, it also makes annuities more expensive.”

In the course of the LAGIC review Ernst & Young undertook a number of studies on behalf of the industry which included comparisons between Australian and international capital standards for annuities and comparisons between Australian life offices and banks, particularly for term annuities and term deposits.

For the benefit of the FSI Challenger engaged Ernst and Young to update some of these studies and their report is at Attachment I to this submission.

A retiree faces a number of risks in using an accumulated lump sum to fund an income stream throughout retirement:

- investment risk, including sequencing risk – the risk that movements in investment markets, and the timing of those movement, results in an adverse impact on the savings of the retiree;
- inflation risk – the risk that the income generated does not keep pace with inflation;
- idiosyncratic longevity risk – the risk that an individual lives longer than an average person for their cohort
- systematic longevity risk – the risk that the average life expectancy of a cohort increases more than expected.

A retiree can choose to mitigate some or all of these risks through the purchase of guaranteed products under which the retiree transfers the risk to a financial institution.

Once a product is purchased, the financial institution takes on these risks and must stand behind the promises that it has made. An important way that financial institutions ensure they can fulfil their obligations is through the holding of capital – amounts in excess of the expected payout to the retiree, which covers a range of potential adverse events.

Financial institutions such as life companies and ADIs are regulated by APRA and are required to comply with prudential standards issued by APRA. These standards are designed to ensure that there is a very high likelihood that the financial institutions will meet their obligations.

In framing these standards, consideration is given to the specific part that the type of financial institution plays in the economy. In this respect, the function of a life company includes the provision of long term guarantees, and the prudential standards are framed to address this function and ensure that, over the long term, the life company is highly likely to fulfil its obligations.

In order to assess the difference in capital approach to meeting long term guarantees, Ernst & Young has compared the capital requirements under a number of guaranteed products between:

- a life company operating in Australia;
- a life company subject to Solvency II, which is due to apply in the EU from 1 January 2016;
- an ADI operating in Australia under the standard capital approach; and
- an ADI operating in Australia under the advanced capital approach.

The products considered were:

- a 3 year term certain annuity / term deposit, with 100% of the initial deposit returned at maturity (RCV100);
- a 5 year term certain annuity / term deposit, with RCV100;
- a 15 year term certain annuity / term deposit with the initial deposit returned throughout the term, so no capital value remains at maturity (RCV0); and
- a lifetime annuity.

The tables below compare capital requirements for Australian life companies, European life companies, Standard ADI and Advanced ADI assuming that they hold four different asset mixes:

- advanced bank asset mix;
- 100% corporate bonds, duration matched to that of liabilities; and
- asset mix weighted towards growth assets (i.e. including an allocation to equities and property). This asset mix is only relevant for the longer term products.

The results are set out in the following tables:

Table 6: 3 year term certain annuity / term deposit (RCV100) – as % of premium

Asset mix	Australian life company	Euro life company	Standard ADI	Advanced ADI
Advanced bank	7%	8%	7%	4%
100% corporate bonds	7%	5%	6%	4%

Table 7: 5 year term certain annuity / term deposit (RCV100) – as % of premium

Asset mix	Australian life company	Euro life company	Standard ADI	Advanced ADI
Advanced bank	10%	12%	7%	4%
100% corporate bonds	11%	9%	6%	4%

Table 8: 15 year term certain annuity / term deposit (RCV0) – as % of premium

Asset mix	Australian life company	Euro life company	Standard ADI	Advanced ADI
Advanced bank	16%	18%	7%	4%
100% corporate bonds	16%	11%	6%	4%
Growth weighting	23%	27%	22%	21%

Table 9: Lifetime annuity – as % of premium

Asset mix	Australian life company	Euro life company
Advanced bank	32%	40%
100% corporate bonds	31%	23%
Growth weighting	38%	44%

The above tables demonstrate that:

- The capital requirements of life companies in Australia are comparable with those proposed under Solvency II. Note that Solvency II requirements presented correspond to the Solvency Capital Requirement as distinct from the (lower) minimum capital requirement. On the other hand, Australian life companies are explicitly required by APRA to hold a target surplus of capital above the amounts presented here.

- The capital requirements for ADIs, both standard and advanced, are materially lower than those for life companies. This is particularly pronounced in the 15 year RCV0 product where ADI capital requirements are of the order of a third of the requirement of life companies, for a typical bank asset mix.
- The capital requirements of ADIs are not sensitive to the tenor of the product being written.
- Overall, ADI capital standards have been designed for financial institutions which offer short term guarantees. Their low levels and lack of sensitivity to the term of the product written demonstrate that ADIs are not well positioned to provide long term guaranteed products. These products are better provided by life companies, where the institution and the regulatory settings have been designed for the provision of such long term guarantees.

