

30 March 2015

Senior Advisor  
Financial System and Services Division  
The Treasury  
Langton Crescent  
PARKES ACT 2600

Email: fsi@treasury.gov.au

## Re: Consultation on the Final Report of the Financial System Inquiry

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

This submission supports the following recommendations of the Inquiry:

### 1. Resilience

#### Recommendation 6: No ex ante fee on the Financial Claims Scheme

- In addition we propose that the cap on the FCS should be lowered to \$100,000 to reduce the distortions the Scheme has created.
- Two reports are attached, one discussing the distortions created by the FCS and the other modelling the costs to the economy and households of those distortions.

### 2. Superannuation and Retirement

#### Recommendation 9: Primary objective of the superannuation system to provide income in retirement to substitute or supplement the Age Pension.

- This submission notes that diverting superannuation savings to other purposes such as home ownership will have adverse implications for retirement income adequacy and that investing superannuation funds for purposes other than providing retirement incomes, such as supporting particular industries will impact allocative efficiency and adversely impact economic performance.
- This submission discusses the subsidiary objectives in detail distinguishing between those that improve sustainability of retirement incomes for the individual and those that improve the sustainability of the retirement income system.

#### Recommendation 11: CIPR and remove impediments from DLAs

- This submission discusses the need for CIPR's to combine an ABP and a lifetime annuity to provide reliable income streams which manage longevity, market and inflation risks.
- This submission proposes flexibility for fund trustees in designing CIPRs to meet the retirement needs of their members.
- This submission proposes APRA develop prudential standards for CIPRs to ensure that all retirement risks are appropriately managed.
- This submission notes that the FSI supports the current Treasury process to remove the impediments to the provision of DLAs.

### 3. Innovation

#### **Recommendation 19: Data access and use**

- This submission discusses the opportunities to use ATO data in a form which protects the confidentiality of individual taxpayers, to assist superannuation funds to better understand the likely needs of their members and to support academic research and evidence based public policy making.

### 4. Consumer Outcomes

#### **Recommendation 23: Innovative disclosure**

- This submission discusses the potential use of visual presentations of retirement risks.

#### **Recommendation 25: Raise the competency of advisers**

- This submission provides an update on a new UNSW Retirement Planning course and the need to require higher levels of competency in ASIC's review of RG146.

### 5. Regulatory System

#### **Recommendation 30: Strengthen the focus on competition in the financial system**

- This submission discusses the need for ASIC to be given a competition mandate in its legislation and for ASIC and APRA to report regularly on their approaches to dealing with competition issues.
- This submission proposes that the ACCC be responsible for regular reviews of competition in the financial services industry.

### 6. Significant matters (FSI Appendix 1)

#### **Recommendation 33: Strengthen the domestic corporate bond market**

- This submission notes post-retirement products will drive demand for domestic corporate bonds.

#### **Recommendation 35: Differentiate finance company products from those of ADIs**

- This submission proposes action to ensure product providers use a standard set of product definitions which are matched to critical product features to ensure transparency about risks.

#### **Recommendation 37: Superannuation fund member engagement**

- This submission discusses the superiority of stochastic modelling for projecting retirement incomes.
- This submission proposes a simpler standard methodology for providing all fund members with a projection of retirement income based on a risk free real return and conservative mortality.

# 1. Resilience

## Recommendation 6: Financial Claims Scheme

Maintain the ex poste funding structure of the Financial Claims Scheme for authorised deposit-taking institutions. The Final Report of the FSI, at page 37, also notes “the cap of \$250,000 is relatively high compared to other countries.”

### 1.1 Positions taken by Challenger, CBA and the FSI on the FCS

Challenger supports maintaining the current ex poste funding model and lowering the cap to \$100,000.

Challenger notes that the CBA's final submission, at pages 64 and 65, adopted the same pair of positions; “*The FCS claim threshold should be lowered to \$100,000. An ex ante fee should not be introduced.*”

The Final Report of the FSI noted that an ex ante funding model has a number of appealing features, including being based on a user-pays principle, and building a fiscal buffer which could be used for wider ADI resolution purposes such as transferring deposits to a new institution as set out in Recommendation 5.

However, at page 83, the FSI gave greater weight to three other factors:

- “*An ex-ante levy would be an ongoing cost for all ADIs. In contrast, the current ex post model only imposes a levy if the FCS is triggered and insufficient funds are recovered through liquidation to recoup the costs.*”
- “*Because Australia's depositor preference arrangements reduce the risk of an ADI's assets being insufficient to meet insured deposits, the case for an ongoing levy is less justified.*”
- Other recommendations of the FSI “*would further strengthen the resilience of the Australian banking sector by reducing the risk of failure and mitigating the costs of failures that do occur. If adopted, these recommendations weaken the case to charge an ex ante levy for the FCS.*”

The FSI's view that the cap of \$250,000 is relatively high compared to other countries is confirmed in an article in the December Quarter, 2011 RBA Bulletin, *Depositor Preference in Australia*, which at page 52, includes a table containing the arrangements for comparable jurisdictions with most having caps equivalent to roughly A\$100,000 in local currency terms. Only the US offers equivalent coverage to that currently applying in Australia.

### 1.2 Independent analysis of the FCS

Challenger commissioned Prof Kevin Davis and Martin Jenkinson of the ACFS (Australian Centre for Financial Studies) to assess the FCS, *The Financial Claims Scheme, an Assessment of the Scheme's Broader Economic Impact, August 2013*. They concluded that the FCS had created a number of distortions and needed to be reviewed. This report is at Appendix A.

Challenger also commissioned Chris Murphy of independenteconomics to model the effects on the Australian economy and households of the distortions created by the FCS and the options for modifying the Scheme to reduce those costs. His report, *Economic impacts of reforming the Financial Claims Scheme, 25 August 2014*, is at Appendix B.

### **1.3 FCS creating major distortions in savings, investment and lending markets**

A principal concern is the impact that the lack of competitive neutrality of the current FCS is having on savings, investment and lending markets. These distortions impact allocative efficiency and are therefore a drag on economic activity.

Rather than retail investors considering the risk return trade-off across the spectrum of potential investments available to them, many accept prevailing fixed term deposit rates given the comfort of an explicit government guarantee. This has resulted in a significant distortion of retail investments at the expense of investments in institutions and funds that are not ADIs. This has flow on effects limiting the availability of finance to households and businesses which otherwise would have been funded by non-bank financial institutions.

The Murphy report noted, at page 5, that; *“The availability of “free” insurance from ADIs can distort the choice of consumers between investing in ADI versus non-ADI financial institutions in favour of ADIs. This non-level playing field may lead to allocative inefficiency, with the ADI sector oversized and the rest of the financial sector undersized.”*

### **1.4 Moral hazard and gross contingent liabilities to government**

To the extent that a large component of savings are directed to ADIs motivated by the FCS, the moral hazard and taxpayer backed contingent liability is unnecessarily amplified.

The government has a gross contingent liability for the ADI component of the FCS of \$732.4 billion as at 30 June 2014 (MYEFO page 249). This is an excessive exposure to the FCS and an inappropriate use of the government’s balance sheet.

### **1.5 Ex ante fee ineffective in reducing distortions and moral hazard**

A fee of a handful of basis points will do little to address the distortions or moral hazard. The public policy conundrum is that to be effective in reducing the distortion and the moral hazard, the fee would need to be market referenced (e.g. credit default swap) and the result would be an unacceptable burden on the interest income of household savers. Therefore, the most effective means of reducing the market distortion, moral hazard and the government’s contingent liability is a substantial reduction in the cap to narrow the application of the FCS.

The Murphy report notes at page 25, that; *“Introducing premiums also reduces, but does not remove, the existing allocative inefficiency resulting from “free”, government-backed insurance. The insurance is no longer free, but it remains government-backed when such backing is not available to non-ADI financial institutions that compete with ADIs.”*

An ex ante fee is unlikely to change behaviour significantly so the distortion must be addressed directly by reducing the cap to no higher than \$100,000 per person.

