



25 August 2014

Mr David Murray AO
Chairman
Financial System Inquiry
GPO Box 89
SYDNEY NSW 2001

Dear Mr Murray

FSI Interim Report – Actuaries Institute Submission

I enclose for your attention a submission prepared by the Actuaries Institute in response to the FSI Interim Report. The Institute welcomes this opportunity to comment on the Committee's observations and is pleased that a number of our original recommendations have been thoughtfully considered.

Members of the Institute have also been pleased to contribute to research projects conducted by the FSI Secretariat. We trust those contributions have helped inform the Committee's deliberations on managing Australia's longevity risk.

If you would like to clarify any aspects of the Institute's submission, please do not hesitate to contact David Bell, Chief Executive Officer, on (02) 9239 6106 or email david.bell@actuaries.asn.au.

Yours sincerely

A handwritten signature in black ink, appearing to read "DS", with a small dot at the end.

Daniel Smith
President



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Response to the FSI Interim Report

1 Introduction

The Actuaries Institute welcomes the opportunity to provide further comment on issues pertinent to the Financial System Inquiry (FSI) and on a number of policy options contained in the Interim Report. The Institute is pleased to note that many views contained in our original submission particularly concerning retirement income and longevity risk products have been strongly considered by the Committee.

The Institute reiterates its previous recommendations to the FSI, especially the need for an overarching policy framework to manage retirement income related issues. A policy blueprint is essential if we are to effectively assist our ageing population.

In Australia we currently have a large superannuation system that focuses on wealth accumulation but lacks the same focus on retirement income streams that will sustain retirees' future living standards. The current system is complex and individuals often lack the financial skills to make critical decisions about retirement funding.

Therefore, given the Institute's deep interest in retirement income policy and demography, we think it is important that policymakers consider default options for channelling accumulated superannuation benefits into retirement income streams, where appropriate, to protect against inflation and longevity risk. We also call for the removal of impediments that constrain the development of a wider range of retirement income products.

2 Key Recommendations

The Institute reiterates key recommendations contained in our original submission to the FSI:

1. **The Government to adopt a comprehensive framework to manage all issues relating to a sustainable financing of our ageing population (see [4.4 Superannuation policy](#)).**

Many submissions to the FSI have identified the lack of a coherent unifying strategy to deal with the interaction of the various financial elements of retirement – Age Pension, aged care, health care and the family home. Given that superannuation funds under management are currently around \$1.6 trillion and expected to grow to \$5 trillion over the next 30 years the lack of an agreed policy framework is a major risk to the system.

The Institute agrees with the FSI that there is no legislative or formal statement of the guiding objectives for the retirement income system (FSI 2-97). This lack of policy clarity has constrained the development of a cohesive retirement income policy that integrates Age Pension, private income streams and aged care objectives. We call for the establishment of a comprehensive policy framework to manage all issues related to the sustainable financing of our ageing population. This should be one of the priority recommendations of the FSI.

2. **The government to establish a mechanism to develop coordinate and drive retirement incomes policy (see [6.2 Regulatory architecture](#)).**

The Government should also consider the establishment of a Government agency similar to the NZ Commission for Financial Literacy and Retirement Income to carry out policy research and report to the Government on a regular basis. This initiative will provide the impetus for policy development and monitoring of emerging issues.



The Council of Financial Regulators (CFR) could be accountable for coordinating and managing financial system policy and eliminating regulatory arbitrage. The CFR's activities should be widely reported on a regular basis to ensure transparency.

- 3. Creation of an open data regime to allow increased access to relevant government held data and modelling information to better manage macro risks to the financial system (see [6.1 Financial System Data](#)).**

The FSI itself has experienced the difficulty of accessing system-wide economic data to guide its deliberations. The Government should streamline the data collection methods of agencies to reduce costs and it should allow greater access to relevant agency held information that can assist private and public sectors to make more informed policy decisions.

