Challenger Limited Submission

Productivity Commission
Inquiry into Caring for Older Australians

Introduction

Challenger Limited is a listed top 100 Australian company with a principal business focus on retired Australians. It is the owner of Challenger Life, Australia's largest provider of annuities with current assets of $7.6 billion and liabilities to 60,000 policy holders of $4.7 billion. Challenger is actively engaged in the current public debate on reform of the superannuation system and sees both parallels and links between providing retirement income security and aged care. Some significant pieces of research, which Challenger commissioned for the Henry Review of the taxation system and the Cooper Review of the superannuation system provide insights which are directly transferrable to the reform of the provision of aged care. These reports by Chris Dalton, the former Australian Country Head of Standard & Poors, and by Access Economics are attached and relate to sections 4, 5 and 7 of this submission.

The purpose of this submission is to demonstrate that APRA regulated life offices could provide products which would make a substantial contribution to assisting individuals to meet the costs of their aged care and to set out some policy responses which the government should take to facilitate that.

This submission:

1. Supports reform to better match fees and subsidies to costs across the aged care sector (Draft Recommendations 6.1, 6.3, 6.4 and 6.7).
2. Supports the principle that the aged should be responsible for their accommodation costs, with a means tested safety net (Draft Recommendation 6.2 and 6.4).
3. Supports the principle that a means tested co-payment system should apply across the aged care sector to assist in meeting the cost of care (Draft Recommendation 6.2).
4. Discusses the need for government to minimise the additional longevity risk it will carry through the aged care system as a result of the ageing population (Draft Recommendation 6.10).
5. Does not support the Productivity Commission's proposal that the government enter the market to provide an equity release scheme and an Australian Pensioners Bond Scheme.
6. Notes the capacity of superannuation immediate and deferred lifetime annuities to provide a stream of private income which would be available to fund recurrent aged care and accommodation costs (relevant to Draft Recommendations 6.2 and 6.10),
7. Supports the release of sufficiently detailed DoHA data, in a form that does not jeopardise the privacy of individuals, for the purposes of both academic and actuarial analysis for research on systemic costs and to permit the development of efficiently priced financial products to assist the aged to meet accommodation costs and co-payments for care (Draft Recommendation 13.1).
8. Provides an example of a possible product, with baseline pricing, which could be offered under the existing aged care arrangements to provide an alternative means to meet accommodation bond requirements (relevant to Draft Recommendations 6.6 and 7.1).
9. Discusses regulatory risk and sets out a number of conditions precedent to permit investment in providing such a product (relevant to Draft Recommendations 6.6 and 7.1).
10. Sets out some other possible product concepts that could be offered provided Draft Recommendation 13.1 is implemented (relevant to Draft Recommendations 6.6 and 7.1).

1. Better matching of fees and subsidies to costs across the aged care sector

The Productivity Commission's draft report paints a graphic picture of an aged care sector where significant distortions in the pricing of accommodation and care have developed over many years. These distortions have been created by a combination of rationing and regulation of pricing and subsidies resulting in a pricing structure which bears increasingly less relation to either the marginal or average cost of supply. The consequences of this are seen with bonds for access to low care residential accommodation. These have become a barrier for many who have been assessed as needing care in that category. An absence of sufficient revenue sources for high care accommodation has resulted in impediments to the provision of new accommodation in that category. There is a significant amount of cross-subsidisation which is independent of the means testing arrangements creating significant inequalities between users.

In the case of low care residential accommodation, the arrangements negotiated between providers and residents can have a substantial impact on the level of subsidy provided by the Commonwealth. This creates inequity with the amount of subsidy paid by government increasing independently of the resident's actual financial circumstances.

These distortions need to be removed if the sector is to expand efficiently to meet the needs of a rapidly growing aged population. The benefits of removing these distortions will be enjoyed by all parties; residents, aged care providers and taxpayers who bear the majority of the cost of the care component. An important benefit of an efficient and predictable pricing mechanism for aged accommodation and care is that it is a pre-requisite for the development of financial products which will assist the ageing to meet the cost of accommodation and co-payments for care.

2. Aged responsible for their accommodation costs with a means tested safety net

The principle that individuals should be responsible for their accommodation costs is sound and removes the potential for cost to unnecessarily influence the decision between residential and in home care. If the pricing for residential accommodation is rational and reasonably predictable that will facilitate the development of financial products which will give more choice to individuals about how they wish to meet those expenses.

3. Means tested co-payment system to assist in meeting the cost of care

It is reasonable to expect that those who have sufficient means make a contribution to the cost of their care. If the cost structures and co-payments for that care are determined on a rational and predictable basis that will provide a foundation for the provision of financial products designed to assist the aged to meet their co-payment obligations and give them more choice in relation to their care.

4. Need for government to minimise its additional exposure to longevity risk

The largest contributors to the projected growth in outlays are for aged care, health and the aged pension. With both an increase in the proportion of the population that is aged and continuing improvements in mortality rates, each of these categories of outlays are recognised in the IGR as key drivers of government expenditure. They should also be recognised as major contributors to the

government's already considerable exposure to longevity risk, in that the government's costs in each of these areas will continue to increase with increasing longevity.

The rating agency Standard & Poors has for some years published a series of Greying Reports, which estimate the trajectory of various developed countries sovereign ratings as a result of the ageing of the population. In this analysis S&P put a similar focus on aged pensions, health care and long term care. S&P compared general government balances with the median for each rating category averaged over the period 2000 to 2008, and found that on this no policy change basis many "AAA" rated sovereigns will hypothetically fall to at least AA by 2020 and then to speculative grade by 2030. However, S&P went on to state, *"It is inconceivable that governments will allow debt and deficit burdens to spiral out of control,"* and that ***"****The financial linkages between social security and fiscal policy call for decisive defensive steps now."*

Hypothetical Ratings Outcomes under No Policy Change Scenario

	2007	2020	2030	2040
Australia	AAA	AA	A	Spec.
Canada	AAA	AAA	A	A
Japan	AA	Spec.	Spec.	Spec.
Sweden	AAA	AAA	A	Spec.
USA	AAA	A	Spec.	Spec.

Source: S&P Global Graying Report 2007

Without reform, S&P said this would likely lead to *'a deterioration in economic prospects, as rising tax levels could cause the accelerated outward migration of ever more mobile factors of production (especially capital and skilled labour), endangering the very sources of growth and fiscal revenue' So while the key ratio of General Government Balance-to-GDP is driving the hypothetical ratings, this downwards trend would also be supported by high debt and debt servicing burdens, and potential weakening in economic prospects and institutional stability." (M Kraemer "Global Greying: Ageing Societies and Sovereign Ratings" Standard & Poor's Global Graying Report 2006, 27 June 2006).*

The implications of this are that any new policy proposals that will either directly increase government expenditure in these areas or expose it to risks of future increases should be examined most critically. While proponents of the government taking on such risks see it as large, capable of managing those risks and able to spread their costs across the community through use of the taxation power, in reality such risks are likely to accumulate, rather than be closely managed, and since they will be substantially or totally unfunded, are certain to create additional intergenerational inequity as the costs are transferred to future generations.

Australia has an enviable political culture where means testing is widely accepted. This has proven effective in providing access to social benefits for people with limited assets and low incomes, while limiting the cost to taxpayers. Where co-payments are appropriate departures from means testing are difficult to justify. The proposal in Draft Recommendation 6.2 to place an absolute monetary limit per individual on co-payments for care is not accompanied by an adequate description of the "catastrophic costs" from which it is intended to afford protection. Suffice it to say that if an affluent individual receives a quite typical level of aged care over many years and the total of their co-payments eventually exceeds $60,000 that is not a catastrophic cost.

While such a stop loss arrangement at a real value of $60,000 for an individual's total co-payments would make it less risky to offer insurance to cover an individual's potential costs of care, in the light of the current trajectory of Australia's sovereign rating, the Productivity Commission should give further consideration to the appropriateness of the government accepting the residual risk. The cost of

that risk will increase if the $60,000 limit is frozen in nominal terms or otherwise manipulated in a way that undermines the effectiveness of the means test arrangements.

5. Government should not become a provider of financial products

5.1 Australian Pensioner Bond Scheme

Draft Recommendation 6.6 proposes that the government establish an Australian Pensioner Bond Scheme which would allow pensioners to place the proceeds from the sale of their home into a government guaranteed account to draw on flexibly for living expenses and aged care. This facility would be exempt from the age pension means test, free from all fees and the capital would be indexed by the CPI.

It should first be noted that life offices already provide capital guaranteed fixed term CPI indexed annuities at rates which generally compare favourably relative to bank term deposits and very favourably relative to indexed Commonwealth bonds. These products are already available at these attractive rates in forms which do not involve fees. If the government believes such products should be age pension means test exempt then it can provide that treatment without also having to provide the financial product.

If the government decided to become a product provider this could be done either on budget or funded. If it were done on budget the return to retirees would reflect the risk free rate for issuing new government bonds that the purchase price of the pensioner bond would replace. Without a subsidy, which would have to be borne by other taxpayers, this would be lower than the rate a private life office would offer the pensioner, reflecting the higher yielding assets the life office would purchase.

If the government decided to invest the funds to provide a market competitive rate of return it would have to accept the same market risks as the shareholders of a private provider. The government would also carry the implementation risk of establishing the new product and integrating it with its existing delivery of aged care as well as the ongoing operational risk.

To provide guaranteed products life offices have to meet the requirements of APRA's prudential standards to hold significant amounts of capital against liquidity, market, inflation and operational risks. In the case of retirees purchasing from the government, this capital would have to be provided by taxpayers or the costs associated with these risks would be additional budget expenses.

A similar issue arose in the course of the Henry Review of the taxation system when it was proposed that the government enter the superannuation annuity market as a provider. The proponents of this concept argued that public provision has a number of benefits over private provision: *"The Government has greater capacity to invest assets in a risky portfolio against long term liabilities of this kind, and it has the lowest possible default risk and cost of capital. By utilizing the existing social security administration, the product would also benefit significantly from economies of scale and scope for extremely cost-effective delivery."*

The question of relative efficiency of administration is a highly contestable point. Modern life offices already have low costs and their operations are highly scaleable.

Any suggestion that the product should be fairly priced has three dimensions, each of which deserve examination:

First, if the returns reflect the government's risk free cost of capital they will be lower than the returns on the same investment in an annuity provided by a life office which earns higher returns. That does not seem to be a fair price for the retiree.

Second, if the government were to fund the return on the bond with more risky assets, like a life office it would need to hold capital against all of the related liquidity market, inflation and operational risks. While the government may be able to borrow at a lower rate than a life office, a proposition which will be dealt with in more detail below, it would be necessary for the government to hold a much larger quantum of capital against a portfolio of riskier assets, and the cost of that additional capital would have the effect of reducing the extra return to the retiree promised by the government from those riskier assets. If the government funded the bond on the basis that it provided weaker provisioning than the capital standards APRA applies to a life office, that would be a major departure from the principle of competitive neutrality and, as such, would not be fair pricing relative to private providers.

Third, unfair pricing, which does not recognise the actual capital requirements, would eventually result in losses being borne by taxpayers. An obvious example is the South Australian Government's SGIC (State Government Insurance Commission) which was established with insufficient capital, relied on a government guarantee, and eventually failed resulting in very heavy losses. That was not fair to taxpayers.

5.2 Cost of Capital

Challenger commissioned Access Economics to examine the implications of using the government's AAA rating and therefore low cost of capital to provide an advantage in pricing a publicly provided annuity. Their report is attached as part of this submission. In summary, Access Economics concluded that the government could use its capacity to borrow at the risk free rate in the short term to benefit buyers of publicly provided annuities but that would not benefit Australians as a whole and the funding advantage would be eroded over time.

