Wealth & Income 4U
33A Bangalla Street
WARRAWEE NSW 2074
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The Treasury
Manager, CIPRs
Retirement Income Policy Division
Langton Crescent
PARKES ACT 2600

This submission from Martin Hickling, Founder and Director of Wealth & Income 4U, relates to the Position Paper 'Retirement Income Covenant Position Paper' released 17 May 2018.

We support the introduction of a retirement income covenant in the SIS Act for Trustees to formulate, review regularly and give effect to a retirement income strategy to assist members to meet their retirement income. As a person who has retired is unable to replenish their wealth, the deaccumulation period in which a person predominantly derives income by exchanging wealth to income is a very important phase of that person's life. As such, it is appropriate for Trustees to provide appropriate capacity for a Member to undertake such deaccumulation in a manner that is in the Member's best interests.

Despite our particular keen interest in the concept of pooling longevity risk with tontines (or 'GSAs') to meet the longevity needs of retirees, we recognise that such longevity products are not appropriate for everyone. As such, we strongly recommend against the proposed requirement for a CIPR to include a component with a 'pooled lifetime income product'. Trustees should be allowed to determine a retirement income strategy which they consider is appropriate for their Member(s), without any form of product compulsion.

It should be noted that the concept of pooling longevity risk does not relate to either a person's retirement age (if there is even such a concept these days) or even the Age Pension eligibility age, but instead when a person's probability of dying is sufficient to justify them entering into a 'reverse' life insurance product (i.e. a benefit paid on survival, but a penalty on death).

"Whether the benefit on survival is in the form of an income guaranteed for life, or some other form (e.g. a lump sum, which might be used to provide further longevity protection subsequently), the benefit is in any case funded by those in the pool who forfeit some or all of their capital on death." A Product To Meet Changing Needs in Retirement, D Rush, Presented to Actuaries Institute, May 2018

Where a person's deemed mortality (qi) is less than 1.0% (roughly age 70 for healthy persons), the expected 'survival credit' will be under 1.01% (i.e. 1.0%/99.0%) which is likely insufficient to justify participation in a 'pooled lifetime income product', especially after the extra fees and charges. It would be similar to betting a large portion of a person's life savings on the odds-on favourite in a horse race paying $1.01 (or even less after fees). Prior to age 70, the 'upside' compares poorly to 'downside' of losing the full amount allocated to a 'pooled lifetime income product'. It's just a matter of the maths.

The reason why the tontine can provide an elegant solution to those who live to an old age is that expected mortality rates typically rise sharply from ages 85-90 onwards and therefore provide a good reverse life insurance 'premium'. Up until age 70-75, expected mortality rates tend to be quite

low, so the 'premium' received from the reverse life insurance is too modest for most to place any capital at risk.

We are concerned that if there is a requirement that a 'pooled lifetime income product' must be included in a CIRP, for people retiring at under 70 years of age that they would be coerced into a 'pooled lifetime income product' at too early an age. It is not surprising that the Position Paper says that Trustees *'are concerned they may be open to claims for loss or damage*' and are looking for a safe harbour defence. This is because it is not suitable to promote, or even soft encourage, a 'pooled lifetime income product' to all Members on retirement.

Instead, there should be a requirement that Trustees consider the expected benefits of a 'pooled lifetime income product' to a Member and not make an offer to that Member unless the benefits are considered to be sufficient to offset the potential risks, including loss of capital on death, provider default risk, and the product fees and charges.

As there is not a 'good health' check requirement before joining a 'pooled lifetime income product', there is minimal opportunity loss arising to the Member(s) from delaying entry into the product until after ages 70-75.

It should be acknowledged that life annuities and deferred life annuities are not fully scalable due to the systemic longevity risk provided by those products. There is a capacity limit to the longevity liabilities that life insurance and life reinsurance companies will be willing to price and to take on. As such they are ultimately unsuitable for mass-market longevity products.

As a 'pooled lifetime income product' is essentially a reverse life insurance arrangement, other than for tax planning reasons, there seems to be very little justification for someone participating in a 'pooled lifetime income product' when concurrently holding life insurance cover (inside or outside of super). This is a mis-selling risk that should be monitored by product providers and regulators. We recommend that this factor must be considered by the Trustees when offering a pooled lifetime income product to Member(s).

The payoff profile of default life insurance is quite different to default longevity products. With default life insurance a member pays a small amount for a large payout on death. There is little risk to Members from this form of default life insurance cover, at least over a short period of time for young lives.