- 4. Remove regulatory and other policy impediments to developing retirement income default options and a wider range of annuity products with risk management features that could benefit retirees (see [S7.1 – 7.5](#)).**

Australian retirees are currently limited to choosing between lump sums, account based pensions and guaranteed immediate annuities to provide their income in retirement. Lump sums and account-based pensions provide no longevity protection, whereas guaranteed immediate annuities reduce the flexibility available to retirees.

This recommendation aims to promote retirement income streams to help manage the longevity risk that the FSI has confirmed is an emerging issue of serious consequence to the financial system.

FSI Observations

In addition to the above recommendations the Institute also makes a number of points in response to a selection of the Committee's observations to assist its current deliberations.

3 Funding

3.1 Future capital flows (2-85)

What effects will the trends in the size and composition of superannuation have on the broader flow of funds in the economy over the next few decades, including on international capital flows to and from Australia?

Response

The assets within the superannuation industry are expected to grow from \$1.6 trillion to more than \$5 trillion over the next 30 years – and represent approximately 160% of GDP. By that stage around 44% of assets will be held in the pension or drawdown phase. Superannuation cash flows will move towards neutrality as pension drawdowns compensate for contribution inflows¹.

As the shift from the accumulation to drawdown phase progresses superannuants' risk aversion and preference for greater capital security (possibly including some life time annuities), will see a shift over time to more conservative investments which will boost demand for long-term defensive asset classes such as government and corporate bonds.

¹ RiceWarner - Ageing and Capital Flows, FSI submission, May 2014
Report commissioned by Actuaries Institute.



4 Superannuation

4.1 Operating costs and fees (2-99)

The Interim Report suggests there is little evidence of strong fee-based competition and that operating costs and fees appear high by international standards.

Response

The Institute believes the complexity of our superannuation system generates costs (administration fees related to tax, insurance, compliance etc.) that often appear high and we support the general impetus to lower fund fees. However, care should be taken when comparing different types of funds especially when making international comparisons. Many domestic funds are 'choice' funds not default plans. Additional costs for financial advice, insurance, distribution and legacy system maintenance also come into play. The system, at the moment, is complex and currently transitioning from a paper-based system to an electronic one. The fundamental issue is whether or not consumers are receiving value for money on a risk adjusted basis.

The SuperStream and MySuper reforms are significant but have not yet had time to dampen the level of operating costs. Moreover, ongoing fund consolidation is expected to add scale that will further drive down costs. This is an issue that should be monitored independently on a regular basis.

4.2 Liquidity: 3-day portability rule (2-114)

Should the 3-day portability rule be replaced?

Response

The Institute believes there is a clear logic for superannuation funds to support longer term investments including infrastructure. A constraint is the need to meet the 3-day portability rule. Although we do not believe this is currently an issue, the regulator should be given the discretion to provide general industry relief from the rule in periods of systemic stress.

4.3 Short-term investment focus (2-115)

Response

There is much debate about active versus passive investment approaches. Different approaches will deliver contrasting results in different time periods and investment environments. There is a recent trend for retail MySuper products to adopt a more passive low cost approach, but the preliminary information to date would indicate that the more active and diversified strategies typically adopted by the larger industry funds (including investments in unlisted classes like infrastructure and private equity) have the potential to deliver better risk adjusted returns net of all fees. Over time increased levels of consumer information about retirement income returns as opposed to accumulated asset figures may eventually encourage more interest in long-term returns.

4.4 Superannuation policy - Observation (2-118)

Superannuation policy settings lack stability, which adds to costs and reduces long-term confidence and trust in the system.



Response

The Institute agrees that there is no legislative or formal statement of the guiding objectives for the retirement income system (FSI 2-97). This lack of policy clarity has constrained the development of a cohesive retirement income policy that integrates Age Pension, private income streams and aged care objectives. We call for the establishment of a comprehensive policy framework to manage all issues related to the sustainable financing of our ageing population. This should be one of the priority recommendations of the FSI.

It is recognised that the establishment of a comprehensive retirement policy is no easy task especially given the overlapping of regulatory perimeters of critical government departments and agencies. One option would be to establish an independent Government body similar to the NZ Commission for Financial Literacy and Retirement Income (see 6.2) with accountability for framing retirement income policy and carrying out periodic reviews to maintain its efficacy.