### **1.6 The modelled FCS scenarios**

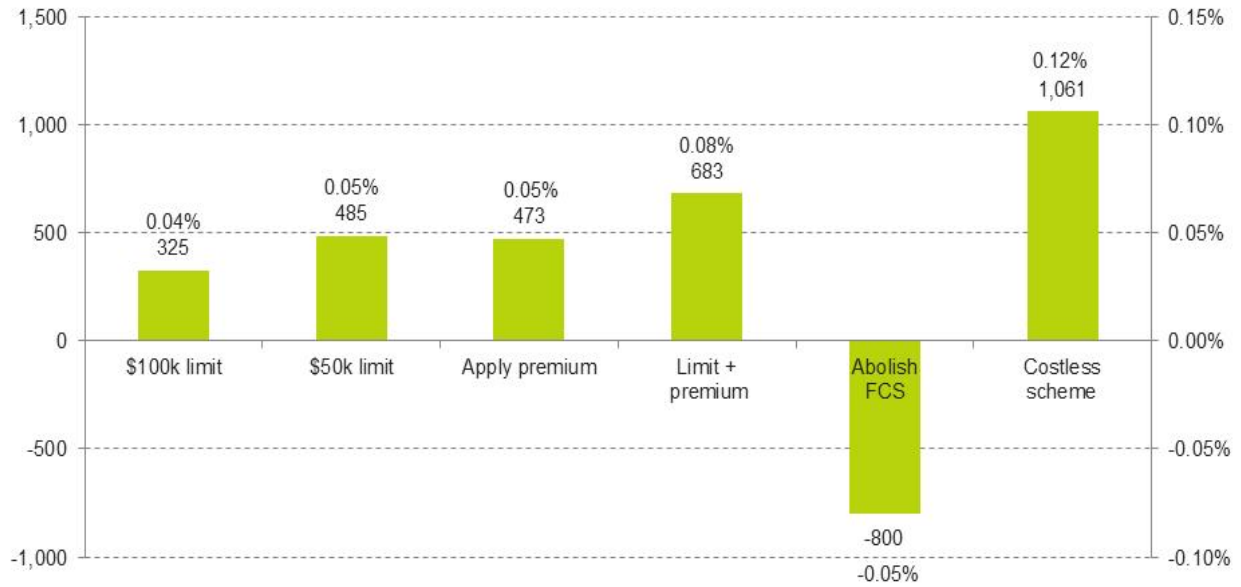
The Murphy Report modelling results are expressed in 2012-13 terms, showing the annual benefit of each scenario after the economy has fully adjusted to its economic shock. This is appropriate because economic policies should be judged against their lasting effects on the economy, not just their effects in the first one or two years.

The modelling of changes to the cap included another adjustment to the FCS, removing the ability for a depositor to split very large deposits amongst a number of institutions to obtain a government guarantee on a multiple of the cap. This issue was not taken up by the FSI, possibly for reasons of administrative complexity.

Reforming the FCS by lowering the insured threshold and closing the account splitting loophole would lower 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 with a reduction in the threshold to

\$100k, or \$485 million with a larger reduction in the threshold to \$50k. 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.

**Effects of FCS policies on Australian living standards (\$million, 2012-13 terms) and on real GDP (%)**



Source: independenteconomics, extended CGE model

## 2. Superannuation and retirement incomes

### Recommendation 9: Objectives of the Superannuation System

Seek broad political agreement for, and enshrine in legislation, the objectives of the superannuation system and report publicly on how policy proposals are consistent with achieving these objectives over the long term.

The FSI proposed that the primary objective of the superannuation system be defined as:

*“To provide income in retirement to substitute or supplement the Age Pension”.*

Challenger supports setting provision of retirement income as the primary objective for the superannuation system. This objective recognises the role of the Age Pension as a means tested safety net and the superannuation system’s role in raising the living standard of retirees above that safety net. It recognises that by providing retirement income the superannuation system should reduce both the proportion of the retiree population requiring Age Pension support and Age Pension outlays to part pensioners.

### 2.1 The primary objective

This primary objective sets as the priority for public policy for the superannuation system the provision of income in retirement above other uses by individuals of their superannuation savings such as a deposit for a first home or to reduce debt incurred in higher education. Such initiatives would require a higher level of contributions to achieve the same levels of retirement adequacy that are now possible without a wider range of uses of superannuation savings. It also sets as a priority the investment of superannuation savings to provide retirement income above the use of those savings as a source of funding for other economic objectives such as infrastructure. This is not to suggest that super funds should not invest in particular sectors, but that there should not be an allocation chosen or mandated for purposes other than providing retirement incomes. Arbitrary allocations to particular sectors will reduce allocative efficiency and result in lower economic performance

The primary objective of the superannuation system providing retirement income is central to the rationale for providing concessional tax treatment for contributions, earnings and benefits as well as the co-payment for low income earners. If the superannuation system does not have a primary purpose of delivering retirement incomes it is simply a subsidised investment vehicle which, like arbitrary allocations of investments to particular sectors, will reduce allocative efficiency and result in lower economic performance.

A superannuation system with a primary objective of providing income to substitute or supplement the Age Pension will enhance living standards in retirement, provide increased financial security, help retirees maintain their non-superannuation assets and assist them to achieve their estate planning objectives.

This objective of providing more reliable retirement income streams does not come at the expense of other wealth management objectives such as estate planning. Watson Wyatt has done actuarial investigations, which were attached to Challenger’s first submission to the FSI (*Watson Wyatt, Retirement Income Modelling, 2 September 2009*) that show that the expected outcome from an ABP with a guaranteed lifetime annuity is superior (providing 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-superannuation assets if their ABP failed.

The FSI identified a number of subsidiary objectives of the superannuation system. These can be divided into two groups; the first group are those that relate to how well the superannuation system achieves its primary objective of delivering retirement income for individuals. The second group are objectives that relate to the sustainability of the superannuation system so that it can continue to deliver reliable income to individuals. It is worth setting out why these are appropriate subsidiary objectives for the superannuation system.

## 2.2 Subsidiary objectives directly relating to individuals

### 2.2.1 Smoothing Consumption

The first subsidiary objective is to facilitate consumption smoothing over an individual's life. Challenger supports this subsidiary objective and notes that the smoothing of consumption has a number of aspects:

- The 9.5% SG (Superannuation Guarantee) is a component of employee remuneration and a deferral of income for use in retirement.
- Individuals have the option of forgoing further income to make concessional contributions, up to a limit, and non-concessional contributions up to a higher limit, to facilitate further smoothing of income over their lifetime.
- The superannuation system should encourage retirees to opt for a sustainable real income stream consistent with their balance on retirement and expected longevity.
- Pooling of longevity risk and transferring longevity, inflation and market risks to a third party better able to manage them can assist with smoothing income to the end of life.

### 2.2.2 Managing Retirement Risks

Challenger supports the subsidiary objective of properly managing retirement risks. This is critical for superannuation fund members. Once an individual stops working there are limited, if any, options available to them to rebuild capital and recover from adverse market events or to make further provision for unanticipated longevity or inflation.

#### 2.2.2.1 Longevity Risk

The key risk for retirees is how long they will live. Without pooling this uncertainty is likely to cause a misallocation of retirement savings either by overspending or underspending, with both likely to result in reduced living standards.

There are two elements of longevity risk: idiosyncratic risk, being the risk that a single person lives longer than the expected average; and systematic risk, being the risk that the mortality experience in a pool of lives or across the whole population changes from levels previously expected.

A lifetime annuity addresses both idiosyncratic and systematic longevity risk by ensuring a certain income stream for life. Annuities require fewer savings to provide the same level of income for a long life than would be the case without pooling.