The central issue is that labelling borrowing as 'public' or 'private' does not change the inherent risk in a transaction, but only who bears that risk. The cost of the marginal transaction – paying upfront now for an income stream to follow – is the same regardless of whether done publicly or privately. Over time, public provision would either draw directly on the Budget or tend to dilute the cost of capital advantage to public sector borrowing as a whole.

Access considered two theoretical economies the first with no net government debt, and all private borrowing subject to the full risk inherent in its underlying economic activities. The second economy is identical in structure to the first, except for a government guarantee on all debt transactions, funded through an efficient income taxation system.

The first economy faces credit defaults on occasion, which are absorbed as costs by creditors, resulting in a higher pre-tax private cost of capital to cover those risks. The second economy has no defaults because they are covered by the government guarantee, so it has a lower pre-tax private cost of capital, but higher taxation which constrains the level of economic activity. With this simple comparison Access demonstrates that;

> *"Some of the costs of default risk can be covered by governments, but only at the cost of externalising the risks toward other parts of the economy…the initial apparent 'savings' on interest payments are in fact matched by costs elsewhere in the economy over time – it is just that the savings are more obvious and the costs more diffuse."*

Debt markets prefer government debt over private borrowing because governments are less likely to default than corporations. Governments enjoy superior credit ratings in part because they have the ability to pass on the cost of debt to taxpayers. Access notes;

> *"Such a transfer of costs is a key benefit for debt investors, who are only interested in recovering their money. It does, however, come at a price – lower living standards for taxpayers and collateral damage to the economy as higher taxes discourage investment and workforce participation."*

If markets are well informed, the cost of capital advantage enjoyed by governments is likely to be eroded as more borrowing increases the risk attaching to government debt. Even if markets do not fully adjust, the actual resulting risks are passed to taxpayers.

While markets hold the view that government activities are better risks than business activities, Access says;

> *"when governments borrow in order to fund the purchase of business assets (as would be the case for a public annuity offering), then that view is diluted. Sophisticated markets are able to look through the public sector 'label' placed on borrowing to the assets underneath, attaching similar levels of risk to those for private borrowers."*

Access points out that there are serious implications in adding to the government's debt exposures;

> *"Increased borrowing costs on all Government debt would offset the borrowing cost advantage on new debt – effectively negating the cost of capital advantage of public provision. That means debt sustainability matters and that governments cannot borrow in a manner which steadily increases overall leverage in perpetuity. Doing so would threaten fiscal sustainability, and hence external stability, the government's credit rating and the cost of credit. An iron rule of economies is that 'somebody pays'."*

Access summarised the government's current exposures from official sources, as follows;

> *"On official forecasts, the total stock of CGS on issue (which is a proxy for gross government debt) is expected to peak at $301 billion by 2012-13 (over 20% of GDP). It is likely that this elevated level of debt will be with Australia for some years to come. Contingent liabilities represent possible costs to the government arising from past events or decisions which will be confirmed or otherwise by the outcome of future events that are not within the Government's ability to control. They include loan guarantees, non-loan guarantees, warranties, indemnities, uncalled capital and letters of comfort. These possible costs are in addition to those recognised as liabilities in the consolidated financial statements of the Australian Government general government sector.*
>
> *Current quantified contingent liabilities are $930 billion. This is around 78% of GDP in 2009-10. When outstanding gross debt is taken into account together with the contingent liabilities, this takes the total government potential exposure to over 90% of GDP in 2009-10."*

Access found that there is no sustainable funding advantage from government provision of annuities;

> *"Even if markets have a degree of unmet thirst for Australian Government guaranteed debt as of today, there is less likely to be any such unmet demand in coming decades, when Government debt is projected to rise. That is important because markets tend to be less forgiving of governments which already have higher debt ratios. The intergenerational*

pressures associated with an ageing population threaten to produce significant primary deficits over coming decades.

The deterioration underway in the current and future creditworthiness of Australian Governments adds to the reasons to believe that there is no economy-wide 'free lunch' to be had in the Federal Government directly selling annuity products to Australians. The initial apparent 'savings' would disappear over time – public annuity provision is more likely to, for example, either add marginally to the overall cost of public sector borrowing and/or add marginally to the overall cost of commercial bank borrowing used to finance Australian home and business loans."

Access concludes that;

"Given the direct and indirect costs of government borrowing, it is unclear that the public sector has or will continue to have a cost of capital advantage over the private sector.
Such a conclusion is supported by a number of papers which state that, in the absence of market imperfections, the cost of capital for public projects should be the same as the cost of capital for comparably risky private ventures. These pressures will be most pronounced at precisely the time that a greater call on government resources would be needed to militate against longevity risk arising from an ageing population."

5.3 Equity release scheme

Draft Recommendation 7.1 proposes that the government establish a government-backed Age Care Equity Release scheme. Equity release schemes are more commonly known as reverse mortgages.

This is another area where there are established commercial providers. If the government has reason to believe that there are deficiencies in the operation of existing reverse mortgage providers there would be wider social value in the government addressing those concerns than by establishing a government reverse mortgage provider.

There are several aspects of a reverse mortgage operation which are inherently incompatible with government and the Australian political process:

a) Even if a no negative equity guarantee is provided the inevitable need to enforce the credit contract by mortgagee sale.
b) The requirement for the government to indicate a specific position by setting and moving a mortgage interest rate.
c) The requirement for the government to take a view on the value of individual pieces of residential real estate and to offer different amounts of credit to different individuals on the basis of those views, with large disparities between different States and different regional areas.

6. Capacity of superannuation annuities to fund recurrent private aged care costs

Superannuation income streams are intended to provide retirees with a higher standard of living than they would have if they were totally dependent on the safety net of the age pension. With the current generous age pension means testing arrangements, most retirees receive at least a part age pension. The most commonly used superannuation private income streams are allocated pensions. Allocated pensions require retirees to take all market, longevity and inflation risk.

For its submission to the Henry Review of the taxation system Challenger commissioned consulting actuaries Towers Perrin to stochastically model the expected duration of income streams from allocated pensions with a balanced asset allocation (50% growth/50% defensive) for different starting balances and two levels of income including any age pension entitlement. The starting balances were $50,000, $150,000, $300,000 and $500,000. The incomes were the Westpac/ASFA benchmarks, modest but adequate (then of $19,000 per annum for an individual) and comfortable (then $37,000 per annum for an individual). The Towers Perrin modelling showed median failure rates (the definition of failure was less than $100 left in the allocated pension account) short of life expectancy even for $500,000 starting balances.

Average Age That Account Based Pension Fund Is Depleted

Starting Account Balance	Target Income	Age 60 Retiree		Age 65 Retiree	
		% of Simulations	Age	% of Simulations	Age
$500,000	Modest	0%	n/a	0%	n/a
	Comfortable	100%	84	100%	89
$300,000	Modest	0%	n/a	0%	n/a
	Comfortable	100%	71	100%	80
$150,000	Modest	1%	72	0%	n/a
	Comfortable	100%	65	100%	71
$50,000	Modest	100%	63	19%	81
	Comfortable	100%	62	100%	67

This shows that these pension products are unlikely to still be performing to provide retirees with income to support the costs of their aged care. Defined benefit pensions, including privately purchased lifetime annuities will reliably continue to provide retirees who have them with substantial amounts of income above the age pension for as long as they live. This income is available to pay for aged care and aged care accommodation.

For its submission to the Henry Review of the taxation system, Challenger commissioned Access Economics to model the budgetary implications of the use of annuities as retirement income streams. Access found that if 30% of retirement balances were used to buy either an immediate lifetime annuity or a lifetime annuity with the payment stream deferred by 10 years, the government's age pension costs would fall by up to 5% (0.2% of GDP) by 2040. The principal effect contributing to these savings is that as a result of annuitisation retirees would continue to have substantial amounts of income late in life which, when means tested, would reduce their call on the age pension. This 5% saving in the cost of the age pension would be significantly increased by additional savings as a result of the means testing of these income streams for aged care purposes.

Challenger also proposed, and the Final Report of the Henry Review recommended, that the government remove the regulatory, social security and tax impediments to the provision of deferred lifetime annuities. Recently others, including the Financial Services Council, which is the peak industry body of the wealth management industry, have supported this reform. As longevity insurance in its purest form, deferred lifetime annuities would allow a 65 year old male to use $10,000 of their retirement balance to buy a deferred lifetime annuity, which would not start to pay an income until they reach their age cohort life expectancy, which for a 65 year old male is 91 years. The pricing provided by Challenger to the Henry Review in 2009 showed that the deferred annuity would then pay an amount equal to an annual income in real terms of $8,000 per year to cover their longevity risk. Superannuation annuities of this kind offer significant amounts of guaranteed income late in life when other income streams are likely to have failed and so can provide a source of income for aged care without having to buy a separate aged care product.

If the impediments to provision of deferred lifetime annuities are removed, a specific outcome of adopting and implementing Draft Recommendation 13.1 on the release of DoHA data would be the ability for life offices to give tools to financial advisers so that they can assist their clients to select starting dates for deferred income streams which incorporate amongst their clients circumstances the age range when they are likely to have a need to pay for aged care.

7. Release of DoHA data, in confidentialised form for academic and actuarial analysis

Draft Recommendation 13.1 proposes that DoHA release aged care data in a form which would protect the privacy of individual aged care users. Such a data set would be capable of being interrogated to establish probabilities, such as the likely length of time in various categories of care and likely progression from one type of care to another (ie home care to low care residential and low care residential to high care). This information would no doubt be useful to providers to plan efficient service delivery. Access to this data is essential for the financial services industry if it is to design, price, distribute and deliver products which will assist individuals to more easily meet their co-payment obligations and aged care accommodation costs.

8. Potential for single premium longevity risked product to fund accommodation bonds

Australia has a product gap in that there is no provision of LCTI (long term care insurance). By making it easier and providing more flexible solutions for an individual to pay for their aged care and accommodation, efficient private financing solutions would assist government in reforming the aged care system.

To demonstrate the value of implementing Draft Recommendation 13.1 on the release of DoHA data, Challenger has modelled a potential product which could be offered to meet an identified need under the existing aged care arrangements.

8.1 The need

The absence of products to assist retirees with nursing home accommodation bonds is a particular problem raised by advisers. Nursing home costs are escalating faster than CPI and accommodation bonds are escalating faster than the cost of aged care. Many frail aged face a financial barrier to obtaining their choice of care. Some of their heirs may prefer exposure to the family home rather than the nominal value of an accommodation bond.

Rather than liquidating their house and other assets to fund an accommodation bond, or not being able to find a place in suitable care, a proportion of frail aged do seek appropriate financial products,

in the form of either conventional loans or reverse mortgages. Life offices could offer a single premium loan product to pay the nursing home accommodation bond at a fraction of the upfront cost of the bond to the resident.

8.2 The product

This would be a pooled lifetime product priced on the expected time a nursing home resident would remain in care, in sequence:

- The resident or their family negotiate the accommodation bond with the nursing home provider.
- The resident pays an age-based premium to the life office to cover the bond.
- The life office pays the accommodation bond to the aged care provider.
- The aged care provider deals with the bond in the normal way, deducting a maximum of $299 per month in retention amounts for the first 5 years and has use of the bond for capital purposes.
- When the resident dies or leaves the home, the nursing home provider returns the full residual value of the bond (bond minus monthly retention amounts) to the life office.