5 Consumer Outcomes

5.1 Insurance Pooling - Observation (3-75)

Technological developments have the potential to reduce insurance pooling. This will reduce premiums for some consumers; however, others will face increased premiums, or be excluded from access to insurance. Underinsurance may occur for a number of reasons, including: personal choice, behavioural biases, affordability, and lack of adequate information or advice on the level of insurance needed.

Response

As technology improves information availability means many insurers are now able to price risk at the "address" level. Consequently, risk pooling and many inherent cross-subsidies previously incorporated in premiums have been eroded and the most 'at-risk' customers now pay a higher price. Reduced affordability can lead to underinsurance. In general insurance, flood mitigation is a strong potential solution for the mid-term.

5.2 Rationalisation of legacy products (3-87)

The FSI proposes the Government should renew consideration of 2009 proposals on product rationalisation.

Response

Legacy products may no longer be servicing consumers' insurance and investment needs. Other flow-on effects include:

- Expensive system maintenance costs are met by consumers.
- Complex and outdated administration systems are preserved to handle legacy products.
- New investment in IT platforms and increased compliance risk are constrained.
- Innovation is impeded as companies will not want to launch new products that could be on the books for many years even if they are not successful.

The introduction of a mechanism for rationalising legacy financial services products (subject to a no disadvantage test or a net system benefit with no substantial individual disadvantage) will generate significant benefits for the economy, consumers and industry participants.



Rationalisation would also enable better data to be gathered to assist our understanding and management of underlying risks e.g. mental health claims within life insurance.

Reforms of this nature will facilitate product rationalisation across all wealth management products and increased development of modern products, leading to better servicing of the population's insurance and investment needs, businesses cost and efficiency benefits for an overall reduction in compliance costs.

6 Regulatory Architecture

6.1 Financial System Data (3-97)

Financial system data is useful for policymakers, regulators, industry, academics and others.

Response

The FSI has identified 'data gaps' with its own investigations into aspects of the financial system. The Government should create an open data regime to allow increased access to and analysis of important government held data and modelling information to better manage macro risks to the financial system.

While currently available statistics provide insight into particular financial sector activities, it is far more difficult to obtain a system-wide sector, market or individual view of emerging risk dynamics and behaviours. This information is important and will be needed to help formulate the most effective policies for managing future macro risks to the financial system. Some consideration should be given to:

- ways of streamlining data collection by government agencies.
- making suitably anonymised data more widely available
- reviewing current data reports – are they still necessary/relevant?
- development of national standards and data dictionaries to enable more efficient collection of data.

6.2 Regulatory perimeters (3-99)

The regulatory perimeters could be re-examined in a number of areas to ensure each is targeted appropriately and can capture emerging risks.

Response

In our original submission to the FSI the Institute proposed the establishment of a Financial System Policy Commission (FSPC) whose role would be to put forward policy options on how to best manage the financial system over the longer term. We said that the FSPC could fulfil a similar function to the Productivity Commission and review policy issues across a range of sectors; banking, insurance, superannuation etc.

The Institute thinks FSI should also consider the merits of another model – the NZ Commission for Financial Literacy and Retirement Income. The Commission is an independent Crown body that has a responsibility to carry out research and consultations and report to government every three years. A primary function of the Commission is to ensure New Zealand's retirement income policy is stable and effective. The benefit of the NZ model is that it is ongoing, maintains a constant eye on the system, raises emerging issues in a timely fashion and is divorced from short



term political debates. The three year time frame for reports to government allows ample time to reflect on strategic issues but short enough to react to emerging systemic problems.

The current regulatory perimeter surrounding the SMSF market segment should receive further consideration. SMSF is a segment that currently manages assets in excess of \$500 billion yet is lightly regulated by the ATO whereas commercial and industry schemes (\$1.1 trillion) are supervised by APRA/ASIC. There is a need to confirm that the level of prudential oversight for the SMSF sector is appropriate to manage the potential for systemic risk in the event of, for example, widespread inappropriate investment strategies such as excessive property gearing or large scale mis-selling.