The Australian Government Actuary's paper, *Towards More Efficient Retirement Income Products*, commissioned by the Financial System Inquiry, says at page 27; "*Based on the assumptions adopted here (that is, the life annuity pricing assumptions and the assumed investment and inflation environment), the life annuity outperforms the account-based pension in most years.*"

#### 2.2.2.2 Market Risk (including Sequencing Risk)

Market risk, amongst other things results from the volatility of asset prices and returns. In retirement a critical subset of market risk is sequencing risk. Sequencing risk relates to the timing of investment returns.

Sequencing risk is a major risk early in retirement. With the requirement to draw a pension, any significant adverse market event close to, or in the first few years of retirement, will deplete the capital base, reducing the capacity to recover and therefore the amount and duration of the future income stream. In retirement the order of market outcomes can be more important than the average rate of return.

#### 2.2.2.3 Inflation Risk

Inflation is a major factor in retirement. This is the risk that the purchasing power of retirement savings does not keep up with the cost of living as it affects retirees. The retiree needs their income stream to have the capacity to sustain its purchasing power over more than two decades. Even at its current rate, inflation will have a substantial impact over a long period. The likelihood of periods of higher inflation or even deflation cannot be ignored.



Investment Trends Pty Ltd November 2014 *Retirement Income Report* found that inflation ranked highest at 44%, with multiple responses permitted, amongst Australians aged over 40 years, listing their worries related to their retirement.

### **2.2.3 Simple and Efficient and Provide Safeguards**

Challenger supports the subsidiary objectives of making the superannuation system simpler, more efficient and safer. Superannuation is compulsory and policy must contemplate how the superannuation system will engage with individuals. Many individuals will not seek to engage with the system themselves and a significant proportion will lack the aptitude and financial literacy to successfully do so. These individuals need policy settings that will provide a simple and efficient system with appropriate safeguards which will meet their needs. In Australia's choice superannuation environment those that have the financial skills and literacy or access to quality advice should be able to make more complex arrangements within broad regulatory parameters.

## **2.3 Subsidiary objectives relating to sustainability issues**

### **2.3.1 Invested in the best interests of super fund members**

Challenger supports the sole purpose test. Achieving the primary objective of providing retirement incomes requires that all superannuation funds be invested for that purpose. Investing even a proportion of superannuation funds with the specific intent of meeting another objective, such as to provide funding to a particular industry sector, will result in distortions, impacting allocative efficiency and detracting from both the economy's performance and the superannuation system's performance in meeting its primary objective. This reflects existing trustee duties which are well understood by them.

### **2.3.2 Alleviate financial pressures on government**

Challenger believes that providing sustainable retirement incomes can make a significant contribution to alleviating the fiscal pressures associated with Australia's ageing society. The 2015 IGR (Inter-Generational Report) shows that the projections for currently legislated Age Pension and aged care entitlements will together require an addition to Commonwealth outlays equivalent to 1.5% of GDP or 4.8% of total government outlays by 2054-55.

A Deloitte Access Economics Report commissioned by Challenger for the Tax Summit in 2011 showed that an average take up of \$10,000 of DLA (deferred lifetime annuity) premiums would reduce combined government outlays on the Age Pension and aged care by 2.6% in 2050, as a result of the effects of the Age Pension and aged care means tests. An earlier Access Economics Report commissioned by Challenger for the Henry Review showed that average annuitisation of 30% of starting retirement balances would reduce outlays by 2044-55 by 0.2% of GDP.

As CIPRs (Comprehensive Income Products for Retirement) are intended to include a pooled longevity component, these estimates may be indicative of the fiscal benefits that would be available from CIPRs.

### **2.3.3 Fully funded from savings**

Challenger believes that for fiscal, prudential and financial stability reasons the superannuation system should be fully funded.

Government should limit its contribution to retirement incomes to the cost of:

- the means tested Age Pension safety net;
- closely targeted superannuation tax concessions;
- contributions to the superannuation of government employees; and
- any unfunded government superannuation scheme liabilities.



Australia's defined contribution superannuation system has proved effective in accumulation to build a savings pool for retirement. Policy settings for retirement incomes should ensure that these accumulated savings are converted into products which are fully funded. Annuities and ABPs both provide pension income streams which are by their nature fully funded and do not involve any government guarantee.

### **2.3.3.1 Government should not become a provider of financial products**

Challenger believes that the Australian Government should not become a provider of retirement income products. From time to time there have been proposals for the government to offer annuities to top up the Age Pension and to provide savings products for the aged as well as home equity release schemes.

The proponents argue that the government has a very large balance sheet, a AAA credit rating and is able to borrow money at a comparatively low rates. However, Government provision of retirement income, saving and equity release products have a number of pitfalls:

- the actual risks and economic costs are the same as for the private sector;
- the government does not have an existing capability to provide the financial advice that would need to accompany the provision of such products;
- without a subsidy from other taxpayers, the income streams would be linked to the government bond rate and be lower than those offered by private providers which invest in higher yielding assets;
- it is likely that decisions by government on pricing and payments would quickly become separated - a situation which cannot last long in a commercial environment;
- in the case of equity release schemes there would be strong political resistance to the government recovering its capital;
- these products would result in government accepting an increased burden of funding additional retirement income; and
- innovation by private providers would be stifled.

These products and these risks can be better managed by private providers in an open market.

#### **Recommendation 11: The retirement phase of superannuation**

Require superannuation trustees to pre-select a comprehensive income product for members' retirement. The product would commence on a member's instruction, or the member can choose to take their benefits in another way. Impediments to product development should be removed.

## **2.4 Public offer superannuation funds to offer a CIPR**

Challenger strongly supports the proposal for all public offer superannuation funds to pre-select for their members a CIPR (Comprehensive Income Product for Retirement).

### **2.4.1 CIPR Features**

A CIPR should possess the following characteristics:

- An extremely high probability that the income stream will not fail, that is it will produce a significant and relatively smooth private income to the end of life.
- It will address the principal risks in retirement:
  - longevity risk;
  - market risk (particularly sequencing risk); and
  - inflation risk.
- It will be acceptable to retirees, that is:
  - sufficiently flexible in terms of providing some access to capital;
  - provides money to assist with aged care costs; and
  - recognises that the retiree may have estate planning objectives.

Those characteristics lead to retirement income solutions which are a combination of account based and pooled longevity income streams. The combinations could be drawn from ABPs (account based pensions), ILAs (immediate lifetime annuities), DLAs (deferred lifetime annuities), RCLAs (ruin contingent lifetime annuities) and immediate or deferred unguaranteed GSAs (group self-annuities).

Critical elements of a CIPR are maintaining exposure to the market over a long period while gaining the benefits of pooling longevity risk.

If one of the components of the CIPR is a guaranteed lifetime annuity it will provide protection against both the idiosyncratic and the systematic elements of longevity risk as well as market risk. If the guaranteed lifetime annuity is an immediate annuity it will provide protection against sequencing risk early in retirement. If the guaranteed lifetime annuity is indexed by the CPI it will also provide protection against inflation risk.

A layer of guaranteed income as part of a CIPR provides the following robust benefits:

- a significant component of the income stream will be guaranteed for life;
- pooling of longevity risk will reduce the cost of living longer than expected;
- the guarantee will be APRA regulated under the Life Insurance Act with prudential standards, supervision and life company capital standards;
- the longevity protection component will be non-commutable and attached to the life of the retiree;
- immediate lifetime annuities will help mitigate sequencing risk;
- RCLAs will match guaranteed income with the point of failure for the account based pension;
- DLAs will provide cost efficient protection against longevity risk (both idiosyncratic and systematic), investment risk and inflation risk late in life; and
- a DLA will define the minimum timeframe for which the account based pension component must provide income.