This capital disparity between life companies and 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:

- ADIs represent a greater systemic risk than do life insurers;
- ADIs have additional regulatory support in that they have an implicit (and currently explicit) government guarantee, and the RBA acts as a lender of last resort.

14.2 Competitive neutrality

At Recommendation 38 the Wallis Inquiry said:

“The APRC (APRA) should regulate life companies. The APRC (APRA) should be responsible for the prudential regulation of life companies on a similar basis to that currently applied by the ISC. However, the prudential regulation of life companies should be designed to provide, as far as is practicable, neutral treatment of life products compared with similar deposit and other investment and risk products. This should minimise the opportunities for regulatory arbitrage between life company investment and deposit taking business”.

In relation to competitive neutrality this recommendation was never implemented and this latest report from Ernst and Young confirms that is still the case. Challenger is not suggesting here that there should be a major realignment of capital and bank capital standards notwithstanding term deposits and fixed term annuities compete head to head in some segments of the market. However in recent years a couple of banks have structured term deposits to provide similar cash flows to annuities and have used the word annuity in the name of these term deposit products. The product disclosure statements for these products were subsequently withdrawn and reissued with the name changed, possibly because of the risk of confusion for clients who might assume those products would receive identical tax and social security treatment as annuities issued under the Life Insurance Act.

It may be the case that in the future banks may seek a capital arbitrage by requesting that term deposits with payment structures that resemble annuities receive the same tax and social security treatment as is provided to annuities. There is a significant difference between the capital requirements of life offices which offer products with very long tenors and banks whose capital standards are only suitable for products with short tenors. It is important that competitive neutrality is maintained and that the tax and social security treatment of annuities is not provided to term deposits, which would encourage capital arbitrage.

15. Advice

It is vital that consumers are clear about the type of advice they are receiving. However proposals seeking to bifurcate the current advice spectrum into personal advice and sales information are problematic.

Much valuable information regarding financial strategies is provided under the general advice definition. Challenger is concerned that redefining general advice as only 'sales' or 'product' information risks denying consumers access to financial education, so they have the knowledge, skills, attitudes and behaviours necessary to make sound financial decisions.

Improving financial education can be achieved via the provision of broad based financial strategies. Examples include salary sacrificing into super, transition to retirement strategies, dollar cost averaging, investing and budgeting. This information is neither personal advice nor 'sales' or 'product' information.

It is critical that under any proposed amendments to the definition of general advice that financial services providers retain the ability to provide broad based financial strategy information without the requirements that apply to personal advice.

Growth and Consolidation

Competitive neutrality is an important foundation upon which growth and consolidation can occur. Current disharmonies result in distortions and capital misallocation and these issues could get worse in the future. Existing disharmonies include subsidisation of bank funding costs through direct and indirect government credit support (as this submission argues in Section 13)), and capital disharmonies under which banks operate under less onerous capital standards than competing funding providers such as life offices (as this submission argues in Section 14). These distortions result in a disproportionate share of credit creation and other funding flowing through the banking system.

There is scope for these problems to get worse. If annuity social security treatments were applied to products offered to institutions operating outside life company capital requirements, capital arbitrage could result.

In this part of the submission, we consider the role that life offices can play in funding infrastructure, and in supporting the development of an Australian corporate bond market. We also examine the SME lending and consider the role that life offices and other non-bank financial institutions can play.

FSI information request	Challenger submission section
Funding	16
What are the impediments to the development of liquid, tradeable claims on infrastructure projects?	16.1
As a greater share of the population enters retirement, would the demand for fixed income products increase in the absence of regulation or other incentives? Would the development of annuity-style retirement income investment products encourage the growth of fixed income markets?	16.2
What are the best options to narrow the informational gaps between lenders and SME borrowers? What are the prospects for a market for securitised SME loans developing? What are the main barriers to greater broker activity in SME finance? Are these barriers transitional or structural in nature?	16.3
Consider additional mechanisms to MySuper to achieve better results for members, including auctions for default fund status.	17.1
Replace the three-day portability rule: <ul style="list-style-type: none"> • With a longer maximum time period or a staged transfer of members' balances between funds, including expanding the regulator's power to extend the maximum time period to the entire industry in times of stress. • By moving from the current prescription-based approach for portability of superannuation benefits to a principles-based approach. 	17.2

16. Funding

16.1 Flow of investment funds from superannuation

Annuity providers require long term inflation linked assets to match lifetime payment promises. Infrastructure, due to its long term predictable cash flows and strong inflation linkages, can be an ideal asset class to form part of the portfolio of backing lifetime annuities. Approximately 5% of Challenger Life's investment assets are infrastructure.