6.3 Regulator cooperation and coordination - Observation (3-120)

During the GFC and beyond, Australia's regulatory coordination mechanisms have been strong although there may be room to enhance transparency by formalising the role of the Council of Financial regulators (CFR), expanding its membership and increasing its reporting.

Response

The CFR is an appropriate regulatory vehicle to coordinate and clarify financial sector policy issues. It should also have an input into the development of a comprehensive policy framework for the sustainable financing of our ageing population. The membership of CFR could also be expanded to include at least the ATO and, if established, the Australian equivalent of the NZ Financial Literacy & Retirement Income Commissioner. In addition CFR could be the mechanism to clarify or determine the appropriate position when cross-regulatory issues arise and to eliminate regulatory arbitrage. Whatever mechanism is used its deliberations should be transparent.

7 Retirement Income

7.1 Approach to retirement income (4-3)

Australia has an inconsistent approach to its retirement income system.

Response

Australia lacks a coherent approach to its retirement income system and requires a comprehensive policy framework and a clearly designated policymaker to ensure the system delivers optimal outcomes for the consumer and the nation. The interaction between retirement incomes, Age Pension, aged care, health care and home wealth is complex and critical to the overall sustainable functioning of the economy. A retirement income blueprint needs to be formulated to increase consumer confidence in the system. The Actuaries Institute is assisting the FSI Secretariat formulate a paper, separate to this submission, that is examining options for the development of retirement income products to manage longevity, inflation and investment risks.

7.2 Longevity risk - Observation (4-8)

The retirement phase of superannuation is underdeveloped and does not meet the risk management needs of many retirees.

Response

This issue was well covered in the Institute's original submission to the Inquiry. Longevity risk management is a major weakness of Australia's retirement income system. Given that the taxpayer ultimately bears the risk related to how individuals access and invest their retirement



savings, it is reasonable that the Government proposes various incentives and/or restrictions on how superannuation fund assets can be drawn down.

The Government should, as part of its development of an overarching retirement income policy, consider options for boosting the uptake of income stream products including the introduction of sensible default options for retirees transitioning to or in the superannuation drawdown phase.

7.3 Counterparty risk (4-17)

The Financial Claims scheme removes counterparty risk for retirees who save through bank deposit products and term deposits, but not annuities.

Response

Products with long-term payment guarantees to retirees issued by life companies are regulated by APRA and are subject to very strong capital and risk management requirements. However, consumer concerns about counterparty risk may pose constraints for future development of lifetime annuity markets and products.

The GFC gave explicit form to the implicit guarantee to the global banking sector. The guarantee further encourages older investors to place a large proportion of their assets in short-term deposits. These are not always suitable investments for the generation of long-term income. Therefore to level the playing field and encourage long-term investments (such as infrastructure), to allay consumer concerns about counterparty risk, and to promote innovation in the longevity insurance market, consideration could be given to the introduction of some support mechanism, to provide financial assistance to consumers that suffer loss through counterparty failure.

7.4 Defaults (4-21)

Defaults have powerful effects on (non)decisions and can address the problems associated with the low level of financial literacy among retirees.

Response

In Australia we currently have a large superannuation system that focuses on wealth accumulation but lacks the same focus on retirement income streams that will sustain retirees' future living standards. Default products can assist those who do not have the financial skills or confidence to make investment decisions that have enormous potential consequences for their quality of life in retirement. It is important to ensure that evolving default products retain some flexibility for retirees to access some capital if, for example, hardship arises that requires funding in excess of regular income amounts. A critical issue will be establishing the appropriate criteria that trigger the direction of a retiree's assets to the default option.

7.5 Retirement income products - Observation (4-25)

There are regulatory and other policy impediments to developing income products with risk management features, such as annuities, that could benefit retirees.