GSAs provide pooling of idiosyncratic longevity risk but not systematic (population wide or pool-wide) longevity risk. They may appear cheaper per dollar of expected income than guaranteed lifetime annuities but all systematic longevity risk, inflation risk and market risk are carried by the retiree and they provide no protection against sequencing risk. For these reasons, there is a good argument that where GSAs are used in a CIPR there should also be a component of guaranteed income.

VAs (variable annuities) are a much less suitable default product because they are too complex, too expensive and don't guarantee enough income – typically only 5% of the nominal value of the starting balance, which after two or three decades is not going to amount to much.

#### **2.4.2 Administration of CIPRs**

CIPRs are not a default product because they will only be triggered by an individual actively taking a decision to commence the pre-selected income stream upon their retirement. Fund members will still have choice including the ability to take a lump sum.

In some countries, governments are prescriptive about the range of income stream types and combinations from which a retiree may choose, for example:

- an immediate lifetime annuity;
- an ABP and an immediate lifetime annuity; or
- an ABP and a DLA.

In Australia's superannuation system the expectation is that the design of the CIPR would be a matter for the superannuation fund trustees. However as the policy intention is to ensure that the principal retirement income risks are properly managed it would be desirable to legislate to require trustees to specifically consider longevity risk, market risk and inflation risk when designing a CIPR.

Page 127 of the Final Report of the FSI says; *“Government should establish a mechanism to ensure each CIPR provides the required features, which should be specified in regulation. Ongoing regulatory oversight will also be required. Meeting regulatory requirements should provide trustees with some protection against breaching their fiduciary obligations.”* This submission proposes a methodology to specifically address this.

### **2.4.3 APRA should provide prudential standards for CIPRs**

One way to implement the CIPR concept would be for Parliament to legislate some high level objectives of the regime and the obligations imposed on trustees, leaving the detail and administration of the regime to APRA in its role as the prudential regulator. APRA could develop a prudential standard that provided guidance and direction to trustees in designing and implementing a CIPR. This approach could be similar to that adopted in respect of the provision of insurance within superannuation. APRA’s recently issued prudential standard on risk management for regulated institutions is a rich source of ideas for helping super funds develop an appropriate strategy for managing the risks faced by their retired members in a CIPR.

Challenger and Mercer are making a separate joint submission on this proposal.

### **2.4.4 Flexibility of CIPRs**

Achieving the primary objective of the superannuation system requires changing the current focus from accumulation to the delivery of retirement incomes. To do this there will need to be a level of engagement by public offer superannuation funds with their members on their financial needs in retirement.

The FSI Final Report notes that; *“Their design could vary with the member’s known characteristics, such as the size of their superannuation benefits, and take account of the possibility of cognitive impairment at older ages.”*

It may be desirable for public offer superannuation funds to develop a number of CIPRs to be pre-selected for different cohorts of their membership, rather than providing a single solution covering the whole of their membership. For example it may be appropriate to pre-select different CIPRs depending on the size of the member’s superannuation assets, to allow for the interaction between income, assets and the Age Pension, which would have implications for asset allocations.

While this will not facilitate simple performance comparisons between superannuation funds as is possible with default MySuper accumulation products, it needs to be recognised that retirement is very different to accumulation and retirement solutions need to meet the individual’s needs as far as they are reasonably identifiable and foreseeable, and can be catered for with a practical, efficient and deliverable product.

There will be significant differences between the membership profiles of individual public offer superannuation funds in terms of occupations and other socio-demographic characteristics. These factors may have major implications for expected longevity of the membership. Superannuation funds whose memberships are likely to have higher mortality should have the opportunity to negotiate group immediate lifetime annuities and DLA arrangements that reflect the higher mortality of the pool. If those funds’ members were required to accept longevity insurance rates which reflected a larger pool of lives with lower average mortality they would be disadvantaged by not having access to a fair rate. Therefore there should be no community rating as there is with private health insurance because that would disadvantage lower socio-demographic groups.

With appropriate engagement a preselected CIPR could also deal with non-financial issues, most commonly arranging for the lifetime annuity component to be for joint lives to cover a spouse, paying down an outstanding mortgage debt, or for more complex health issues such as arranging underwriting for an impaired lifetime annuity for a member with chronic illness who would be denied a fair rate if the lifetime annuity component were provided at a group rate. Annuities also provide reliable income late in retirement when capacity to make financial decisions is diminishing and dementia may also be a factor.

### **2.4.5 Cooling off period**

At page 128 the Final Report of the FSI says; *“Cooling off periods coupled with the provision of a (diminishing) return of capital in the event of early death may be appropriate for some pooled products.”*

A CIPR requires a cooling off period to give retirees a period to reverse their decision if they acted without fully understanding the nature of the product and subsequently discover it is not right for them. This is already the case for pension products with the current law prescribing a cooling off period, or “free look” of two weeks, in which a decision to purchase can be revoked without cost to the consumer. This is established commercial practice and should apply in the case of a CIPR.

A cooling off period currently implies reversal of the transaction at no cost. Cooling off periods at no cost to the retiree need to be restricted in length because they effectively grant an option which the purchaser can exercise at significant cost to the provider. The cost of that option has to be priced into the product and is therefore borne by other users of the product who do not exercise the option. Industry experience indicates that a significant proportion of those who would exercise the option would do so not because they didn't understand the product but because they were financially savvy and understood the value of the option.

An efficient approach to revoking an election to take a CIPR, which will assist rather than detract from retirees' decisions to take an income stream, should have two tiers:

- The current two week “free look” period with the purchase price to be returned in full if the retiree changes their mind; and
- A longer period specified by the product provider where the reasonable costs of relinquishing the CIPR are carried by the retiree.

The second tier needs to be matched to social security, tax and SIS pension rules. The Earnings Tax and SIS pension rules are currently being dealt with in Treasury's Review of retirement income stream regulation.

### **2.4.6 Suitability of CIPRs for low starting balances**

Due to the immaturity of the superannuation system average balances on retirement are low. A large proportion of these small balances are taken as lump sums and are therefore removed from the superannuation system, and after paying off debts the remainder is typically placed in a term deposit. The Final Report of the FSI suggests that term deposits represent a good outcome and that the default position for low balances could be a lump sum.

Both term deposits and account based pensions are now deemed, for the purposes of the Age Pension means test so from a social security perspective there is no advantage in taking one product and not the other. Similarly, if a retiree's income is below the limit for the Senior Australian and Pensioner Tax Offset they will not be disadvantaged from an income tax perspective if they invest in a term deposit rather than an ABP. The only advantage of a term deposit over an account based pension is that the term deposit has no minimum drawdown requirement.

However, term deposits lack a number of attributes which a CIPR that includes an account based pension and lifetime annuity should provide:

- Guidance as to a safe rate of withdrawal with a high probability of the income stream lasting for the retiree's lifetime. A term deposit controls ongoing payments but only according to the rate paid with no link to expected longevity.
- A smooth income stream without the interest rate risk associated with term deposit rollovers.
- Longevity protection which would ensure that no matter how long the retiree lives their superannuation savings will not exhaust and they will not be totally dependent on the Age Pension.
- Access to mortality credits.
- Exposure to growth.
- Inflation protection if part of the CIPR is indexed.
- Access to capital without penalty for unforeseen contingencies.
- Annuity income late in life which requires no investment decisions when cognitive decline or dementia are likely to be factors.

There is a well-founded alternate view amongst some superannuation funds that have been considering the issue how best to meet the needs of members with small balances that they would be better served by paying off their debts, keeping a small amount for contingencies and converting the rest into an indexed lifetime income stream.

Assuming \$50,000 at 3.0% per annum in the current environment, this small balance produces \$1,500 per annum or \$125 per calendar month. That will supplement the Age Pension by about 7.5%. Assuming the Age Pension will cover basic living expenses the supplement could make a significant difference to a retiree's quality of life by providing the capacity for coffees, beverages and meals with friends and such things as sporting or social club memberships, helping to ensure that these retirees do not suffer social exclusion because of lack of income above the Age Pension.

