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Submission on the Retirement Income Covenant Position Paper

Thank you for the opportunity to provide feedback on the Retirement Income Covenant Position Paper which was issued following the recent Budget.

Introduction

RGA Australia (RGAA) is part of Reinsurance Group of America, Incorporated – one of the largest global life and health reinsurance companies. In Australia, RGAA provides life reinsurance services within the traditional areas of death and disability coverages, both to the retail market and to the superannuation group insurance market.

Globally, the RGA group is a major reinsurer of longevity risk, most notably in the UK where we reinsure existing longevity risks of defined benefit pension funds and where we additionally provide enhanced annuity terms to the UK retail pension annuity market. RGA is one of the largest contemporary writers of longevity risk on enhanced terms in the UK market.

If the market settings are right, RGAA would be keen to support Australian retirees, funds and insurers by deploying its longevity risk-bearing expertise and enhanced annuity expertise to help Australian superannuation funds and insurers to offer CIPRs to members and thereby better assist members to meet their retirement income objectives.

RGAA has confined its comments to certain aspects of the Position Paper where RGAA considers that it has particular expertise and/or experience to draw upon in support of its feedback.

RGAA would be pleased to meet with Treasury in Canberra to discuss this submission.

“Enhanced” Lifetime Income Streams

RGAA sees a key role for underwriting enhancements within CIPRs and lifetime income streams - which better reflect the socio-economic, lifestyle and medical characteristics of like members within a deep risk pool – in order to provide greater equity for and among retirees in relation to the “price” each member pays to protect against longevity risk.

Such enhancements improve customer outcomes, and having access to such enhancements in a flagship CIPR will likely play a key role in better safeguarding member equity.



By way of background, some recent statistics from the UK market and, more specifically, from RGA's UK operations are illuminating:

- According to recent Association of British Insurers' (ABI) statistics, almost one-third of new pension annuities are enhanced annuities.
- RGA's enhanced annuity underwriting tools currently provide enhanced terms for 76 lifestyle and medical characteristics or conditions.
- The three most commonly presented to RGA for enhancement are smoking, diabetes and cardiac-related conditions (including high blood pressure and heart attack).
- RGA's enhanced annuity underwriting tools provide automated enhancement quotes to the UK market on a daily basis. Based on recent quote statistics:
 - 33% of RGA's quotes offered a mortality loading of between 50% and 100%
 - A further 20% of quotes offered a mortality loading of >100%
 - Thus, more than 50% of RGA's quotes offered a mortality loading of 50% or more.

By way of explanation, an enhanced annuity provides a larger income stream (per \$1000 invested) to pensioners whose lifestyle, medical or other characteristics render them at greater risk of death than a pensioner who is considered to be a "standard" life.

To put this in perspective, a mortality loading of 75% might increase the dollar income level from a simple, non-commutable lifetime annuity commencing at age 65 by approximately 15%, compared to an equivalent annuity issued on standard terms. Put another way, to achieve this uplift in income without having access to enhancements would require bond yields to be approximately 1.5% per annum higher than current rates.

The increase in income for a simple, non-commutable deferred lifetime annuity (DLA) purchased at age 65 with income payments commencing at age 80 would be even higher – perhaps in the order of 40-50%, in theory, although this is obviously accompanied by a materially higher risk of dying before age 80.

RGAA's Other Feedback

- 1) *We would like to offer an overarching comment in relation to the Position Paper – namely that a key outcomes-test for the proposals will be whether the Retirement Income Framework fosters a materially greater "mass-market" take-up of lifetime income streams among retirees.*

The lower the take-up, the greater will be the adverse selection risk, the less efficient will be the longevity pooling achieved, and the poorer will be the outcomes for retirees. We note that this observation is relevant both to lifetime income streams that are provided via insured arrangements and to those that are provided via a pooling arrangement among members.

In formulating the detailed legislation and regulations, we suggest that Treasury keep this key outcomes-test uppermost in mind and critically assess whether the proposed CIPR framework includes elements that risk unduly constraining the take-up of lifetime income streams.

We understand Treasury's rationale for, at this stage, not making the purchase of a lifetime income stream compulsory for members, and for requiring there to be explicit member consent before a CIPR commences. Within this overall constraint, we have provided feedback in this submission on a number of areas which may better facilitate a higher take-up rate.