To the extent that the size of the annuity market increases, it would be reasonable to expect demand for infrastructure investments to increase. Such increased demand, as well as assisting in funding Australia's future more broadly, could lead to greater tradeable liquidity in infrastructure projects as multiple annuity providers build diverse portfolios of infrastructure assets.

16.2 Domestic corporate bond market

Over 70% of Challenger Life's \$11 billion in investment assets are fixed income including corporate bonds. Challenger Life is one of the country's most significant investors in corporate bonds. We are a major holder of long dated corporate bonds and long dated bonds issued by infrastructure projects.

To the extent that the size of the annuity market increases, demand for corporate bonds will correspondingly increase. This will enhance price discovery and sponsor further development of Australia's corporate bond market. A deeper corporate bond market will, in turn, improve overall stability Australia's financial system.

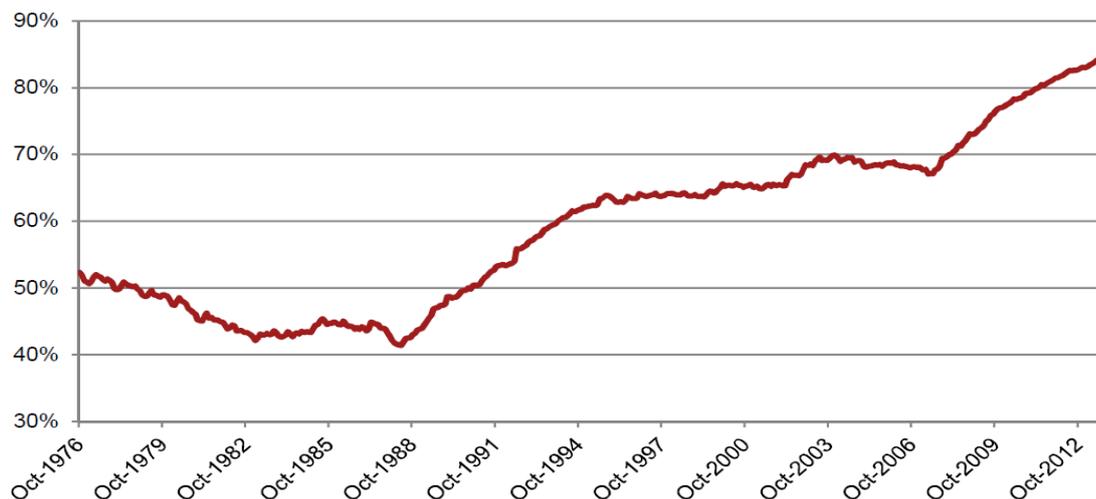
16.3 Lending to SMEs

16.3.1 What are the best options to narrow the informational gaps between lenders and SME borrowers?

Small Business Access to Funding

PwC's submission to the FSI, supported by the Australian Bankers Association (ABA) (see Figure 7 below), displays two distinct periods of rapid growth in bank share of credit provision. One from Oct 1988 to Oct 1994 and the second post the GFC from the end of 2006.

Figure 7: Bank loans as a proportion of credit (per cent)



Source: RBA, PwC analysis, 2013

The first period coincided with the rationalisation of non-bank lenders into the banking sector. Finance companies were acquired and integrated in the 4 major banks whilst credit unions became banks.

Interestingly, as evidenced by the ABA's data presented graphically below (see Figure 8), during the 12 years following this period and leading up to the GFC in 2007, bank lending less than \$2 million as a percentage of all business lending fell from over 50% to 20%. The bank share of overall credit continued to rise albeit more modestly.

Figure 8: New business lending less than \$2m (annual) as % of all business lending



Source Australian Bankers Association

The second period of rapid increase in bank share of credit was a logical result of the GFC. Many non-bank finance companies were unable to source funding and foreign speciality finance company subsidiaries retreated to their core European or US markets (for example Societe Generale's equipment finance business). This period also saw the further rationalisation of the banking marketplace with the acquisitions of St George and Bankwest. Most recently, the speciality finance business of Investec and Capital Finance (subsidiary of Lloyds Bank) have been sold to banks.

In relation to the share of bank lending less than \$2m, in the post GFC period it rose initially to above 30% but subsequently fell to around 27% currently.

The initial FSI report referenced some of the difficulties faced by SME's in relation to accessing capital. In addition to the issues around information asymmetries and small business credit quality that were raised in the report, product offering should be part of the solution. Matic, Gorajek and Stewart presented to the RBA's Small Business Finance Roundtable in May 2012 (Small Business Funding in Australia). The paper provided a good insight into the issues and alternatives available to small business to fund their business. In particular, the increased propensity for small business to use specialty products such as leasing, equipment finance and debtor finance.