#### **2.4.7 Multiple premium longevity insurance**

Australia's current annuity market is comprised of fixed term and lifetime products that are purchased with a single premium. The introduction of DLAs into the Australian market will present an opportunity to introduce multi-premium products. Some industry funds have identified a need for products purchased by this means and this is reflected in Treasury's consultation paper for its Review of retirement income stream regulation. Interest from a number of superannuation funds indicates that multi-premium longevity insurance will be an important feature of many CIPRs.

Many superannuation funds provide group risk insurance to their members through their superannuation fund. However as the member nears retirement they may have paid down their mortgage and therefore have less need for insurance, the cost of which is likely to be rising at the expense of growing their superannuation savings. In these circumstances a shift from death and disability insurance to multi premium longevity insurance would better meet an ageing worker's needs. Purchasing longevity insurance over a long period allows averaging in of premiums as conditions in capital markets change, rather than the superannuation fund member being exposed to the risk of adverse capital market conditions at the time they retire.

#### **2.5 AGA paper "Towards More Efficient Retirement Income Products"**

The Financial System Inquiry commissioned a paper from the AGA (Australian Government Actuary) entitled, "*Towards More Efficient Retirement Income Products*", the purpose of which was to look at the efficiency of retirement income products that can be purchased by retiring Australians with their accumulated superannuation money.

The paper used a stochastic model to project future income streams which could be derived from an account based pension and a form of group self-annuitisation (mortality pooling). The stochastic modelling took account of:

- Volatility of investment returns; and
- Volatility of numbers of deaths in a population, assuming that the base mortality rates are correct.

The resulting income streams were also compared to a payment on a lifetime annuity, the amount of which was supplied by the FSI secretariat.

While the AGA's paper provided some valuable information, there were a few points which could lead to incorrect conclusions being drawn, including:

- The projection of mortality underlying the GSA outcomes only allowed for idiosyncratic mortality risk (that is, the risk of which particular individuals will die, assuming that the underlying mortality probabilities are correct). It therefore did not allow for systematic longevity risk, which is the risk that the mortality rates of the population as a whole may be different from those assumed. As a result, the variability of outcomes from the GSA is understated;
- This is particularly important when comparing against the outcomes of lifetime annuities, which protect against both idiosyncratic and systematic longevity risk. By ignoring a risk that is eliminated under one product, but retained under the other, an invalid comparison is obtained.
- The lifetime annuity payment amount was provided to the AGA by the FSI based on pricing requested from Challenger, rather than being derived on a consistent basis with the remainder of the report. This payment amount was calculated on a far more conservative mortality basis than the account based pension and GSA outcomes, leading to an invalid comparison.
- An underlying assumption of the investment return model is that returns will mean-revert. At the point that the projection commenced, the then-current returns were significantly different from the assumed long term averages, leading to distortions in the projections.

We have reproduced the calculations from the AGA's paper, addressing these points. The results are set out in the paper attached as Appendix C.

The paper concludes that:

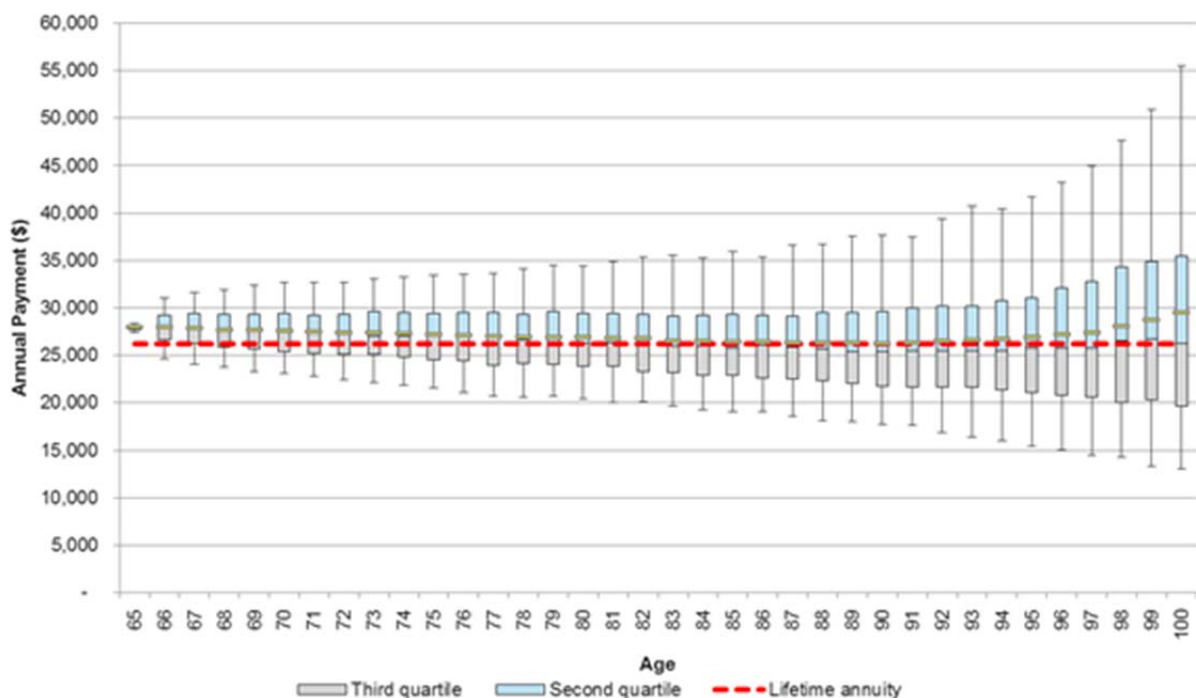
- While the AGA paper's conclusion that *"the income from a lifetime annuity is very likely to be less, on average, than the income from a GSA"* is correct, the difference between the lifetime annuity and GSA is substantially less than shown in the AGA paper analysis.
- This difference, which is driven by the cost that a life company must bear in providing the capital to support all of the risks that it has taken on from an annuitant, is around 3% of payment amount (\$26,179 compared with \$26,913), rather than 15% of payment as determined in the AGA paper.
- The range of outcomes from the GSA is wide, with a large proportion showing payment outcomes lower than the lifetime annuity.
- In particular, the range of outcomes from these results shows very wide dispersion in later years. The results are more widely dispersed than the AGA paper results because the AGA paper ignores systematic mortality risk.
- In contrast, the lifetime annuity provides a guaranteed payment amount which does not change (in real terms) over the entire period.
- Overall, this illustrates that a GSA results in the investor retaining significant risk (systematic longevity risks, market risk and inflation risk) leading to uncertain and volatile future incomes that will be unsuitable for many retirees.



The chart below shows:

- At each age, the range of outcomes for the GSA. The line at the centre of the boxes shows the median outcome, while the boxes show the 25th and 75th percentiles of outcomes. The lines extending from the boxes show the 5th and 95th percentiles of outcomes. The darker line in the boxes shows the mean outcome.
- The payment amount for a lifetime annuity is now on a comparable basis: that is, using the same mortality and investment return environment as the GSA projection.
- All payments amounts are shown in real terms.
- The payments arising from the GSA under these results are generally higher than in the AGA paper. The reason for this is that the mean reversion within the AGA paper investment model leads to early losses.

**Figure 1: GSA outcomes vs Lifetime Annuity**



Source: Challenger Limited

## 2.6 Means test settings

*"It is important tax and Age Pension settings do not discourage people from using CIPRs."* FSI Final Report page 126.