2) *RGAA supports the proposed CIPR commencement date of 1 July 2020.*

The proposal to delay the commencement date to 1 July 2020 seems reasonable in the circumstances, particularly in view of the Protecting Your Super package that was also announced in the Budget, which is likely to draw heavily on fund and insurer resources in the near term. Given the ever-growing volume of retirements within the superannuation system, it would seem desirable that the CIPR commencement date not slip any further.

3) *The permissible range for the test of constant expected income appears too narrow and risks stifling innovation (refer to the middle of page 6 of the Position Paper).*

The +/- 2.5% range proposed appears to be too limiting in a number of respects and risks unduly stifling CIPR innovation in pursuit of the efficient delivery of lifetime income streams. We appreciate that this is only intended to be an expectation at outset and that actual income performance can vary from this. Nevertheless, we consider that having such a narrow expectation range at outset will unduly constrain CIPR solutions. We offer the following observations in this regard:

- In a world of ever heightening consumer expectations (notwithstanding explicit performance qualifications stated within product terms), it creates a distinct risk that members will be conditioned to expecting the CIPR to perform within this 2.5% range at all times, despite the absence of any stated guarantees.
- We read the Position Paper as defining the range as being fixed at +/- 2.5% of the first year expected income rather than being allowed to reset each year relative to a reasonable trajectory of expected income. We consider that having a wider range and a rolling reset would provide greater scope for innovation without unduly compromising the underlying income-for-life objective of a CIPR.

4) *Enhanced CIPR terms for less healthy retirees on account of their socio-economic, lifestyle and/or medical characteristics should be eligible for inclusion within a flagship CIPR, and variations in the terms offered for each member on account of such enhancements should still constitute the same flagship CIPR (refer to the A+Plus example on page 8 of the Position Paper).*

The Retirement Income Covenant and the CIPR regulations should recognise the value of, and facilitate the development of, “enhanced” lifetime income streams for the benefit of less-healthy retirees. While the “A+Plus” example in the Position Paper appears to allude to this (when it refers to smoking and blue/white collar status), we have suggested below some aspects for inclusion in the relevant regulations in order to more clearly capture the range of enhancement factors that would still constitute the same CIPR.

We suggest that the regulations treat all forms of socio-economic, lifestyle and medical enhancements (to constant expected income) as falling within the same flagship CIPR, rather than constituting a different or alternate CIPR.

We also suggest that the apparent limitation stated in the “A+Plus” example to the effect that the impact on life expectancy has to be capable of reliable estimation be dealt with in a different manner in the regulations in order not to unduly constrain a flagship CIPR. For example:

- a) “Reasonably estimated” would seem a better standard than “reliably estimated” since the latter might be too onerous in practice; and

- b) If an unrelated third party (to the fund) is prepared to provide longevity protection at a guaranteed price on the basis of the enhancement characteristics applicable to a particular member, the arms-length nature of these pricing terms ought to be sufficient on its merits, without any need to additionally satisfy a “reliably estimated” or “reasonably estimated” criterion.

We regard enhanced annuities as a particularly important feature of the UK market and we can foresee that Australian market participants will consider that it is in the better interests of members for CIPRs to provide similar “enhanced” terms within any lifetime income stream that is provided. The Retirement Income Covenant and CIPRs should facilitate this, in the interests of improving customer outcomes.

Enhancements should be capable of being embedded within the flagship CIPRs, rather than being delivered solely via alternative non-flagship CIPRs. Indeed, having such enhancement to constant expected income within the flagship CIPR, with the enhancement varying according to the lifestyle, medical and other factors presented, is likely to play an essential role in fund trustees being comfortable that they have reasonably discharged their duties to members within the CIPR framework.

Lastly, it should be noted that such income uplifts would in principle be available regardless of whether the relevant CIPR was a fully-insured arrangement or a member-pooling arrangement or some hybrid of the two.

- 5) *A flagship CIPR should permit a combination of products that may include a programme of phased locking-in of a lifetime income stream during the course retirement, for example, via the phased purchase of multiple lifetime annuities as one’s retirement advances, rather than a single one-off purchase at the point of retirement (refer to the third paragraph on page 7 of the Position Paper).*

There is a growing body of research and analysis which points to the merits of locking-in longevity protection during the course of early-to-mid retirement, rather than at the point of retirement. There are various strategies that could achieve this outcome.

The regulations should enable a trustee to design a flagship CIPR which combines an account-based pension with a preset, phased purchase of a lifetime income stream in instalments. The purchase price of future instalments would not be guaranteed at outset. If a member chooses to opt-in to this CIPR, he/she should then have the ability to turn off future phased purchases and retain the lifetime income tranches purchased up to that point. Treasury’s original discussion paper appeared to allude to a CIPR strategy of this nature but the Position Paper appears to be silent.