8.3 Pricing

The baseline pricing below shows the proportion of the bond paid by the life office,

The pricing methodology uses projected cash flows and targets a return on capital. Policy cash flows are projected corresponding with the cash flows to the life office.

The life expectancy at each age has been derived from a summary table provided by the Productivity Commission to provide assumptions governing the behaviour of the policy cash flows. These assumptions include exit probabilities and a fee of $299 per month for the first 60 months.
The exit probabilities are the single most important reliance placed on the pricing results. It is noted that the assumption was made that people purchasing this product will have the same exit profiles as the people already in aged care. In other words, there was no allowance for anti-selection factored into the pricing.

The assumptions governing the cash flows to the life office include distribution and administrative expenses along with a capital structure consisting of AAA credit capital and longevity capital. Given the government guarantee on the repayment of the bond, a AAA credit capital structure is appropriate.

We have modelled the pricing of the product assuming two different structures for the repayment of the bond upon the resident exiting care.

The no bequest pricing assumes that no premium is returned to the resident no matter how short the length of time they spend as a resident. The 12 month reducing bequest pricing assumes that if the resident dies or leaves the home in the first year there is a proportionate return of the premium, 364/365 on the first day and 1/365 on the second last day of the first year. This is only an indicative example for the model based on the limited data available, as actual pricing would have to consider a number of complexities, such as rollovers if a resident moved between nursing home providers.

The differences in pricing between a $200,000 bond and a $1 million bond reflect distribution and administration costs, and the regular deduction from the bond by the aged care provider.

The percentages represent the proportion of the bond paid by the life office. The numbers in brackets are the life expectancy (period of residential care) of a person of that age and gender entering residential care at that age.

No Bequest

Age	Bond	Male % (LE years)	Female % (LE years)
55	$1,000,000	74% (3.52)	70% (4.19)
65	$1,000,000	78% (2.92)	72% (3.75)
75	$1,000,000	82% (2.18)	73% (3.55)
85	$1,000,000	84% (1.77)	76% (3.08)
95	$1,000,000	87% (1.37)	80% (2.31)

Age	Bond	Male % (LE years)	Female % (LE years)
55	$200,000	70% (3.52)	66% (4.19)
65	$200,000	73% (2.92)	68% (3.75)
75	$200,000	77% (2.18)	69% (3.55)
85	$200,000	79% (1.77)	71% (3.08)
95	$200,000	82% (1.37)	76% (2.31)

12 Month Reducing Bequest

Age	Bond	Male % (LE years)	Female % (LE years)
55	$1,000,000	65% (3.52)	62% (4.19)
65	$1,000,000	69% (2.92)	65% (3.75)
75	$1,000,000	74% (2.18)	67% (3.55)
85	$1,000,000	77% (1.77)	70% (3.08)
95	$1,000,000	79% (1.37)	74% (2.31)

Age	Bond	Male % (LE years)	Female %(LE years)
55	$200,000	60% (3.52)	57% (4.19)
65	$200,000	63% (2.92)	60% (3.75)
75	$200,000	67% (2.18)	61% (3.55)
85	$200,000	69% (1.77)	64% (3.08)
95	$200,000	71% (1.37)	68% (2.31)

This pricing reflects all exits from residential care in the sample population data provided by the Productivity Commission. There are a large number of factors which could ultimately influence pricing. Some of these factors could be determined by access to additional data of the kind contemplated by Draft Recommendation 13.1 (for example differences in exit experience exist between low and high care facilities but the current data available does not differentiate between these) while other factors relate to actual behavioural experience:

- Will experience of all lives be representative of experience of purchasers?
- Are less healthy (early exits) less likely to purchase due to capital loss?

A critical factor is the design of the bequest model. To sell most lifetime annuities it is necessary to have features that provide a return of capital if the policy holder dies early. Nursing home accommodation bonds are a particularly complex area for product design because of the range of circumstances that may pertain to people leaving a facility.

9. Regulatory risk and the conditions precedent for aged care products

There are some regulatory risks associated with providing a single upfront premium lifetime loan to assist retirees to pay nursing home accommodation bonds, principal amongst these are:

- Government changes to the size of bond required or residual amounts;
- Government changes to retention amounts; and
- Removal of the government guarantee on return of the bond.

There would be no policy justification for making any of these changes retrospectively. In any event retrospective changes could be expected to result in successful claims for compensation on just terms.

Prospective regulatory changes could change the size and shape of the market, but there would be sufficient lead time to adapt a product offering or for a provider to wind down their business and leave the market.

There are a number of regulatory conditions precedent for provision of a single premium lifetime loan product:

- Government guarantee on return of the bond to the life office should apply in the same way as it applies to a resident;
- Product needs to be assets test exempt in the same way as a bond paid by the resident;
- Resident must be legally capable of assigning to the life office any right to return of the bond so that it can be dealt with outside their estate; and
- Alterations to the ACAT assessment standards must be capable of being monitored so that life offices can understand changes in the risks they are underwriting.

10. Some other potential products that could assist the provision of aged care

There are a number of other products which could be provided to assist retirees and their families to fund accommodation bonds and co-payments for care:

a) Risk products, either single or periodic premium - providing a payment or payments triggered by entering aged care (a limited form of LTCI).

b) Deferred lifetime product – non-commutable single premium deferred lifetime annuity with known real return covering two risks:
   1. risk of needing care (survivorship and age of needing care), and
   2. longevity (length of time in care)

c) Reverse mortgage - to pay accommodation bond (or the premium on a nursing home accommodation bond single premium lifetime annuity), care co-payments (fees) or other living costs.

Implementation of Draft Recommendation 13.1 on the release of DoHA behavioural data is essential to create the kind of risk products described in this submission.

These risk products are financially efficient and will allow retirees to make provision to fund their aged care and accommodation at a lower cost than if they attempt to self-insure.

DoHA behavioural data would also be useful to credit providers offering reverse mortgages to pay for aged care and accommodation because it could be used to improve the suitability of products and the quality of advice.

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21 March 2011

August 2009

CDC

THE RATING OF AUSTRALIA AND THE PROPOSAL FOR PUBLIC PROVISION OF ANNUITIES

The implications for Australia's credit rating of the introduction of public provision of annuities as part of retirement income policy

A Report by Chris Dalton Consulting Pty Ltd

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1. About CDC Pty Ltd

Chris Dalton Consulting Pty Ltd (CDC Pty Ltd) is a boutique credit risk research and advisory form. This report has been compiled by the following senior consultants:

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Chris is the Chief Executive Officer of The Australian Securitisation Forum, the peak industry association for participants in Australia's securitisation. He is also a Director Trustee of the Emergency Services and State Superannuation Fund, a 150,000 member exempt public sector super fund. Prior to these roles Chris was the Country Head of Standard & Poor's (S&P). This role had responsibility for the management of S&P's credit ratings, risk solutions, managed fund research, index services and financial data and information businesses in Australia and New Zealand. Chris joined S&P in 1990 and successfully established Standard & Poor's as the leading ratings agency of mortgage and asset-backed securities. In 1997 Chris was awarded a McGraw-Hill award for management excellence and spent 3 years in New York in senior management of the global structured finance group. Prior to joining S&P he held roles in corporate banking, treasury, technology and auditing with Elders Finance & Investment Company Ltd, Shell Australia Ltd and Coopers & Lybrand

Louise Griffiths, Consultant, B.Ec (Sydney University), GAICD

Louise has over 20 years experience in finance and credit risk assessment with a focus on government owned entities, infrastructure and risk consulting. Louise joined Standard & Poor's in 1993, and initially lead the infrastructure finance rating team and focussed on assessment of sovereign and sub-sovereign credit risk including local governments, government owned businesses, utilities, transportation infrastructure, public private partnerships and project financing in Australia and New Zealand and emerging Asian markets. In 2001 Louise established S&P's risk consulting business in the Asia Pacific region, providing risk consulting advice to financial institutions. Prior to her 15 years with Standard & Poor's, Louise worked with the Victorian Department of the Treasury on financial policy around state regulated non-bank financial institutions, state owned financial institutions and government borrowing agencies.

2. Executive Summary

1. The number of Australians aged between 60 and 74 will be double the number of people aged 25 to 39 by 2014 and eclipse the 10 to 24 year age group by four times[1]. Ageing and longevity risks are significant risks to government finances. The recent Global Financial Crisis (GFC) has exacerbated the problem. The IMF estimates that for advanced economics that for the period to 2050, the fiscal burden of the GFC will be about 10% of aged related costs. The other 90% will be extra spending on pensions, health and long term care. The need for policy change to address this in Australia is urgent.

2. In an increasingly globalised economy the long term rating of the Commonwealth of Australia is critically important for governments, banks and corporates to access capital in global markets. Credit rating analysts can be expected to positively view pro-active measures to address the ageing and longevity risks facing Australia. The proposal for private sector annuities as part of a revised retirement income policy could be expected to be viewed positively as a policy change that limits the future call on the public purse from retirees.

3. Ratings agencies look for a demonstration of willingness by governments to address emerging fiscal issues, as well as evaluating the government's current fiscal strength and flexibility. Australia's current rating benefits from the proactive policy of superannuation where the working population can build up retirement assets and potentially lessen the potential call on the public purse for pensions.

4. A downgrade or move from a stable to negative outlook of the rating would be a signal of deterioration in the creditworthiness of the Australian Government which would cause global investors to re-price its risk premium and or ration investment in the Australian economy.

5. Forecasts by rating agencies indicate the cost pressure of the ageing population and longevity risk will become a serious budgetary matter by 2020, less than three elections away.

6. Analysis by Standard & Poor's indicates a status quo approach to the ageing and longevity risks could result in Australia's rating being downgraded to the 'AA' category by 2020 and even reach sub-investment grade by 2050.

7. The Government has acknowledged the significance of the ageing and longevity risks. The former government led the creation of the Intergenerational Reports specifically addressing the issues[2] of retirement incomes policy, demographic change, health and aged spending along with climate change and water are highlighted by the current Federal Government as the key long-term policy issues[3] Australia faces.

[1] Residential Development Council "Australia on the Move" report July 2009

[2] Australian Government, 2002, Budget Paper No. 5, *Intergenerational Report 2002-03*, Commonwealth of Australia, Canberra. And, Australian Government, 2007, *Intergenerational Report 2007*, Commonwealth of Australia, Canberra

[3] Kevin Rudd "The Road Ahead" , *The Age*, 25 July 2009, page 5

8. While the issues of an ageing population and longevity risk will manifest themselves over the longer term, failure to address them now will increasingly weaken Australia's fiscal position and is likely to place pressure in coming years on the rating of Australia. Acting now will be easier than addressing this problem in 10 years time when the proportion of the voting population reliant (or soon to be reliant) on age-related services including the age pension will have increased.

9. Australia's relatively high degree of pensioner poverty reduces the Government's political flexibility to cut age-related expenditure to limit the increasing costs of ageing and longevity.

10. The proposal to adopt a comprehensive annuity scheme as part of the Government's retirement income policy will be seen by ratings analysts as being a proactive and efficient policy to limit the future impact on Australia's public finances. It would create a competitive and diverse domestic annuity market and avoid the problem of adverse selection which has been a major structural impediment to the development of voluntary annuity markets.

11. If the Government was to step in as a direct provider of annuities this would reverse a rating positive trend which has seen successive Australian Governments seek to transfer commercial risk to the private sector e.g. sale of Housing Loans Insurance Corporation and Commonwealth Bank of Australia.

12. Ratings agencies would be likely to view negatively a proposal for the Government to either directly or through the Future Fund (or similar structure) enter the financial services market to provide annuity products. Such a policy would increase the Government's balance sheet and indicate to rating agencies both a higher contingent risk exposure as well as a higher risk tolerance by the Government.