*"Government would need to consider how the Age Pension means test applies to new income stream products. In principle, the means test should not discourage products that manage longevity risk, should aim to provide neutral treatment of products with longevity risk protection, and should not make it difficult for individuals to smooth their income and consumption over retirement. Without some amendments to the Age Pension means test, some CIPRs could increase the cost of the Age Pension to taxpayers."* FSI Final Report page 127.

*"Under the principles of the current means test, products with longevity risk pooling tend to increase Age Pension costs in the early years of retirement (due to faster depletion of assets when the means test is binding) and reduce costs in later years (because of higher income when the income test is binding)."* FSI Final Report page 127.



The FSI has not made specific proposals in relation to means testing. It is worth noting that under current rules a combination of an ABP and immediate lifetime annuity in a CIPR will balance and smooth the effect of the means test over retirement. It is also worth noting that a DLA will provide a step down in Age Pension costs towards the end of retirement when an ABP would be likely to be depleting resulting in a full Age Pension entitlement.

The government will need to determine the specific means test treatment for new retirement products, in particular DLAs and GSAs, which at the moment have no legislated means test treatment. Social security treatment is a critical factor for part pensioners when choosing retirement products.

Pooled longevity products are currently sold with death benefit and commutation features designed to address retirees' behavioural biases. These features are an important consideration in ensuring that means test settings do not discourage people from using CIPRs.

## **2.7 Impediments to product development should be removed.**

The FSI Final Report says at page 125, *"The Inquiry supports the review of retirement income stream regulation being undertaken by Government, which is examining ways to reduce or remove barriers to developing a market for DLAs."*

Challenger has made a comprehensive set of submissions to Treasury's Review of retirement income stream regulation as well as to the Financial System Inquiry on removing the impediments to DLAs. Efficient longevity products require pooling of capital. They provide more income if they have no liquidity features but providers must overcome retirees' behavioural biases including aversion to irreversible decisions. DLAs, as pure longevity insurance, can achieve high returns for a relatively small investment given a long deferral period with non-commutability. DLAs are an efficient means of providing longevity insurance and will be an important component of many CIPR offerings.

## 3. Innovation

### Recommendation 19: Data access and use

Review the costs and benefits of increased access to and improving the use of data, taking into account community concerns about appropriate privacy protections.

### 3.1 Enhanced provision of government data sets for research

Superannuation funds have a significant amount of data relating to their own members' accounts but are not likely to be aware of their members' accounts with other superannuation funds unless the member asks for them to be consolidated. Funds will not be aware of their members' non-superannuation income or assets. This limits the ability of funds and service providers to use the data they have to gain insights into the behaviour and needs of their memberships. Access to wider data sets would assist funds to come to a more complete understanding of their markets, including the likely characteristics of their members. Access to such data would assist them to improve their products and distribution systems to meet their members' needs and enhance competition in the industry.

Academics conducting investigations in the field of superannuation have very limited access to appropriate data sets for empirical research. They have access to a range of published and unpublished ABS data, and published APRA, DHS and ATO statistics. However the nature of those statistics and the way they are compiled limit the research questions they can be used to address.

Policy makers have better access to data in the form of the large amounts of information maintained by departments to administer the tax, social security, aged care and health systems. Because of its size and the complexity of the systems which manage it, access to this data has a high public cost which limits its direct availability even for evidenced based policy making by government.

Industry associations in financial services have only developed very limited capability to fill any of these gaps with their own statistical collections. This is not the case in some other jurisdictions like the United States, where industry associations collect and distribute vast amounts of data. An exception is Sirca Technology which has developed a very large data set of Australian share market transactions.

Over the last 12 months the Monash CSIRO Superannuation Research Alliance and CIFR (Centre for International Financial Regulation) have made progress in getting access to ATO data, in a form which protects the confidentiality of individual taxpayers. This is being used for superannuation research projects. This is critical to informing debate on future superannuation policy and also in providing insights which will help superannuation providers better meet their members' needs. As this data has to be in a form which protects the confidentiality of individual taxpayers before the ATO can release it, expanded provision should not await the recommended Productivity Commission examination of data provision.

## 4. Consumer outcomes

### Recommendation 23: Facilitate innovative disclosure

Remove regulatory impediments to innovative product disclosure and communication with consumers, and improve the way risk and fees are communicated to consumers.

#### 4.1 Visual representations of risk

ASIC faces significant challenges in ensuring that financial risks are properly disclosed to consumers and many consumers face significant challenges understanding those risks even when they are properly disclosed. Australia has tested the benefits of providing transparency to consumers with lengthy written product disclosure statements and these have been found to be much less effective than was assumed when they were first made mandatory. This continues to be the case despite significant efforts having been made to shorten and simplify them.

Many product providers and advisers have recognised the value of a range of calculators and online tools that have greatly assisted their clients to better understand their own financial situations and the practicalities of the financial products that are available to them. ASIC has developed regulatory guidance with a view to ensure that such calculators and tools do not lead consumers to erroneous conclusions about the benefits of particular products. ASIC has been particularly concerned to stop product providers using these devices to sell their own products by making selectively constructed comparisons with the performance of the products of their competitors. This has proved a particularly difficult area to properly regulate.

However, accurate information can be conveyed in many ways and interactive tools and calculators can graphically present fair comparisons between product types and show how each would perform when subjected to identical market conditions. Stochastic modelling allows comparisons to be made using a very large number of possible economic paths and to assign probabilities to possible outcomes. Those outcomes and probabilities can be represented graphically and shown dynamically to give clients a better appreciation of the risks they may face over time than would any single statistical measure.

Challenger has built a particularly useful retirement calculator that is capable not only of dealing with risk on a stochastic basis but it also has full social security functionality and can demonstrate the interactions of more than one product with the age pension means test. This calculator can demonstrate the effect of sequencing risk by reversing the order of a random set of economic outcomes and can assign probabilities showing the likelihood that an income stream will last to a certain age in retirement. The calculator also displays age cohort life expectancies for all relevant ages to provide a measure of longevity risk for non-guaranteed income streams.

What are the difficulties in regulating the use of such devices? First of all the assumptions need to be reasonable and based on some empirical analysis. Risks need to be expressed as a range around a central measure. Any returns assumed need to accord with a reasonable level of risk to be taken by a consumer. It may be appropriate for the returns used to be regulated to avoid product providers or advisers using excessively high returns to hold out the prospect of an unrealistically high retirement income.

**Recommendation 25: Raise the competency of advisers (page 222)**

Raise the competency of financial advice providers and introduce an enhanced register of advisers

## **4.2 UNSW course in Retirement Planning**

Challenger recognised the absence of adequate courses for financial planners to educate them to provide advice on the management of post-retirement risks and in 2013 entered a partnership with the UNSW Business School to develop suitable curriculum with UNSW having full academic control over the curriculum and teaching. In 2014 UNSW Business School introduced the course ACTL5401 Retirement Planning. This is an elective course, delivered in face-to-face mode in the Certificate, Diploma and Master of Financial Planning programs and may be taken as an elective in 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. From June 2015 this course will be accompanied by a fully online version (called ACTL5402 Retirement Planning Online), which covers exactly the same material in online mode, using Smart Sparrow's Adaptive eLearning Platform. The online version may also be taken by both award and non-award students. Enrolment in the online version will not be restricted by the standard university calendar. Students will be able to enrol at any time, and will be given the equivalent of a standard teaching semester (13 weeks) to complete the course. Its online delivery mode will greatly increase the accessibility of the course.

Prof Hazel Bateman has provided an update on the provision of this retirement planning course which is provided at Appendix D.

Given that this course is widely available, and others such as ASFA (Association of Superannuation Funds of Australia) are now following with courses with similar content, there is no barrier to setting appropriate competency standards for financial planners in the area of retirement planning when ASIC (Australian Securities and Investment Commission) revises RG146.