A phased-lock-in CIPR strategy would be capable of fulfilling the overall objective of delivering a lifetime income stream. This strategy would be a viable, and in some instances a more optimal, alternative to purchasing a DLA.

- 6) *We caution against relying too heavily on a presumption that DLAs will be readily available on economically-attractive terms when formulating the detailed regulations for CIPRs (refer to the various references to DLAs in the Position Paper, most notably the A+Plus example on page 8 and the illustrations provided in Appendix A).*

A number of significant factors militate against insured DLAs at present - including the small and self-selected pool of existing annuitants, the associated relative lack of experience data with which

to price, the greater parameter estimation risk in pricing a DLA, the long time-lag before a provider will know whether their experience assumptions were correct or not, and the potentially greater risk capital required to back the product - all leading to the need for conservatism in pricing. Faced with this current reality, it remains to be seen whether the supply of insured DLAs will be sufficient in volume and pricing terms to make a material contribution to CIPRs.

By contrast, a phased locking-in of tranches of lifetime income progressively through retirement may provide a better balance of price, guarantees and lifetime income. A flagship CIPR should therefore accommodate such phased-lock-in programmes per the comments in (5) above.

- 7) *Data from the UK pension annuity market might suggest that the proposed CIPR exception for balances of less than \$50,000 should be lowered (refer to principle 8 of the Position Paper).*

There is merit in having a minimum balance exception for very small balances. However, recent UK ABI market statistics for pension (lifetime) annuity sales suggest that \$50,000 might be too high. Following Pension Freedoms in 2015, the volume of lower-balance pension annuities purchased in the UK market has reduced. However, for the first 9 months of 2017, over 60% and 40% of sales (by count) were for initial investments of less than GBP50,000 and less than GBP30,000 respectively. While some of these purchases might have been made alongside a larger investment in an account-based pension, the make-up of the UK pension market suggests that it is reasonable to conclude that a material portion of these purchases will have been made on a standalone basis, utilising the majority of a new pensioner's retirement savings.

It is also noteworthy that the UK age pension is not means-tested. Thus, at these investment levels, the UK and Australian entitlement to a full age pension are comparable. A possible countervailing view is that the Australian age pension is more generous, thereby lessening the need for low-balance retirees to top-up their age pension with a modest lifetime income stream. However, who's to say that what might appear to be a relatively modest top-up to the age pension isn't of meaningful utility to lower-balance members?

Given the above, Treasury may wish to consider reducing the currently proposed \$50,000 limit, particularly bearing in mind that CIPRs will remain opt-in for all members in any event.

- 8) *Portability requirements for lifetime income streams should not be introduced (at least not initially)*

Portability is a complex issue for longevity-pooling products to accommodate and seeking to do so adds further product complexity and pricing inefficiency, which may in turn militate further against mass market take-up of CIPRs. The new tax treatment of innovative lifetime income streams already provides a basis for retirees to exit should a fund/provider choose to offer such exit terms. Competitive market dynamics will determine whether such exit terms become prevalent without the need for additional portability requirements.

- 9) *Where practicable, key parameters/settings applicable to the framework and to the operation of CIPRs should be set out in regulations rather than in the SIS Act itself, to enable these parameters/settings to be adjusted more quickly.*

Should Treasury find that the take-up of CIPRs falls short of its expectations, the ability to change parameters/settings via regulations might facilitate faster adjustments in the interests of fostering greater market take-up of lifetime income streams.



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10) *RGAA supports the latest proposal to move away from a primary focus on “constant real income” (refer to the last paragraph on page 6 of the Position Paper).*

There is a growing body of research and analysis which suggests that it is too simplistic to presume that retirees will need a constant real income throughout retirement.

11) *The reference to age 105 in the CIPR section of the Position Paper could be misconstrued (refer to the second paragraph on page 7).*

It is presumably not the intention of Treasury that an “income-for-life” CIPR could have a payment cut-off age of 105 (or any other age). The example provided in the paper could be misconstrued as such. The draft legislation and regulations will hopefully remove any scope for misunderstanding on this point.

We are happy to discuss this feedback further. As noted earlier, RGAA would also be pleased to meet with Treasury in Canberra for the purpose of such discussion.

Regards,

A handwritten signature in black ink, appearing to read 'D. Rawlinson', is written over a light blue horizontal line.

Duncan Rawlinson
SVP, Australia & NZ