13. Direct Government provision of annuities is likely to significantly distort financial markets and asset prices in a small economy such as Australia's.

14. Government can play a very important and beneficial role in growing the annuity market by providing the regulatory framework in which the market can operate and safeguard the interests of annuity holders. Further it can benefit the market by issuing long dated and inflation indexed bonds for annuity providers to use in matching assets and liabilities. It would be sub-optimal for the Government to devote its resources to the direct provision of annuities when it could provide tremendous assistance through setting and aiding the mechanics of a competitive and innovative market and transfer risk to private annuity providers.

15. The private sector with its mix of local and global financial services firms, that already posses the required product risk and administrative infrastructure, coupled with the existing strong and comprehensive regulatory regime would be considered by rating agencies to be better placed from a risk perspective to operate and provide an expanded annuity scheme.

16. The prospect of a large annuity market is likely to attract new global financial services firms to Australia which would complement Australia's ambition to be a major financial centre.

17. The qualitative implications of having the private sector provide annuities is likely to be very highly regarded by the rating agencies as they seek an indication from the Government of how it will deliver on the near term recovery of the Government's balance sheet following the impact of the GFC as well as address longer term and ageing longevity obligations.

3. Factors Affecting the Rating of Australia

3.1 Current Sovereign Credit Ratings of Australia

The Commonwealth of Australia holds extremely high credit ratings, reflecting high quality, extremely strong creditworthiness with minimal credit risk. The major rating agencies, Standard & Poor's (S&P) and Moody's Investor Services (Moody's), rate the Australian Commonwealth at the highest level ('AAA'/'Aaa') for both local and foreign currency ratings. Fitch Ratings (Fitch) has rated Australia's foreign currency rating at one notch below the highest level, at 'AA+', reflecting a slightly harsher view on the level of foreign indebtedness in Australia.

Table 3.1 Commonwealth of Australia Credit Ratings

	Moody's Investors Service	Standard & Poor's Ratings Agency	Fitch Ratings
Foreign Currency			
Long term	Aaa	AAA	AA+
Short term	P-1	A-1+	F1+
Outlook	Stable	Stable	Stable
Local Currency			
Long Term	Aaa	AAA	AAA
Short term	P-1	A-1+	F1+
Outlook	Stable	Stable	Stable

Source: S&P, Moody's, Fitch

The rating reflects an assessment of a range of factors from political stability, the institutional framework of the economy, the near term outlook for the economy and the fiscal position including the balance sheet of the sovereign. In Australia's case there are a number of positive fundamental factors supporting the high investment grade foreign currency rating.

Factors such as the small size of the Australian economy and its dependence on overseas capital to fund the current account deficit are characteristics that introduce vulnerability to the rating of the Commonwealth.

Despite the slight differences in foreign currency ratings, the three agencies generally agree on the strengths and weakness of the Commonwealth of Australia and have not changed ratings as a result of the global recession, credit rationing, increased contingent liabilities from guarantees of the banking sector, and the fiscal stimulus measures of the recent budget.

Key strengths from a credit rating agency perspective can be summarised as the following.

- Open trade policies, free-floating exchange rate, and a market orientated regulatory regime that provide a favourable environment for growth.
- A local economy that continues to show resilience to global slowdowns despite exposure to volatile agriculture and mining sectors.
- While near-term trends are not positive with deficits projected to continue beyond 2013, a history of long-standing fiscal prudence and previously strong budgetary position underlies expectations that **fiscal discipline will return over the medium term**.

- Low levels of general government debt - well below medians - provide a degree of fiscal flexibility. The rapid rise forecast in Commonwealth Government net debt over the near term is manageable due to a low starting point.
- Strong institutional frameworks with high levels of political consensus, strength and conservatism of Australian banks and banking system, and a well-developed domestic capital market.

Risks cited by rating agencies to the rating focus on two key areas.

- Persistent and widening current account deficits and heavy net external indebtedness well above median ranges for rating category, leaving Australia exposed to shifts in international confidence. Within this, high levels of household indebtedness are particularly noted by Fitch, which has Australia one notch below its highest rating.
- **Rising social welfare spending and risks of long term shift in budget balances to address costs of an ageing population.**

Importantly, the level of conviction that each rating agency has on the ability of the government to deliver budgeted outcomes is an overriding qualitative factor in the rating consideration. This assessment is akin to the evaluation of a company's board and executive management's discipline and appetite for business and financial risk that is conducted by rating analysts when assigning a corporate bond rating.

While the agencies each have broadly consistent sovereign rating criteria, each references slightly different key ratios. Each agency may factor in slightly different assumptions underlying their calculations of these ratios, and the financial data they publish are derived from each agency's proprietary database and may not be highly consistent. The general thrust of the analysis are consistent and support the view that it is qualitative rather than quantitative considerations driving the ratings, especially at this highest rating level.

Table 3.2 provides the key ratio's published by Moody's in their May 2009 report on the Government of Australia.

Table 3.2 Selected Indicators

	2004	2005	2006	2007	2008	2009f	2010f
Real GDP Growth	3.9	2.8	2.7	4.2	2.4	-1.1	0.8
Inflation	2.3	2.7	3.3	3.0	4.3	2.5	2.5
General Government Balance/ GDP	1.1	1.5	2.0	0.7	1.8	-2.4	-2.8
General Government Debt/ GDP	17.0	16.7	16.1	15.4	14.9	16.4	16.6
General Government Revenues/ GDP	47.1	46.1	44.6	43.5	41.9	48.2	48.5
Current Account Balance/ GDP	-6.1	-5.8	-5.3	-6.3	-4.2	-5.2	-4.8

Source: Moody's Investor Services [4]

[4] "Government of Australia" Credit Opinion, Global Credit Research, Moody's Investor Services, 5 May 2009

3.2 Sovereign Criteria

A complex range of quantitative and qualitative analytical factors are combined in the determination of a sovereign's ability and willingness to repay its debt obligations on time and in full. Sovereigns by their very nature are different to other borrowing entities. There may be a point where a sovereign government will decide that the political, social, and economic costs of paying a debt are higher than not repaying that debt. There is no way to compel a sovereign to repay debt or to recover debt by handing over assets. Given ratings measure both the ability of a sovereign to repay debt and its willingness, a heavy weighting on qualitative factors is incorporated into the assessment.

Ratings are forward looking measures, so the rating committee heavily weights trends and potential developments including political risks and economic shocks in forming a forward looking view of debt servicing capability.

A government's medium term plans are scrutinised alongside independent forecasts. The interaction between public sector finances, external debt and a range of other variables including export growth, asset quality in the banking system and potential changes in local or overseas interest rates are considered. Strong policy responses to emerging issues are critical to maintaining credit quality in the face of negative trends, and a robust policy framework is crucial for strengthening both the economic environment and sovereign creditworthiness.

It is important to note, that despite the publication of a range of key ratios for each sovereign and in some cases median ratios for various credit rating levels, quantitative analysis does not drive credit rating outcomes. Long Term credit ratings focus on the medium term and within that timeframe, movements of key ratios compared to history and past forecasts are a better indicator of ratings outcomes than comparisons to data of other countries and median ratio measures.

Each of the ratings agencies pubished separate critieria that describes their approach to rating sovereign governements. While each has a slightly different emphasis in the way they describe their approach, the key factors are broadly similar and the ratings outcomes are generally synchronised. The key rating factors can be grouped as

Resiliancy to Withstand Shocks
- Political Risk & Institutional Strength
- Economic Structure
- Economic Growth Prospects

Government Fiscal Discipline
- Fiscal Flexibility
- General Governement Debt Burden
- Contingent Liabilities
- Monetary Flexibility
- External Liquidity
- External Debt Burden

Attachment 1 provides a combined summary of the key ratings factors of the three agencies and Attachment 2 is an overview of S&P's sovereign rating critieria.

A note on sovereign credit ratings

While credit ratings attempt to be "absolute" measures of the probability of default (and in some cases recovery) , sovereign credit ratings are considered more as a "relative" measure of credit quality. Corporate default ratings can be quantified on something close to an absolute scale based on many years of data, over economic cycles, across large numbers of rated entities to determine how accurately these ratings predict default. [5] *Without this data it should be noted that there is a higher degree of relativity in a sovereign rating than a corporate bond rating.*

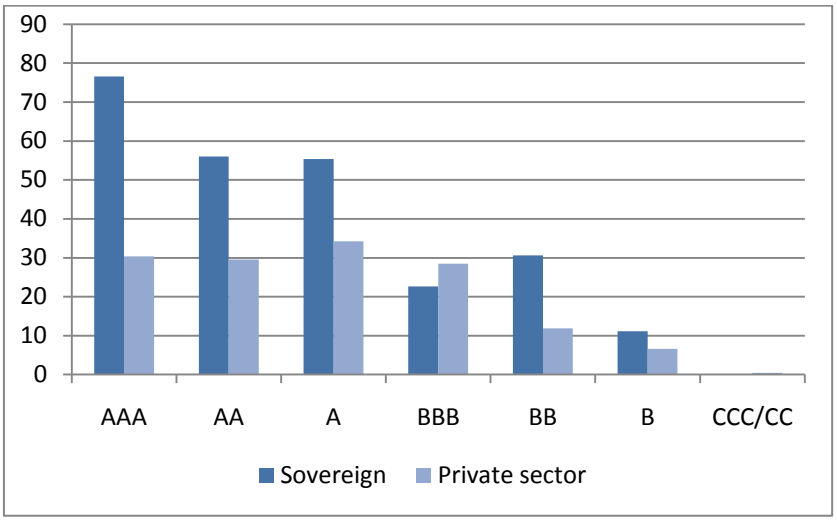
However, this does not necessarily dictate that there will always be sovereigns rated at the 'AAA/Aaa' level . Not so long ago, there were a signficant number of international banks rated at the highest 'AAA/Aaa' level. Even before the Global Financial Crisis (GFC) , there were very few banks at this level, and now in the post GFC environment it could be argued most major international banks would have speculative grade ratings if it were not for sovereign government support. Likewise General Electric Corporation has lost the 'AAA/Aaa' credit rating it held since 1956. It is hard to imagine how many corporates or banks could ever again have the market and credit strength required to sit at the 'AAA/Aaa' level. Likewise it is therefore not impossible to envisage there being no or very few sovereigns rated at the 'AAA/Aaa' level within 20 years. Those developed countries who had previously occupied this space, will be dealing with the signficant constraints of ageing demographics. Those countries without the demographic bulge ahead of them, generally do not yet have the track record of resilient and diversified economies and stable politics and institutions to attain the 'AAA/Aaa' level.

While not explicitly stated, ratings stability is an important consideration when rating sovereigns, especially with regard the impact they have on the private sector and government ratings within each country. The ratings agencies all state their aims of looking through economic cycles to determine an underlying position.

Chart 3.1 on the next page compares rating transition data for sovereign ratings versus private sector ratings at the same category. ***Over a ten year period, sovereign ratings display a significantly higher degree of stickiness than private sector ratings.*** *After 10 years, over three quarters of sovereign 'AAA' ratings are still rated 'AAA' whereas only a third of other ratings are still at this high level. This supports an argument that rating agencies are extremely reluctant to change sovereign ratings, especially at the highest levels. This does not mean that sovereign ratings are not changed, but it would appear there has to be overwhelming weight of factors for consideration to be given to rating changes.*

[5] Default is defined generally as the failure to meet payments on time and in full as specified in the loan or bond documentation. IN the absence of a specific definition, the Basel II definition of 90 days past due is the generally excepted measure.