## 5. Regulatory system

### Recommendation 30: Strengthen the focus on competition in the financial system

Review the state of competition in the sector every three years, improve reporting of how regulators balance competition against their core objectives, identify barriers to cross-border provision of financial services and include consideration of competition in the Australian Securities and Investment Commission's mandate

#### 5.1 Including consideration of competition in ASIC's mandate

Challenger supports the inclusion of competition in ASIC's mandate. APRA already has such a mandate included in its legislation. Any regulator responsible for consumer protection across a large industry sector with many segments and products cannot avoid influencing the competitive dynamics between industry participants if the effect of regulation falls more or less heavily on one sector or set of products than another. Regulatory requirements may differ between products or sectors depending on factors such as complexity and risk or the sophistication of investors but the regulator needs to be conscious of the potential of its regulatory approach to affect competition and the need to minimise such effects.

In some areas ASIC could adopt a pro-competitive approach, for example by reviewing its regulatory guidance on product comparisons to ensure that consumers have more information about the products that are available for them to choose between and that they are better able to determine not just what is appropriate but what is best for them.

ASIC's mandate should include both a requirement to consider how its regulations and processes affect competition and how its regulatory processes, including disclosure requirements can enhance competition.

#### 5.2 Regulators should report on their actions in relation to competition

Challenger supports financial services regulators being required to include in their annual reports their approach to dealing with competition issues, the actions they have taken to enhance competition, and how they have balanced maintaining an innovative and competitive market with the other aspects of their regulatory mandate.

An issue of particular interest on an ongoing basis should be capital standards for prudentially regulated entities of different types selling like products, eg. fixed term annuities and term deposits.

ASIC's MoneySmart website is justifiably a preferred and trusted source of reliable information on personal finances for consumers. ASIC should ensure descriptions of generic products, product features and commentary on the MoneySmart website are up-to-date, accurate and properly balanced, noting that not all product types are equal in the way they manage different risks or provide liquidity.

#### 5.3 Periodic regulatory reviews

Challenger agrees that the Government should commission periodic reviews into the competitiveness of the financial system. These should be conducted by the ACCC (Australian Competition and Consumer Commission). The first of these should not be delayed for a period years after the FSI process is completed because they will assist the regulators in the exercise of their competition mandate.

## 6. Significant matters (FSI Appendix 1)

### Recommendation 33: Retail corporate bond market

Reduce disclosure requirements for large listed corporates issuing 'simple' bonds and encourage industry to develop standard terms for 'simple' bonds.

### 6.1 Post-retirement products will drive the domestic corporate bond market

The need for suitable products to provide retirement incomes will drive demand for domestic corporate bonds. This demand will come from life companies backing annuities and superannuation funds adjusting their asset allocations to meet the income needs of ageing members. This institutional activity will aid price discovery for an emerging retail corporate bond market.

### Recommendation 35: Finance companies

Clearly differentiate the investment products that finance companies and similar entities offer retail consumers from authorised deposit-taking institution deposits.

### 6.2 Differentiation of products

The FSI considered whether to ban finance companies from accepting retail funds from consumers but, recognising that well-run finance companies have a useful role in the market, decided the best approach would be to differentiate the products of finance companies from accounts offered by ADIs. The Inquiry therefore recommended APRA ban finance companies from offering at-call products to retail consumers and from using bank account-like terminology. This is an important lesson from the GFC where at call accounts, mortgage funds and cash management trusts were put under significant pressure because of contagion from an international liquidity crisis which at that time also affected banks.

This principle should be extended more generally. Products should not be given names that imply they are inside the perimeter of prudential regulation of guarantees or insurance when this is not so. Similarly there needs to be more control over names that imply products will receive tax or social security treatment for which they are not eligible.

It would be beneficial for consumers if regulators required product providers to use a standard set of product definitions which are matched to critical product features without ambiguity:

- Guaranteed annuities or longevity insurance issued by a life company – fixed, deferred and immediate lifetime annuities where APRA regulates performance in terms of the policy promise and the risk is carried by life company shareholders.
- Non-guaranteed pooled longevity products, where the outcome will depend on actual market and mortality experience and all risk is carried collectively by members of the fund.
- Wraps and structured products that are used to hedge various market risks for a fee but performance is not regulated by APRA.
- Account based pensions where all risk is carried by the fund member.

It is critical that this issue be addressed at this time because a range of new products are expected to enter the market in the next few years and there needs to be transparency about who is carrying the risk in each case. Where products combine a number of components, regulators will need to ensure complete transparency about which risks are being carried by whom.

### **Recommendation 37: Superannuation member engagement**

Publish retirement income projections on member statements from defined contribution superannuation schemes using Australian Securities and Investments Commission (ASIC) regulatory guidance. Facilitate access to consolidated superannuation information from the Australian Taxation Office to use with ASIC's and superannuation funds' retirement income projection calculators.

## **6.3 Projections based on the need for sustainable income streams**

### **6.3.1 Support for retirement income projections**

Challenger agrees with the rationale and intent of Recommendation 37, and supports the inclusion of retirement income projections in super funds' members' statements.

The compulsory super system was devised in order to produce retirement income which can supplement and/or replace reliance on the Age Pension.

Communication to members of the likely income stream to be produced in retirement can be expected to increase member engagement and education, and is likely to precipitate larger contributions and therefore improve retirement income adequacy.

These projections should be available on member statements and on demand online, by phone and face to face.

In the interest of producing the most accurate picture possible, projections from multiple funds should be facilitated by the ATO giving access to additional data, as suggested in Recommendation 37.

Challenger is of the view that the projection of retirement income should not be optional but rather, mandatory to ensure all members receive the benefit of this important measure.

### **6.3.2 Regulation of retirement income projections**

The appropriate regulator for the provision of retirement projections is APRA, due to its existing regulatory oversight of super funds through administration of the Superannuation Industry (Supervision) Act. APRA is also more suited to this task than ASIC because it has an actuarial capability for dealing with longevity and mortality risk and investment methodologies.

While ASIC's RG229 can provide guidance and a starting point on an appropriate regulatory framework, a new approach is required for providing the member with the most accurate estimates possible rather than limiting the potential for super funds' mis-use of the projection as an upselling or churning sales tool, which is the current rationale for its inflexibility.

### **6.3.3 Full stochastic modelling**

While Challenger supports the projection of retirement incomes, it strongly cautions against adopting the same methods and approaches common to accumulation investing to the retirement phase of superannuation because investing in retirement is different in material respects:

- Investment contributions cease.
- The ability to derive non-investment income from personal exertion is impaired.
- The investment horizon is unknown.
- Investment focus changes from wealth accumulation to reliable income generation.
- Capital is being converted to income.
- Consequences of investment risks (inflation, liquidity, extrapolation, idiosyncratic and systematic longevity, sequencing, reinvestment, and sovereign risks) are more profound.
- Age pension entitlements and eligibility become relevant.



Most retirement and superannuation calculators and tools fail to acknowledge many of these differences, particularly the potential impact of market sequencing risk and longevity risk, and cannot incorporate age pension considerations. They are also vulnerable to overly pessimistic longevity expectations and overly optimistic investment return assumptions such as the unjustified extrapolation of historical equity risk premia.

For these reasons most retirement projections, estimations and calculators are more likely to mislead and confuse retirees rather than educate or properly engage them.

Moreover, consumers' well-known anchoring bias and use of heuristics in financial decision-making makes it a mistake to presume that a miscalculated view of income is superior to an unquantified income.

Ideally retirement income projections should be:

- mandatory for all defined contribution super funds;
- published only as the output of an estimation methodology prescribed by regulation;
- use stochastic modelling to ensure longevity risks, inflation, and investment (especially sequencing) risks are adequately dealt with;
- use both fixed and expected return assumptions based on empirical data capable of being peer reviewed
- incorporate likely age pension payments; and
- allow further refinement and tailoring of projections through complementary calculators and tools.