"Beyond using debt products designed for households, and using residential property as loan collateral, smaller businesses also make use of alternative sources of debt. One example is equipment and vehicle leasing."

"Another important form of alternative debt finance for smaller business is debtor finance, which is short-term funding that a business obtains in exchange for selling its accounts receivables"

The reduction in the share of lending < \$2m correlates with the integration of the bank owned finance companies into the main banking operations and the exit from or loss of speciality product capabilities. As an example, the sale of the car leasing businesses of NAB's fleet finance businesses in 2006 and the exit of ANZ and CBA from the invoice discounting / debtor finance business.

The integration of the finance company capabilities into the core functional areas of the parent banks has resulted in the speciality products now being delivered by generalist relationship managers/business bankers and approved by generalist credit staff.

The banks have also adopted a more quantitative approach to credit and policy. A point acknowledged by Matic, et al.

“Also, because smaller businesses tend to have less detailed reporting requirements and a shorter financial history, banks have less financial information with which to make credit risk assessments, a problem that has become greater in recent years as banks’ have placed more weight on quantitative risk assessment methods.”

Specialty providers tend to respond to the challenges posed by small business lending by employing specialist staff that understand the products they offer and the industries in which they are exposed. They also understand the value of the security they hold and ways to recover on this security to minimise losses. This is particularly true for the debtor finance, equipment finance and insurance premium funding specialists.

Large players in any industry tend to focus on the larger market segments. Niche providers can successfully participate in segments unserved by the larger competitors. This is true for financial services except that the smaller niche players need access to capital. This capital is either provided by the banks or capital markets. Capital markets are of little value to the specialist providers as the scale and nature of the business will often not meet the needs of investors and rating agencies. The specialities often require a combination of risks including asset values in the case of leasing or operational risk in the case of debtor finance, accessing capital can be difficult.

There are effective but specialised risk management practices that can be applied to these products that result in predictable outcomes in losses and returns when delivered with appropriate operational risk management and governance principles. The pool of funds within the Australian superannuation sector is well suited to fund the non-bank finance industry and assess the specific operational risks as well as the traditional credit risks. It requires a combination of debt and equity risk analysis and the application of appropriate pricing and capital allocation principles.

Specialised finance is an important part of the funding solution to the SME segment. Absorption of specialised finance businesses into traditional banks and has resulted in reduced funding alternatives and a reduced supply of funding to the SME segment of the economy. This absorption and consolidation has partly been sponsored by market distortions such as implicit and explicit support for banks (as this submission argues in Section 13) and more favourable capital rules for banks than other finance providers such as life offices (as this submission argues in Section 14). In turn the banks homogenise their product offering (preferring lending and collateral structures better suited to their capital rules and standardised underwriting processes) diluting the benefits to SMEs of the specialised nature of the finance.

17. Superannuation

17.1 Auction for default status

Annuities lend themselves well to an auction style process. This submission discusses this in Section 3.3 Defaults.

17.2 The 3-day portability rule

This submission proposes the use of lifetime annuities in combination with ABPs to provide superannuation pensions with adequate protection against longevity risk, investment risk, and inflation risk. These combinations of lifetime annuities and ABPs are highly suitable as a post-retirement solution.

Superannuation providers that do not also have a life office could enter into a variety of types of relationship with a life office to provide the necessary guaranteed lifetime protection.

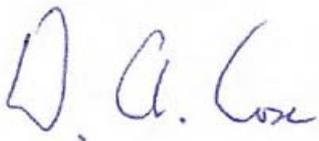
Free looks and initial periods of commutability to deal with behavioural biases aside, lifetime annuities attach to a particular life and must be non-commutable to avoid serious selection issues which would remove the life office's ability to incorporate mortality credits in the pricing. The availability of mortality credits, the pooled longevity risk, is an essential component of the value proposition these products provide to retirees.⁵

For that reason, if lifetime annuities are incorporated within a pension superannuation interest, legislative provision needs to be made for the lifetime annuity to remain attached to the retiree if they decide to change providers.

Challenger hopes this submission and its supporting attachments are a useful contribution to the Inquiry's consideration, particularly of: the management of post-retirement risk, both for individuals and government; retirement income outcomes including for retirees who are disengaged from the financial system; fiscal sustainability of the superannuation system; financial system distortions including those arising from the current settings of the Financial Claims Scheme; and funding the economy.

We appreciate the constructive engagement we have had throughout this process with you, other Inquiry panel members and the Secretariat.

Yours sincerely

A handwritten signature in blue ink that reads "D. A. Cox". The signature is written in a cursive style with a large initial 'D'.

David Cox
Head of Government Relations

⁵ Refer to section 8.3.1 for a discussion on mortality credits.