Chart 3.1 Sovereign Vs Private Sector Transition Rates over 10 years



Source: Standard & Poor's

3.3 Why are Foreign Currency Ratings Different to Local Currency Ratings?

Local currency ratings reflect the sovereign's ability and willingness to repay debt denominated in the domestic currency. A sovereign's ability to repay its debt on time reflect the ability to raise additional taxes, cut costs, liquidate assets or obtain financing from the central bank. Each of these measures has possible downsides including dampening growth, depleting productive national resources, and fuelling inflation and social discontent. Each government therefore undertakes a cost benefit analysis of repaying versus rescheduling debt and this willingness to repay debt must be factored into creditworthiness considerations.

In assessing the risks in repaying sovereign debt denominated in foreign currency, the ability of the government to access foreign reserves either held with the central bank or convert currency through the foreign exchange market in a timely fashion must be evaluated. This factor may not always be in the direct control of the sovereign government. In a country with a high capital account deficit driven by high private sector foreign currency debt, lack of confidence amongst global investors or the foreign exchange market may lead to a currency crisis.

The sovereign's own foreign currency debt levels would increase and foreign currency reserves may already be depleted. As a result the entire country's external position must form part of the analysis. Monetary flexibility and geo-political risk are considered by the ratings agencies as the most significant factors that drive a difference between local currency and foreign currency ratings. Australia's current level of private sector external debt and its associated funding and rollover risks leave Australia's foreign currency rating subject to a change in sentiment among global investors.

4. The Significance of Longevity Risk in the Rating of Australia

4.1 Longevity Risk - Ratings Agency Considerations

The impact of changing demographics on sovereign government's creditworthiness is widely acknowledged as the greatest challenge facing global public finance. While current commentary focuses on the impact of the GFC, the cost of protecting the various banking systems, and the impact on sovereign budgets of fiscal stimulus measures, the issue of longevity will persist after these issues have been digested. And unlike the unpredictable nature of global recessions or localised impact of war, almost all developed economies will be affected by this well understood and highly predictable change.

Moody's view a government's ability to increase pension contributions, postpone retirement age and lower pensions as important tools in the management of public finance liabilities. Views of the resilience of a government's fiscal position reflect in part the ability and willingness of a government to take these steps and other expenditure reduction steps in order to reduce the impact on budget deficits. Fitch looks for a robust and cohesive macroeconomic policy framework that incorporates the management of these key risks to government.

S&P has undertaken by far the most extensive analysis of the rising longevity risk and the impact of this megatrend on ratings over the longer term. In the years of 2004, 2005, 2006 and 2007, it published global graying reports which attempted to quantify the size of the challenge facing sovereign governments by the ageing population[6].

S&P produced estimates of the increased spending on age-related services resulting from increased dependency ratio's arising from demographic modelling. Under a scenario where there was no significant change to current government policy, S&P estimated the increase in age related spending and the impact on government fiscal indicators. Assuming the increasing age-related deficits were funded by new debt, S&P then estimated the impact on sovereign ratings over the next 40 years.

S&P acknowledge changes would initially be slow, deficits averaging around 4% of GDP in the mid 2020's (for a selection of developed economies), would increase to around 6% of GDP by 2030 and 14% by 2050. For the same sample, the initial impact on net debt would be modest until around 2015, increasing thereafter to rise from just above 30% of GDP in 2015 to 80% of GDP in the mid 2030's.

Under a no change scenario, S&P forecasts net general government debt to increase to an "overpowering" 180% in 2050. In the group of sovereigns analysed by S&P the impact of higher age related spending, combined with the higher debt servicing costs under a no change scenario, will grow total government spending from an average of 44% of GDP today to 56% of GDP by 2050[7].

[6] M Kraemer "In the Long Run, We are All Debt: Aging Societies and Sovereign Ratings", *Standard & Poor's Global Graying Report 2005*, 28 June 2005; M Kraemer "Global Greying: Ageing Societies and Sovereign Ratings", *Standard & Poor's Global Graying Report 2006*, 27 June 2006; M Kraemer "What a Change a Year Makes: Standard & Poor's 2007 Global Graying Progress Report", *Standard & Poor's Global Graying Report 2007*, 19 Sept 2007.

[7] S&P Global Graying, 27 June 2007

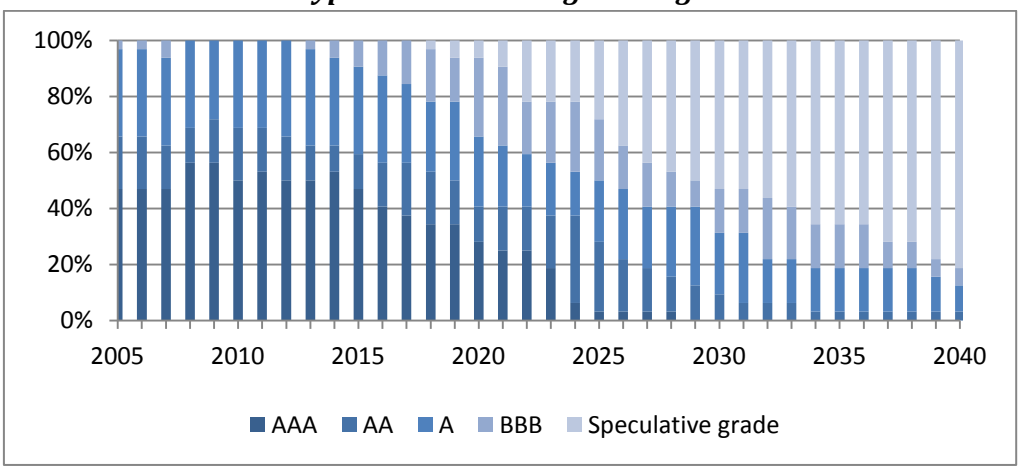
As Government age-related spending grows, the economic weight of government increases with it. **The key elements of age-related spending considered by S&P were the aged pension, healthcare and long-term care.**

Aged pensions are expected to exert the most pressure on government spending with an average of 8.7% of GDP across the sample in 2005 increasing to an estimate of 12.8% of GDP in 2050. Public healthcare and long-term care spending is much harder to forecast as it will depend to a significant extent on technological developments over the period, however this will represent an increased percentage of GDP. Any offsetting reduction in unemployment benefits were also taken into consideration, however tightening labour markets would expect this offset to be minimal. Likewise education spending is unlikely to reduce in most knowledge-based societies, and any reduction in the number of children eligible for child-care benefits may be offset by more generous programs to boost labour force participation. If these estimates are realized, the diversion of national product towards the state sector will change the nature of many societies.

Under the 'no policy change' scenario, S&P has indicated that many highly rated sovereigns will be under pressure from early in the next decade. While in the near term, many qualitative and quantitative factors are taken into account in determining sovereign ratings, over the much longer term perspective, "prolonged fiscal imbalances tend to become a dominant factor"[8].

By comparing general government balances with the median for each rating category averaged over the period 2000 to 2008, many "AAA" rated sovereigns will hypothetically fall to at least AA by 2020 and then to speculative grade by 2030. (See Chart 4.1) However, S&P goes on to state, "It is inconceivable that governments will allow debt and deficit burdens to spiral out of control."[9] **This analysis is timely reminder to sovereigns that they need to take action now to address the looming fiscal burden of an ageing population.** Attachment 3 provides further details of these hypothetical changes to selected sovereign ratings over the next 40 years.

Chart 4.1 – Hypothetical Sovereign Ratings Distribution



Source: Standard & Poor's Global Graying Report June 2007

[8] M Kraemer "What a Change a Year Makes: Standard & Poor's 2007 Global Graying Progress Report", *Standard & Poor's Global Graying Report 2007*, 19 Sept 2007.
[9] ibid

While the impact of the ageing demographic will be felt more harshly after 2020, the argument for reform is an urgent one. "The financial linkages between social security and fiscal policy call for decisive defensive steps now"[10] The twin targets of fiscal consolidation and benefits reform can immediately generate a cushion against the cost of future entitlements.

From a political perspective, as the general population ages, so does the proportion of the electorate that is entitled to aged pensions and other benefits. "If no fiscal or structural reforms occur, the resulting social inequities and tensions would have the potential to undermine the very foundations of solidarity and cohesion on which most societies are based."[11] Without reform, S&P have stated that this would likely lead to "a deterioration in economic prospects, as rising tax levels could cause the accelerated outward migration of ever more mobile factors of production (especially capital and skilled labour), endangering the very sources of growth and fiscal revenue." [12] So while the key ratio of General Government Balance-to-GDP is driving the hypothetical ratings, this downwards trends would also be supported by high debt and debt servicing burdens, and potential weakening in economic prospects and institutional stability.

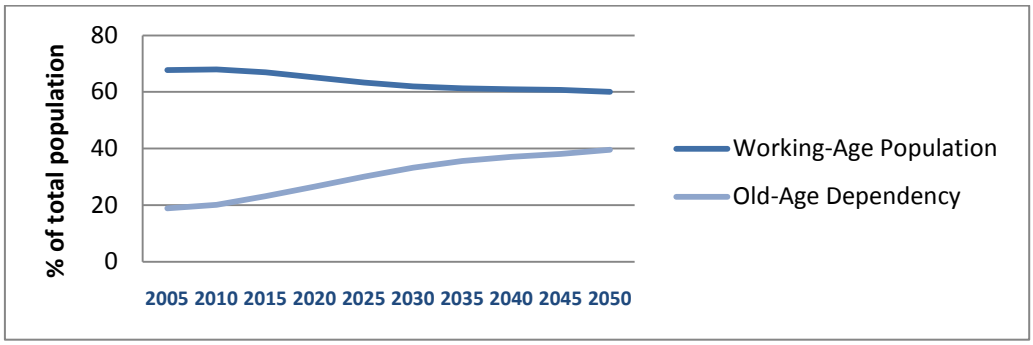
4.2 Impact of a "Do Nothing" Policy on the Drivers of Australia's Rating

Clearly it is understandable, given this backdrop that the management or mismanagement of the longevity and ageing issues are areas of focus for the rating agencies. Moody's has highlighted the long term risk that longevity and aging pose to their current rating of the Commonwealth when they noted "any trend or event that caused a long term shift in budget balances to significant deficits and an increasing public debt burden might put downward pressure on the rating. Such trends could include, for example, fiscal costs associated with an aging population." [13]

From the mid 2020's there will be a rapid reduction in the population of working Australians supporting an increasingly ageing population. The demographic profile in Australia shows the old age dependency ratio (population over 65 to working age population) more than doubling over the next 40 years. While the definition of "working age" in Australia can now be increased to 67, the trend remains unchanged. When current trends in fertility and inward migration are combined with increasing longevity, this is a problem that is not going away.

[10] M Kraemer "Global Greying: Ageing Societies and Sovereign Ratings" , *Standard & Poor's Global Graying Report 2006*, 27 June 2006;
[11] ibid
[12] Ibid
[13] Moody's Investors Service Credit Opinion: Government of Australia, 5 May 2009

Chart 4.2 Australian Population Dependency



Source: S&P

In the 1980's, Australia adopted the Superannuation Guarantee (SG) levy as part of its retirement income policy. The intent of the SG levy was to reduce the increase in expenditure related to the age pension. Australia is one of only a few nations that have proactively adopted policies to prefund a portion of retirement income streams of its ageing population.