An example of a sophisticated calculator is the Accurium SMSF Retirement Health Check calculator. Accurium is a Tasmanian based actuarial services firm that was acquired by Challenger in 2014. While directed at professional use in an advised context, the tool nevertheless demonstrates that the technology exists today to provide more accurate retirement income forecasts than are commonly available.

### **6.3.4 An alternative “simpler” model**

An alternative approach is a much simpler one. While not as useful or sophisticated as a full stochastic model, this simple approach at least would not be open to manipulation and would provide a consistent basis for comparisons on income to be made across super funds.

This approach would require superannuation funds to provide members with estimates of the income stream their current balances could provide if they were retiring now at particular ages above preservation age. The income stream estimate would be a conservative one based on the current real rate of return and would be set having regard to ABS Life Tables adjusted for expected mortality improvements to provide a high degree of probability that the income stream could be maintained for the member's lifetime.

This projection would be a standard formula for the entire industry. The objective would be to:

- focus fund members on income streams as an outcome, rather than account balances; and
- provide guidance to retirees about the sustainable rate at which they could drawdown their current retirement savings.

By relating retirement income to their current balances superannuation fund members should be able to make a prudent estimate on their own of achieving their retirement income objective given their planned age of retirement.

This approach avoids the significant variability in providing very long term forecasts and it avoids funds gaming the income projection requirement for commercial reasons by providing estimates based on overly optimistic growth rates or claims about their own products.

The projections should be set to provide an indication of what they can draw if they wish to maintain a stable income stream throughout their lifetime, recognising that the income they can draw will depend on economic circumstances, in particular real rates of return available in the market.

The projection could be presented together with an explanation that retirement income would grow with:

- additional compulsory SG contributions made during the years to retirement;
- any voluntary contributions made up to the concessional and non-concessional caps;
- earnings on superannuation savings prior to retirement; and
- extra years worked after preservation age.

The income stream from an account could be projected on the basis of:

- Investment earnings on the account balance / purchase price being set equal to a risk-free real rate of return such as the return on long-term inflation-linked Commonwealth Government Bonds;
- A prescribed mortality table, which takes appropriate consideration of future mortality improvements and includes a degree of conservatism to increase the probability of payments lasting throughout life, and is subject to a minimum expected future payment period, say 10 years.

APRA would determine, publish and annually review the parameters which would be used by super funds to make their projections for fund members. An example table of parameters, based on current market conditions and relevant assumptions is at Table 2 on page 25 of this submission.

It should be mandatory for superannuation funds to present them in current dollars representing the income that could be drawn from each member's account balance if they commenced an income stream at each age.

### **Example: Member with a current account balance of \$250,000**

The XYZ superannuation fund provides the member with an annual statement showing her accumulated balance as at 30 June 2015 is \$250,000.

The member's annual statement then says:

"You should not think of your account balance as a lump sum payment, you should think of it in terms of the annual income you could reliably draw from it each year over the course of your retirement.

All superannuation funds are required to provide indicative projections on the same basis. These projections do not reflect the performance of the assets in your accumulation fund or the pension fund you may ultimately choose. They are set according to a prescribed formula to give you an indication of an income stream you could reasonably expect. The actual income stream you receive will depend on the pension fund you choose and may be affected by changes in market performance.

The income projection provided here cannot be used to compare performance with other funds.

The income projection is to give you a guide to the income you would be able to take if you were retiring today at various ages (say 60, 65 and 70 years). The income you can take will be affected by prevailing real rates of return when you retire. This is presented as a range. In the income projections below, the Expected income projection is based on a real inflation adjusted return of 1% p.a., while the lower and upper bounds are based on 0% p.a. and 2% p.a. real returns respectively.

If you continue to work your employer will continue to make SG contributions. There will also be earnings on your current balance and these additional contributions. Together these will increase your superannuation balance and the size of the income you can draw from it when you retire.

If you wish to have a higher income in retirement you can also make voluntary contributions, either or both up to the concessional and non-concessional caps. If you are fit enough you could also choose to work a few years longer".

**Table 1: Income projections for a \$250,000 retirement balance**

| Age | Lower bound | Expected   | Higher bound |
|-----|-------------|------------|--------------|
| 60  | \$7,400pa   | \$8,800pa  | \$10,300pa   |
| 65  | \$8,700pa   | \$10,000pa | \$11,600pa   |
| 70  | \$10,400pa  | \$11,800pa | \$13,300pa   |

**Table 2: Retirement balances required to fund a sustainable retirement income, expressed as a multiple of the annual income amount**

| Age | 0% real | 1% real | 2% real | 3% real | 4% real | 5% real |
|-----|---------|---------|---------|---------|---------|---------|
| 60  | 35      | 29      | 25      | 21      | 18      | 16      |
| 61  | 34      | 28      | 24      | 21      | 18      | 16      |
| 62  | 32      | 28      | 24      | 20      | 18      | 16      |
| 63  | 31      | 27      | 23      | 20      | 18      | 15      |
| 64  | 30      | 26      | 23      | 20      | 17      | 15      |
| 65  | 29      | 25      | 22      | 19      | 17      | 15      |
| 66  | 28      | 25      | 21      | 19      | 17      | 15      |
| 67  | 27      | 24      | 21      | 18      | 16      | 15      |
| 68  | 26      | 23      | 20      | 18      | 16      | 14      |
| 69  | 26      | 22      | 20      | 18      | 16      | 14      |
| 70  | 25      | 22      | 19      | 17      | 15      | 14      |
| 71  | 24      | 21      | 19      | 17      | 15      | 14      |
| 72  | 23      | 20      | 18      | 16      | 15      | 13      |
| 73  | 22      | 19      | 17      | 16      | 14      | 13      |
| 74  | 21      | 19      | 17      | 15      | 14      | 13      |
| 75  | 20      | 18      | 16      | 15      | 13      | 12      |
| 76  | 19      | 17      | 16      | 14      | 13      | 12      |
| 77  | 18      | 16      | 15      | 14      | 13      | 12      |
| 78  | 17      | 16      | 14      | 13      | 12      | 11      |
| 79  | 16      | 15      | 14      | 13      | 12      | 11      |
| 80  | 15      | 14      | 13      | 12      | 11      | 11      |

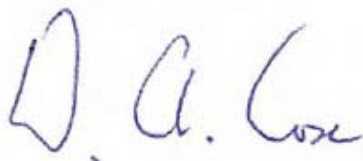
These income projections:

- Are conservative;
- Use female mortality for all people since male mortality would be too high for females. Alternatively separate income projections could be used for males.
- The base mortality table is the ALT table (at 2011), multiplied by 50% to allow for:
  - people who have been employed having lower mortality than those who haven't;
  - people from higher socio economic levels having lower mortality – to ensure that the minimums are relevant to people from medium to higher socio- economic levels; and
  - a level of conservatism to provide a better than 50% chance that the income will be stable for life, with a high probability that the funds will not run out.
- Mortality improvements are the 25 year average mortality improvements as published by the Australian Government Actuary.
- The income projection is based on  $1 / (\text{annuity value for life expectancy at the risk free rate})$ , where life expectancy has a minimum of 10 years. Note that the minimum of 10 is to avoid the minimum rising to very high levels at older ages. For the purposes of simplicity the factors are based on a fixed annuity to life expectancy, rather than a full survival curve.
- The income projections are expressed as dollars per annum of income, rounded down to the lower \$100.
- No adjustments have been made to allow for guaranteed life annuities to cover cost of capital.

## Conclusion

The FSI's recommendations propose major reforms to the superannuation system that are capable of simultaneously improving living standards in retirement; sustainability of retirement incomes; and fiscal sustainability of the retirement incomes system. These recommendations should be implemented as soon as possible. Challenger is available to provide any clarification in relation to this submission or other information that Treasury requires in preparing the Government's response to the Inquiry.

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