However, with longevity products, members put a large amount of money at risk to receive a small benefit. Inevitably, some product providers will try to mask this reality by using 'features' such as a return of (nominal) capital on death before 75, but underlying such 'features' is essentially a reversal of the longevity protection the member has purchased (while still paying the product fees!). As 'longevity' products have an asymmetric payoff profile, it should be a requirement for such structured products to require an informed decision of 'opt-in' when the longevity risk (i.e. loss of capital on death) predominantly kicks in (e.g. at age 75). Otherwise, it would not be equitable for those in poor health.

For unhealthy lives a longevity product may not be appropriate. This does not just include those individuals with 'a terminal medical condition'. It essentially includes all those who are likely to have a higher mortality rate than used by the pool's actuaries to determine their longevity benefits. Depending on the fund and the pool this may be a significant proportion of members. It is a difficult task for Trustees to make an assessment if a Member is less healthy than what the deemed mortality rate for determining longevity benefits will be for that individual. That is why the purchase of a

longevity product must be an informed 'opt-in' decision by a Member. Individuals need to determine if a longevity product is right for them. This would most likely require both medical and financial advice.

It is likely that 'impaired lives' longevity products would be developed for those people who are less healthy, including products based on employment history. To access these products, one would need to meet certain criteria for an 'impaired life'. Again, this would most likely require both medical and financial advice, and would be difficult for Trustees of public offer funds to offer as part of a CIPR.

Under Covenant principles, on Page 4 of the Position Paper, there is the statement that "*Importantly, the strategy should focus on the collective needs of members*". It adds the retirement strategy "*should primarily focus on delivering retirement income solutions that are appropriate for members as a whole or for large cohorts of members*". This collective view should be reconsidered.

While there are benefits of pooling (such as lower costs, especially for group life), this should not be confused with acting as if Members are some form of collective. On a practical level most superannuation funds are public offer and allow full portability, so there is not a 'collective'. On a philosophical level, the assets in a superannuation fund are the property of the Member. The assets are not a form of 'collective' or State monies. All references to the 'collective' or 'members as a whole' should be eliminated from any proposed regulations for retirement covenants. In the accumulation phase of converting income to wealth, many members will have a similar objectives, however the deaccumulation phase in retirement is much more nuanced and a one-size fits all (or even most) approach is not appropriate.

Trustees should be required to consider issuer default concentration risks of exposure to provider(s) of longevity based products, particularly for products which carry an inherent mismatch risk between assets and liabilities, as do some life annuities currently offered in the domestic market.

Just as a fixed interest portfolio investor would never invest in only one corporate issuer, particularly not for long-dated paper, it is not appropriate for Trustees to exposure Members to significant default risk. Even with highly-rated corporates, a fixed interest fund would typically hold at least 20 securities to provide sufficient diversification against default risk. Default risk is particularly important to manage as late in life the longevity product(s) may be a person's remaining source of income.

It should be noted that there are currently limited product offers in the market place for 'pooled lifetime income product'. As such, if a significant proportion of a person's assets are held in such products it is highly unlikely that sufficient diversification could currently be achieved to manage default risk on life annuities and deferred life annuities.

The Position Paper doesn't sufficiently address the lack of portability of longevity products. The longevity product itself cannot provide flexibility. If people were able to withdrawal monies when they became ill, then that would be to the detriment of others in the pool. As such, the longevity component of a CIRP is unlikely to be portable when provided by the superannuation fund itself, and potentially difficult and costly when provided on a group basis by an external provider(s) – especially where the underlying products are diversified by issuer. In fact, for these reasons it may make better sense for an individual to hold their longevity protection outside of the superannuation environment.

Trustees should be careful when explaining longevity products to Members. It should be made clear that the uplift to payments is compensation for putting capital at risk on death. It would be inappropriate to compare the income levels of longevity products to account based pensions without acknowledging the capital loss on death for the longevity products. Charts such as those shown in Scenario 1, 2 and 3 on Page 15 of the Position Paper are potentially misleading to Members as they don't show the cost of putting capital at risk on death. The charts are comparing apples with oranges, and should not be allowed in PDS and marketing material without specific warnings about loss of capital on death.

The size of the tontine component of a CIPR should be capped in both purchasing power and percentage of CIPR terms. At current purchasing power a $400k tontine seems sufficient to provide a base level of income if a person lives into their 90s. An appropriate percentage cap may be around 75% of a person's CIPR assets.