Response

There are a number of impediments that constrain institutions from developing retirement income products including the following supply-side issues:

- | | |
|------------------------------------------------------------------------------|----------------|
| 1. SIS Regulations – standards for products to qualify for the tax exemption | Regulatory |
| 2. Age Pension assets test and income test | Tax/Social Sec |
| 3. Need for multiple approvals, by organisations with different interests | Regulatory |
| 4. APRA Minimum Surrender Value requirements in LPS360 | Regulatory |

As a result, Australian retirees are currently limited to choosing between lump sums, account-based pensions and guaranteed immediate annuities to provide their income in retirement. Lump sums and account-based pensions provide no longevity protection, whereas guaranteed immediate annuities reduce the flexibility available to retirees.

None of the impediments are considered insurmountable although the cost of guarantees associated with these products is high and act as a disincentive. The Government should look to develop a policy and a mechanism that could remove or reduce current regulatory, economic and consumer impediments to development and innovation in the retirement income segment.

7.6 Home equity (4-33)

What regulations, if any, impede the development of products to help retirees access the equity in their homes?

Response

Currently there are no explicit regulatory impediments constraining the development of home equity release products. However, there is a supply-side issue with a lack of funding from lenders/ investors. There are also demand side issues, in particular arising from the exemption of the family home for the age pension assets test compared with the treatment of other assets, which can be an impediment to retirees releasing housing wealth. These sorts of issues should be considered by the relevant policy agencies in order to encourage the use of housing wealth as a more widely used source of retirement funding.

8 About Actuaries

Actuaries' role in the Financial Services Industry

Actuaries have a reputation for a high level of technical financial expertise and integrity. They apply their risk management expertise to allocate capital efficiently, identify and mitigate emerging risks and to help maintain system integrity across multiple segments of the financial and other sectors.

Within the community we rely on engineers to stop things breaking down. We rely on actuaries to do a similar process in the financial system. They provide a control cycle with regard to pricing, reserving and risk management.

They have performed this control function in the life industry ever since it began, in general insurance over the last 30 years and more recently in health insurance. Within superannuation they have particularly assisted in defined benefit superannuation schemes.



Actuaries also work in other areas in non-statutory roles such as risk management, banking and data mining. By combining commercial acumen with mathematical rigour and deep analytical skills, actuaries have the ability to find pure, honest insights within business data. Insights which are then used to inform business and government and drive change.

In many instances, an actuary's role complements that of the government regulator by bringing attention to the board and management, issues that represent regulatory needs. As such, Actuaries are well placed to comment on the fitness of the current financial system to continue to support consumer needs into the future.

Although actuaries are embedded in the financial services industry, they have rigorous practice requirements, quality practice guidance and valuable continuing professional development, all of which ensure their integrity and effectiveness.

The Actuaries Institute

The Actuaries Institute (Institute) is the sole professional body for actuaries in Australia.

This submission's recommendations are underpinned by the Institute's adherence to the following policy principles:

Public benefit

The Institute holds the 'public interest' or 'the common good' of the Australian community, or to a particular group of consumers, as a key principle of policy development. The financial services system should fundamentally serve the broadest public benefit whilst satisfying individual consumer needs.

Risk focus

In considering solutions to public policy issues actuaries take an evidenced based approach that focuses on identification and management of risks – what they are, who carries them, who should carry them and how those risks should be best managed.

Transparency and disclosure

The careful analysis that actuaries can provide is underpinned by the availability of data. Broadly, the more data that is available and the better the quality of that data the more accurately risk can be assessed. Actuaries also value clear, concise and standardised disclosure of information to consumers on the basis that such disclosure enables consumers to exercise choice more confidently.

Equity

Individual consumers should be given fair treatment and commercial enterprises should be allowed to compete on a 'level playing field'. Technological advancement is fostering new sources of competition from non-traditional players. As long as required capital standards are met consumers can benefit from this increased level of competition. Nevertheless regulation should be neutral for all competitors to avoid any arbitrage that can undermine consumer protection.

'Good' regulation

Excessive or unnecessary regulation can diminish market efficiency and undermine public benefit. Good regulation should balance cost and benefit. Self regulation is favoured as it is often efficient and reduces consumer costs although prescription can sometimes be more appropriate.