In addition, the Future Fund was established in 2004 to fund the government's own employer pension obligations. The benefit of this policy was recognised by rating agencies in their credit assessment of the Commonwealth. S&P's rating report dated April 14, 2009 state "the government has been building up financial assets to fund its pension obligations, improving Australia's inter-temporal fiscal position"[14]

Moody's Credit Opinion on the Government of Australia[15] also addresses the longevity issues. The report indicates a challenge to Australia's future creditworthiness is the expected "rising social welfare spending". While Moody's note the Government's current fiscal flexibility it does make a special mention of the potential impact of the aging and longevity risks. "Although Australia's demographics and policy framework leave it well positioned to deal with population aging relative to other industrial countries, the government's own analysis indicates the health and aged-care spending will lead to the emergence of a funding gap over the next 40 years. While the fiscal burden is well into the future, policy measures to address it will have to be initiated in the near term". Failure to manage costs of an ageing population as a key factor that may cause "a long term shift in budget balances to budget deficits and an increasing public debt burden might put downward pressure on the rating"[16]. Moody's then go on to state that given the Commonwealth's proactive response to date through superannuation policies and healthcare reforms, they anticipate that government policy will address any sustained fiscal deterioration threatened by these demographic changes.

S&P, as part of its global graying study, has undertaken extensive work on the impact of age-related spending on the rating of the Commonwealth. In 2006, S&P estimated total age related government

[14] Kyran Curry, "Commonwealth of Australia", Standard & Poor's, April 14, 2009.
[15] Thomas Byrne, "Despite weaker Fiscal Position, Australia Aaa Rating Unaffected", Moody's Investors Service, May 5, 2009.
[16] Ibid

spending in Australia will grow to 17.3 % of GDP by 2050, significantly lower growth than other sovereigns in the sample.[17] (See Table 4.1)

The bulk of the increase comes from increased healthcare spending followed by pension costs. It should be noted, this estimate factors in only current levels of pension and other spending, whereas the reality is that as more of the voting population reaches retirement age, there will be increased pressure to raise the level of pensions and expenditure on other age-related services.

Table 4.1: Age-Related Government Spending -Australia

(% of GDP)	2005	2010	2015	2020	2025	2030	2035	2040	2045	2050
Pensions Spending	4.8	4.7	5	5.4	5.7	6.1	6.3	6.5	6.8	7.0
Health Care Spending	5.6	6	6.4	6.8	7.2	7.5	7.9	7.9	7.9	7.9
Long-Term Care Spending	0.8	0.8	0.9	1	1.2	1.4	1.6	1.8	2	2.1
Unemployment Benefits Spending	0.8	0.7	0.7	0.6	0.6	0.5	0.5	0.4	0.4	0.3
Total Age-Related Spending	12	12.2	12.9	13.8	14.6	15.5	16.3	16.6	17	17.3

Source: Standard & Poor's Global Graying Report 2006

In 2006, the S&P analysis indicated that under a no change scenario, Australia may hold onto its 'AAA' rating until 2015. However the mounting fiscal pressures would likely result in an 'AA' rating by 2020, just over 10 years away, and a rapid deterioration thereafter to 'A' by 2025, 'BBB' by 2030 and speculative grade by 2035. This analysis was based on pre Global Financial Crisis assumptions that showed Australia preserving a budget surplus and negative net debt position until at least 2015 before the drag of increased spending brought the budget into deficit and net debt increased (See Table 4.2).

Table 4.2: S&P Estimates of General Government Balance and Net Debt – Australia

Australia	2005	2010	2015	2020	2025	2030	2035	2040	2045	2050
Real GDP (% change)	2.5	3	2.8	2.6	2.3	2.1	1.9	1.8	1.9	1.9
General government balance/ GDP (%)	0.8	0.6	0	-1.1	-2.3	-3.8	-5.4	-6.7	-8.4	-10
Net general government debt/ GDP (%)	-2	-5	-6	-2	5	17	34	55	78	105

Source: Standard & Poor's Global Graying Report June 2007

While Australia's credit rating will continue to benefit from the negative net debt starting position and strong fiscal discipline of recent years, current budgetary and economic outlooks must place the current credit rating of Australia under pressure.

While Moody's and S&P both issued post-budget affirmations of the rating, Fitch appears to be ahead of the pack in holding Australia's credit rating one level below the highest rating. According to current budget data, the general government balance is forecast to stay in deficit for the medium term before returning to surplus in 2015. As a result of these deficits, net debt levels will increase to peak at 13.8 %

[17] S&P Global Graying Report 2006

of GDP in 2013 before starting to fall to 3.7% by 2020. (See table 4.3) With the loss of at least 5 years of fiscal surpluses, and consecutive increases in general government net debt, it is hard to see how the 'AAA/Aaa' rating is not already under significant pressure from both S&P and Moody's.

Table 4.3 Budget Estimates Australia

	2013p	2012p	2011e	2010e	2009e	2008
General government balance/GDP, %	-2.0%	-3.4%	-4.7%	-4.9%	-2.7%	1.7%
Net general government debt/GDP, %	13.6%	12.4%	9.2%	4.6%	-0.4%	-4.0%

Source: Australian Government, 2009, Budget Paper No 1, 2009- 2010

The reality is that ratings are not driven by quantitative analysis alone but by a range of qualitative assessments of the rating agencies. Rating analysts seek to identify emerging trends and factor any risks into their determination of the rating. A robust public policy environment, a track record of achieving strong surpluses and managing debt, a commitment by past governments to making tough political decisions to support strong fiscal discipline, and a resulting solid government balance sheet are all factors that support Australia's strong ratings.

The qualitative aspects of any change in government policy will be closely scrutinised and will have a significant impact on the credit rating going forward. Concerns regarding potential deterioration of the banking system in the weakened economy, and the ability of the current and future governments to extract growth benefits from the range of fiscal stimulus introduced in the last budget will be critical. While the restoration of the government's fiscal position is mapped, it will be a slow process. **Continued demonstration of a commitment to ongoing principals of fiscal prudence including addressing the impending costs of aged-related services will be paramount to preserving the current rating.**

4.3 Comparison to the Retirement Income Policy and Ratings of Peer Group

Many OECD countries are facing similar demographic trends which will place constraints on the degree of flexibility governments will have in framing budgets after 2020. The aging of the population, particularly the baby boomer generation, increasing life expectancy arising from the advances in medical technology and low birth rates will increase expenditure and reduce the relative size of the working age population from which the governments can raise tax revenue.

OECD Governments are aware of the looming fiscal squeeze they face. According to The Economist[18], the developed countries on average have about four people of working age for every person over 65. But by 2050 this will have come down to only two workers for every pensioner. That will impose a huge burden on public finances. The Economist argues that pensions will have to become less generous, and most people will have to keep on working well beyond 65.Pension and healthcare reform are topics universally raised in OECD countries as needing forward-looking policies to address and manage future budgetary risks arising from the ageing and longevity risks. The impact of the risks vary from country to country as do the policies governments are implementing to address them.

[18] The Economist The end of Retirement June 25, 2009

As interest in the issue of longevity risk grows across capital markets, how Australia responds will increasingly be measured against the responses and ratings prospects of other 'AAA' rated economies. Table 4.4 below indicates the potential impact ageing and longevity risk could have on the ratings of several OECD member countries if no action is taken by governments to address the potential impact on the public finances. While the sample governments are all currently rated highly, their ratings could fall as early as 2020 under a status quo policy position.

Table 4.4 Hypothetical Ratings Outcomes Under No Policy Change Scenario

	2007	2020	2030	2040
Australia	AAA	AA	A	Spec.
Canada	AAA	AAA	A	A
Japan	AA	Spec.	Spec.	Spec.
Sweden	AAA	AAA	A	Spec.
USA	AAA	A	Spec.	Spec.

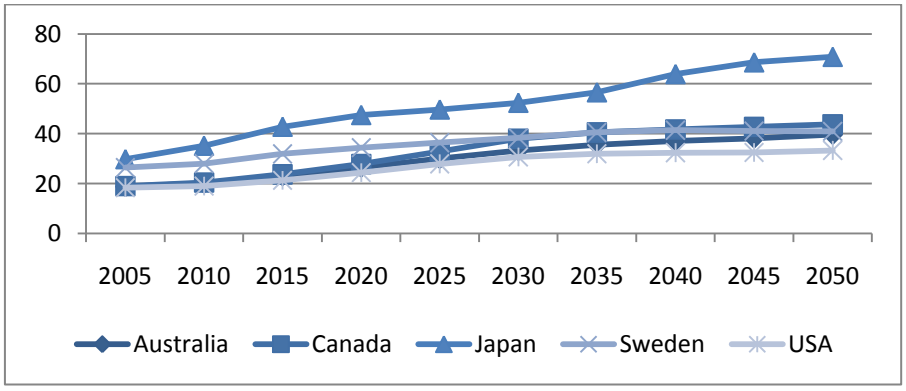
Source: S&P Global Graying Report 2007

Australia will need to adopt fiscal policies to mitigate the risks of structural budget deficits as a result of the ageing of the population. Expanding the balance sheet of the Government through the public provision of annuities to retirees will increase the degree of risk the Government will need to manage and could accelerate the downgrade trend hypothesised above. Attachment 3 contains further details of the S&P Graying report and the estimated changes to ratings in a no policy change scenario.

The growing challenge to a peer group of governments is illustrated in the ratio of working age population to over 65's (See Chart 4.3). Japan in particular has a daunting task. By 2050, the median age in Japan will fall from an already older 42.9 years to just over 52 years. With extremely low fertility rates and restrictive immigration policies, population levels are forecast to fall in absolute terms and the working age population is forecast to be only 50% of the population in total by the middle of the century. By then, Japan's dependency ratio is estimated to be around 71%.

Australia is forecast to reach a dependency ratio of nearly 40% by 2050, which is only slightly below Canada and Sweden. The USA, from a significantly younger average starting point, is forecast to have a retirement population of only a third of the working age population, led in part by the increasing inward migration and the higher fertility rates of the growing Hispanic and Latino population.

Chart 4.3 Population Dependency Ratio (%) – selected peers



Source: S&P Global Graying Report 2006

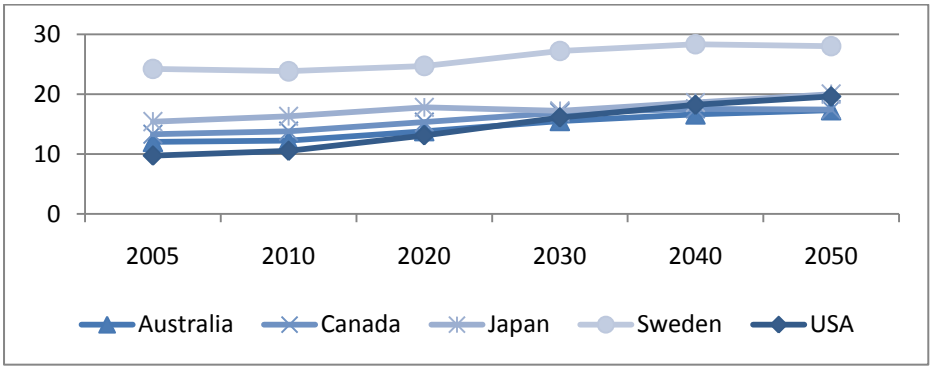
These changing demographics will have profound impact on government spending over the next 50 years. Sweden already has amongst the highest age-related spending in Europe. Its large general government sector, and the significant budgetary call of its public pension, is considered by the rating agencies a constraint on its fiscal flexibility at the 'AAA' level. With a major drag on public finances, Sweden has built up assets in the National Pension Fund of around 30% of GDP, and the private pension funds have assets of above 50% of GDP. In order to address this significant obligation, a balancing mechanism has been implemented in the Swedish pension system, which indexes pensions to restore any imbalance of assets (fund balances and estimated contribution revenues) below liabilities (pensions). Sweden has also indexed benefits to current life expectancy, providing a significant buffer to future obligations.