The concept of a CIPR as a broadly constant income stream seems to be at odds with the necessary 'opt-in' approach to a longevity product. The lack of portability and the lack of withdrawal components of the 'pooled lifetime income product' together with the importance of assessing a person's health at the time of joining a longevity product means that this should be an explicit decision made by the individual member and not as part of a default selection, or as a default offer.

Given the lack of portability for longevity based products, the structure for holding those assets needs special consideration. The assets of life annuities and deferred life annuities are held in statutory funds, with the funds and entities regulated by APRA. Consideration should be given to requiring separate statutory funds for CIPR life annuities to reduce the risk of depletion of funds from losses in other classes of business. The assets of tontine (or 'GSA') based products need to carry similar protections to statutory funds. It is appropriate that they are regulated by APRA. As individual members cannot withdraw funds there is a heightened risk of a Ponzi-style scheme developing with these products.

Members must be able to determine through a vote which entity has the management responsibilities for a tontine (or 'GSA'). The management company for a tontine should not be allowed to claim penalty for termination at contract end by members and management contracts should be limited to three years. For example, a vote of 75% of members (by number and assets) should be sufficient to change management companies of a tontine.

It remains unclear if a tontine is, or is not, a life insurance contract as defined under LIFE INSURANCE ACT 1995 - SECT 9. A tontine appears to be covered under Section 9 1. (a) is "A contract of insurance that provides for the payment of money on the death of a person or on the happening of a contingency dependent on the termination or continuance of human life;". It does not seem to be an exclusion.

If a tontine must be issued by a life insurance company this is a clear impediment to competition given the capital requirements and infrastructure required to operate as a life insurance company in Australia.

With respect to legacy issues for products, Members should be able to vote at a 75% threshold to replace the management company of a longevity product provider. APRA should authorise the merger of longevity pools where appropriate in the circumstances. Longevity product providers should not be able to enter into onerous management fee contracts, and should receive minimal exit compensation if Members determine to cease using that provider.

With respect to definitions in the glossary of the Position Paper:

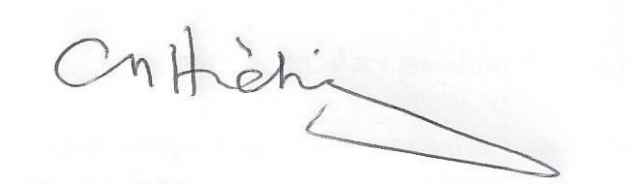
- The term 'Annuity' should not only relate payments provided for life or for a fixed number of years by a life insurer. Annuity means 'a sum of money payable yearly or at other regular intervals'. There is no requirement an annuity is paid by a life insurer. This is a form of industry capture of a word 'Annuity'. Instead for products issued by a life insurer and subject to a life contingency, the terms 'life annuity' or 'deferred life annuity' should be used. These terms are more precise. By including the word 'life' prior to annuity it makes it clear that the annuity will cease on death. Where a payment is not contingent on a life event, it would be called an annuity.

- The term 'Pooled lifetime income product' should only be used for products that mutually pool risk, with the corresponding lack of guarantee for income payments. Life annuities and deferred life annuities should not be included in the definition of 'pooled lifetime income product' as it incorrectly conveys the message that the systemic risk of improved mortality is a pooled risk. The systemic risk of improving mortality cannot be pooled and is therefore subject to capital risk for writers of life annuity guarantees.

In summary, as the market and structure of longevity products currently is poorly developed, and life annuities and deferred life annuities are likely to have capped capacity given the systemic risk of longevity for those products, it is not appropriate that Trustees be forced to provide longevity options to their Members as part of considering retirement income strategy.

Rather than the current focus of encouraging longevity products within superannuation, it may make better sense to incentivise longevity products - those which have no withdrawal benefit - to be held outside of superannuation. For example, individuals could be given a tax incentive (similar to that if the monies were to remain inside of superannuation) between ages 70-80 to withdraw monies (maximum $400k) from their account-based pension to invest directly in APRA authorised longevity product(s). This would remove the portability concerns of holding such longevity products in a superannuation environment. It would also increase the flexibility of product offerings, particularly the inclusion of reversionary spouse benefits, increase competition (as otherwise the large superfunds will dominate the flow of monies), and allow for greater consideration of a Member's individual circumstances at that time.

In addition, an industry compensation fund to cover default risk of APRA regulated longevity product providers should be considered. This would reduce the risk to Member(s) from product provider concentration risk, which otherwise may be too costly for the individual to achieve.



Martin Hickling

Founder and Director, Wealth & Income 4U

mhickling@wealthandincome4.com