Estimated low growth in total age-related spending in Canada provides support to its 'AAA' rating. Canada acted to reform the tax payer obligations arising from its public sector pension plans in the late 1990's. Contributions were increased and the benefit formulae adjusted. Cash flow surpluses were increasingly given over to investment boards with mandates to develop higher longer term returns through diversified portfolios, rather than the previous investment plans of government only debt. Canada's pension plan now holds assets of 40% of GDP, surplus to fund these considerable future obligation.

As a contrast, S&P has estimated that, under a no change scenario, general government expenditure in Japan is forecast to grow substantially to 65% of GDP in 2050 with a combination of age-related spending and the growing interest bill from funding of increased deficits and debt. Japan undertook some reforms of its defined benefits pension fund system in 2004, by increasing member contributions, delaying the start of payments, and reducing the amount of payouts. However further structural reforms of both the pension and healthcare systems will be required before Japan's budget position can start to appear more sustainable. The political gridlock that effects policy decisions in Japan will continue to make any significant reform difficult.

The US will experience more modest growth in dependency ratios due to a younger population, but with the lowest starting point of age related spending, at below 105 of GDP in 2005, will more than double by the middle of the century.

Chart 4.4 Total Age-Related Spending (%) – selected peers



Source: S&P Global Graying Report 2006

There have been significant changes in the global economy and the fiscal positions of all peers since S&P last updated their forecasts in the global graying report. The latest report was released in 2007

and presented forecasts for the 2010 based on 2005 or 2006 financial positions. In this period, Australia and Sweden will have moved from a forecast surplus to a deficit, and Canada's debt to GDP ratio will has increased by almost 30%. Contrary to this trend, in 2010 and Japan is expected to have improved net general government debt-to-GDP as forecast in that report by almost 7 percentage points – due to some of the reforms introduced to Japans budget position in the last few years.

Significant caution should be used in anticipating ratings based on net general government debt measures alone. S&P recently indicated "we expect that the U.S.'s net general government debt will rise to about 90% of GDP by 2013; we expect that of the U.K. to rise to nearly 100%."[19] However they have affirmed the USA 'AAA' rating and only downgraded the UK's 'AAA' rating outlook to negative. S&P indicates that one of the key strengths underlying the US rating is the key international role of the US dollar that provides the US with substantially more fiscal flexibility than other countries (including the UK).

S&P also stresses the importance of the market view of the handling of government finances. As a result of the international role of the currency, the US government will face limited widening of credit spreads despite significant increases in debt "as long as the market viewed its plan for fiscal consolidation as credible"[20]. Despite the significant increase in debt for the longer term, the UK will maintain its 'AAA' rating if the rating agencies are convinced there is fiscal consolidation in place to return the government's finances to a sustainable footing.

So while the fiscal ratios released in the S&P Graying Reports have been superseded by the impact of the GFC, the assumptions underlying the S&P estimates have not changed so the general trends can be considered valid. Support for financial systems and fiscal stimulus measures have not lessened the impending demographic challenge.

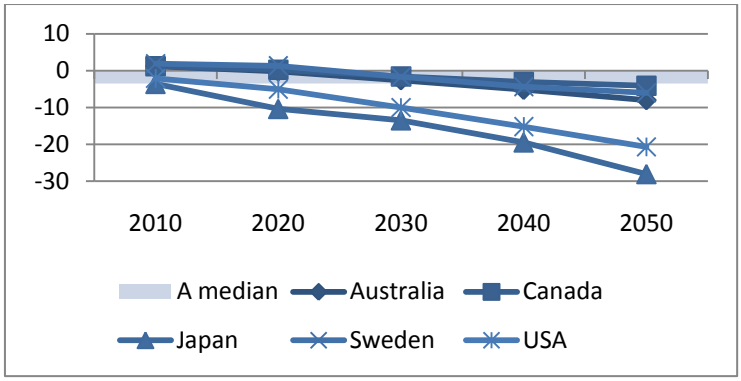
Increases in age-related spending, weakening in budget balances and increased levels of debt all remain, now overlayed on fiscal positions already weakened by the stimulus and rescue measures in response to the GFC. The demographic challenge remains to be added as a significant risk factor to ratings that could already be considered under pressure from weakening fiscal positions.

Japan's fast-aging population still poses enormous challenges for the economic system and the fiscal position of the country and it will show the most dramatic deterioration in financial profile under an estimated no policy change scenario. In Japan, the implications for public finances will be severe. Prior to the GFC and without any fiscal or structural policy measures, by 2050 the general government deficit was estimated to rise sharply to 37% and net debt will reach 530% of GDP. In contrast, Canada's strong performance under a no policy change scenario reflects its strong initial fiscal position with government surpluses running at about 1 to 2% of GDP in recent years. Unfunded pension liabilities remain but these will tail off due to the recent pension reforms. In addition to it starting position, Canada also has more flexibility than most of Australia's peers to adjust immigration policies to increase the working age population.

[19] "Credit FAQ: Why It Is Unlikely That The Ratings On The U.S. Government Will Be Lowered In The Near Term" Standard & Poor's June 11 2009.
[20] ibid

The earlier forecast of budget deficits under a no-policy-change scenario is outlined in Chart 4.5. The chart highlights the median budget deficit to GDP of 'A' rated sovereigns in 2009, of only 3.5%.[21] While this is not the only measure driving the deterioration in ratings, it does paint a strong picture of the directions ratings are expected to head if there are no changes.

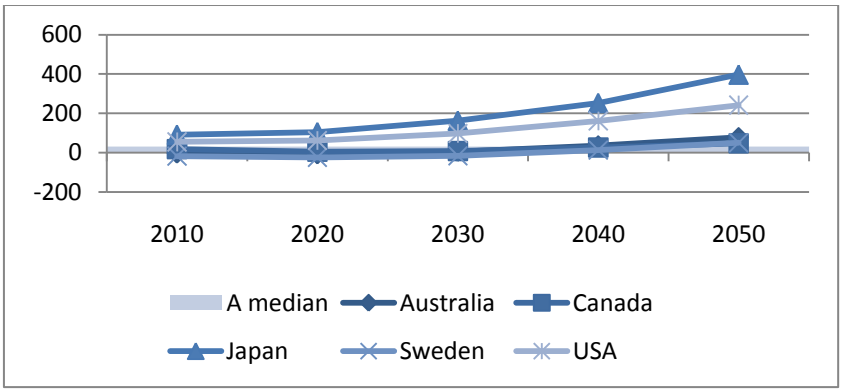
Chart 4.5 Forecast Budget Deficits under No Policy Change Scenario (% GDP)



Source: S&P Global Graying Report 2007

Likewise, earlier forecasts of net debt to GDP are shown in Chart 4.6 and compared to the median levels of net debt for 'A 'rated sovereigns in 2009. All peers weaken against this 'A' rated median, with Japan and US shown as significant outliers over time.

Chart 4.6 Forecast General Government Net Debt under No Policy Change Scenario (% GDP)



Source: S&P Global Graying Report 2007

Japan's diversified and mature economy is more comparable to sovereigns rated 'AAA' than peers in the 'AA' category. However the challenges faced by Japan in the medium to longer term already see it rated below 'AAA'. Significant among these is the chronic challenges driven by Japan aging population combined with a weak starting point with a large fiscal deficit, and heavy outstanding general government debt. The ongoing structural reforms required in social security and the health insurance systems, or changes to immigration policies will be hard to implement in the current political environment, and so a deterioration for Japan's rating is expected with a potential fall to 'A' category

[21] "Sovereign Risk Indicators", Standard & Poor's, February 26, 2009

within the next 5 to 10 years and fiscal indicators in a no change scenario that would be more typical to performances currently associated with speculative-grade sovereigns.

The S&P report indicated that the US rating could fall to 'A' level by 2020 if there were no changes to the current policy stance. However the rating agency view of the financial flexibility provided to the US creditworthiness by the importance of the US dollar in the global economy, could postpone this downgrading. Sweden and Canada are forecast to retain their AAA rating by 2020, due to their strong fiscal balances today and the pension reform already undertaken.

5. Rating Agency View of Public Provision of Annuities

5.1 Additional Risks likely to be a Concern

For government fiscal policy, an ageing population is a huge headache. In countries where public pensions make up the bulk of retirement income, these will either consume a much larger share of the budget or they will have to become a lot less generous. The latter can be expected to be met by solid political resistance. And because of a huge increase in the number of over-80s, a lot more money, and careful thought, will be needed to provide long-term care for them as they become frailer. The case for changes in Australia's retirement income policy is clear. **The Government needs to formulate policies now to provide incomes for retirees that are not funded from the public purse.**

To date, Australia has taken a pro-active approach in starting to address the retirement income needs of its ageing population through the introduction of the mandatory superannuation system in 1991. The retirement assets of Australia are growing and are significant in world terms at more than A$1 trillion. However the challenge of having a policy and framework to appropriately transition the accumulated retirement assets into predictable retirement income streams is yet to be fully reflected in policy. The rating agencies will be increasingly interested in how governments are responding to this longer term demographic challenge.

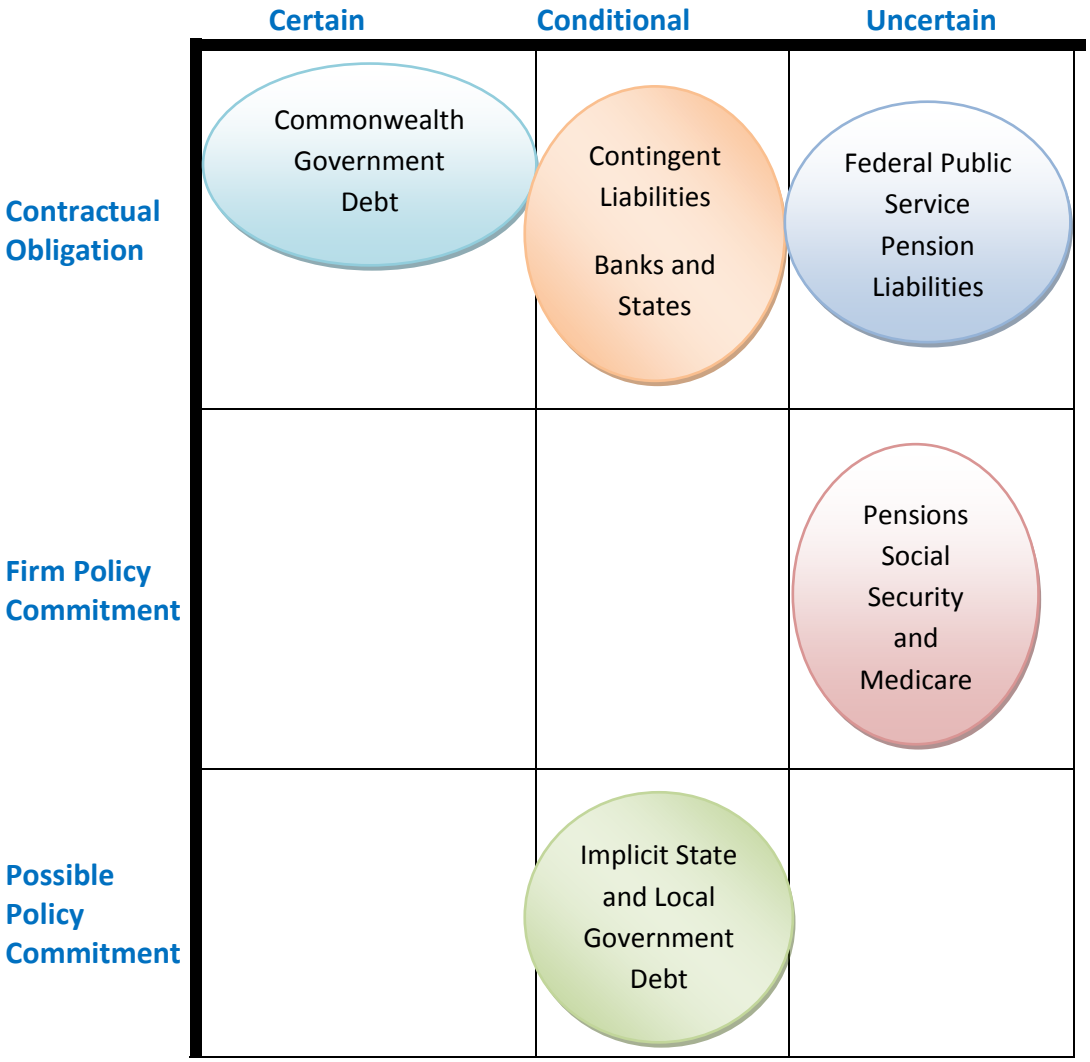
The proposal, to require Australian retirees to take a sizeable proportion (30%) of their retirement savings either as an immediate or deferred lifetime annuity, would be of positive significance to credit rating agencies in considering the policy settings of the Government to maintain a conservative fiscal strategy over the longer term.

Rating analysts typically consider the "whole of government" debt when evaluating creditworthiness and the rating of a sovereign. Moody's [22] states "this holistic representation of the balance sheet includes items that are not normally recognised under current accounting conventions, such as off-balance sheet liabilities (guarantees)". Rating analysis of governments and corporates attempts to evaluate the assets and liabilities of the organisation from an economic perspective regardless of how they may be treated in accounting statements. Analysts will however differentiate debt and liabilities based on the certainty of the financial obligation. Table 4.1 illustrates how government liabilities can be represented in terms of the certainty of the obligation and the impact on fiscal policy and budgets.

Contingent liabilities are not treated the same as the liability of Commonwealth Government Securities but they are still analysed based on the product of exposure at risk and probability of materialising. This would be a similar treatment of the contingent liability of the Government committing its balance sheet to provide for increasing longevity and market risk through the means tested Aged Pension in the absence of some form of compulsory annuitisation.

[22] Moody's Sovereign Analytics "Not all Public Debt is the Same: navigating the Public Accounts Maze" February 2009

Table 5.1 Australian Government Liability Matrix



Retirement income policies must address both the accumulation phase and the retirement phase. The OECD argues that while governments should have policies that encourage participants in labour markets to accumulate an adequate level of wealth at retirement, such a goal is not sufficient in itself to guarantee a living standard during the retirement years.

In considering retirement income policy, it is often overlooked that investment strategy and hence risk post retirement is proportionately more important than pre-retirement. Russell Investments[23] estimates that for each dollar decumulated in retirement, 10 cents comes from savings in a person's working years; 30 cents come from investment return during the accumulation phase and 60 cents of investment growth during the decumulation phase. The OECD points out that the second component

[23] Russell investments Insights - November 2008

of a retirement income policy is to ensure that wealth is decumulated properly.[24] An appropriate retirement income policy must help retirees maximise the income benefit and duration of their accumulated retirement assets.

Analysis by Mercer[25] portrays the prevalence of lump sum benefits negatively as a feature of Australia's retirement income policy and it can be expected that ratings analysts would have a similar concern. Introducing a retirement income policy that includes annuities would be a step to address this negative feature. Mercer argues there are "significant problems" regarding the use of the final retirement assets, where systems allow benefits to be taken as a lump sum. Mercer point out that employees lack financial knowledge to appropriately manage a potentially significant lump sum benefit with the consequence that the accumulated retirement assets are exhausted far too quickly.

The lump sum mentality prevalent in Australia has not been discouraged by the minimal tax advantages of converting the accumulated retirement assets into income-style benefits. Mercer argues that enhancements are required to limit access to, or reduce the tax effectiveness of, lump sum payments and to increase the amount required to be taken in income form such as an annuities. **This view coincides with the OECD [26]view that there is a growing need for insurance based products, such as annuities, to provide retirees with a guaranteed income as long as they are alive.**

The challenge of providing adequate retirement income policies have been exacerbated by the GFC . Over the last 12 months, Australian superannuation funds have been among the worst performers in the world. Australian super funds have been savaged by the financial crisis with losses of almost 27% last year, the second worst performance of all 30 OECD countries. Further **Australia has one of the highest rates of old-age poverty, according to analysis by the OECD. The OECD report noted more than one in four senior Australians in poverty, with the low age pension cited as one of the major reasons.**

The challenge for Australia is to manage the demographic change while preserving or even enhancing post-retirement incomes. Current policies may provide incentives for opportunistic behaviour, where retirees have incentives to consume their accumulated wealth shortly after retirement and then to rely on the publicly-financed age pension safety net in the following years. Such short-term behaviour of retirees would exacerbate the risk to government finances and increase pressure on the credit rating of the sovereign.

The OECD suggests a high degree of annuitisation preserves retirement incomes and therefore works to protect public finances. Further the OECD[27] also suggests a spin off benefit of annuitisation is that it increases the sophistication of the country's financial services markets which would further assist the Government's aspirational objective to promote Australia as a financial services centre.

[24] Ignazio Visco "Retirement Savings and the Payout Phase: how to get there and how to get the most out of it" OECD Financial Trends Vol 2009/1
[25] Ben Facer, "Lessons to learn from DC systems in the Asia Pacific region" mercer.com 23 July 2009
[26] "Pensions at a Glance 2009: Retirement Income Systems in OECD Countries", OECD, June 2009
[27] Stewart, F.(2007), "Policy Issues for Developing Annuities Markets", OECD Working Papers on Insurance and Private Pensions, No. 2

Moody's[28] in commenting on the impact of the GFC on sovereign ratings note that the wide scale "risk socialization" where governments have deployed their balance sheets and raising sovereign debt to counter the GFC has been of historic proportions.

Moody's note the challenge for a 'Aaa' rated government such as Australia who have expanded their balance sheets and increased debt will be to "grow out of its debt". For the Australian Government this will be to manage its growing age-related expenditures and grow at a rate to contain the impact of increased government debt issued to counter the GFC and Australia's infrastructure needs over the next two decades.

To require 30% of all superannuation withdrawals to be taken as an annuity stream would contribute to a solution to the ageing population without a cost to the budget and without weakening the income available to the post working age population. Access Economics[29] research indicates that if 30% of retirement savings were invested in annuity products, a saving of up to 5% in the cost of the age pension could be achieved by 2040[30]. At the same time it is estimated that post retirement incomes could increase by between 0.3 to 0.4 % of GDP. The potential for this level of savings would be viewed positively by sovereign ratings analysts in that it could provide future governments with a greater degree of financial flexibility.

The proposal will also result in immediate qualitative benefits. A significant increase in retirement incomes above the full aged pension will reduce pressure on government to justify the sustainability of current aged pension arrangements. With less people dependant on the aged pension over the near term, there should be less pressure to increase the base rate over the near term. And the government remains free to use financial capacity to provide incentives for people on low incomes to increase their retirement savings, ahead of the impending dependency bulge from 2020.

[28] How Far Can Aaa Governments Stretch Their Balance Sheets?, Moody's Special Comment February 2009

[29] Challenger Submission on the Retirement Income System 6 March 2009

[30] Access Economics 2009

6. Rating Implications of Public versus Private Sector Annuities

6.1 Risk to Government of Direct Provision of Annuities

Over the last two decades rating agencies have increasingly factored in the bi-partisan approach by the two main Australian political parties of removing commercial business enterprise risks from the Government's balance sheet. Privatisation of the Commonwealth Bank, Qantas and Telstra has been a positive factor in the rating of Australia. Rating agencies have viewed favourably the policy of various Australian Governments to contain Government activity to traditional provision of services such as defence, healthcare, education and income and age support.

A key element of rating analysis of companies is management's track record in executing business and financial strategies. Inconsistent execution or frequent changes in strategy can diminish the faith rating analysts have in strategic intent and credibility of the organisation. Rating analysts utilise the same approach in evaluating the creditworthiness of governments. Analysts look to the policies of the government to evaluate tolerance of financial and business risk.

Government policies which introduce a greater degree of fiscal risk or introduce new risks to the balance sheet will weigh heavily in the determination of the rating. The fiscal conservatism of Australia's major political parties and the ongoing policies to remove commercial risk from the balance sheet of the government have been positive factors in Australia's credit rating.

Introducing investment in annuity products as a key part of Australia's retirement income policy would be considered as a positive response to the issue of adequacy of income in retirement. **However, any consideration by the Commonwealth to directly create and provide annuity products would indicate to rating agencies a significant change in the philosophy of the role of government from that followed over the last two decades.**

Rating analysts could be expected to view negatively any move by the Government sector to enter into a new financial services business providing annuity products to retirees. Rating analysts would consider the investment, administration and longevity risks the Commonwealth would take on to enter into the annuity market as contingent liabilities of government. **This view would be held regardless of whether the annuity scheme was provided directly through a Government department or agency (e.g.Centrelink) or via an investment fund such as the Future Fund.**

In rating an organisation or government rating analysts evaluated both debt obligations reported on the balance as well as those debt like obligations that are off balance sheet. In evaluating the creditworthiness of the Commonwealth, rating analysts consider the risk and financial obligations of government related bodies such as EFIC and the Future Fund.

Prior to the GFC it was common for many financial institutions to fund assets off-balance sheet. The experience of the GFC has demonstrated how quickly the risk and liability of such financial strategies can come back on balance sheet. The balance sheets of many global banks such as Citibank increased dramatically when liquidity in capital markets dried up bringing off balance assets back on balance sheet.

Rating analysts look closely at off-balance sheet and contingent liabilities when evaluating credit risk. In the case of Australia's rating the contingent risk of the credit guarantees given by the Export Finance and Insurance Corporation, a statutory authority, is factored into the modelling of Australia's liabilities even though the absolute risk of these is a modest 1% of GDP.

If the Government decided to directly provide annuities, the credit risks of such a policy would also be modelled and evaluated by rating analysts. While annuities will be backed by assets transferred from retirees, there is a significant degree of market and investment risk that will need to be managed by the Government in order to meet the contractual obligations under the annuities. Table 6.1 sets out some scenarios that could be evaluated, in a ratings context, to quantify the additional contingent risk to the Government's balance sheet through public provision of annuities.

Scenario A (worst case) is an indicative representation of the potential absolute increase in the size of Government liabilities from current total (accumulation and pension) superannuation assets should it commit to a policy of public provision of annuities, with only a 10% take up of government annuities. For the purpose of comparing relative orders of magnitude, these potential new contingent liabilities of $103billion are presented in Table 6.1 alongside the Budget estimate of net debt of $188billion in 2013. This is an amount equal to almost 54% of the estimated 2013 net debt.

Scenario B (base case) recognises that the actual contingent risk transfer would occur over time as superannuation assets are moved from the accumulation to pension phase. In this scenario it is assumed in 2013 that 20% of the $1.03 trillion in superannuation assets belong to retirees, and that 10% of those assets have been used to purchase a government annuity. In that case the Government's contingent liability would rise by $21billion. This represents an additional 11% of the forecast net position taking this comparison of government liabilities to almost $209billion in 2013.

The risk to the Government in providing annuities will be crystallised when markets and investment risk materialises as it did in the GFC. In this situation the contingent liability of a public provision of annuities policy can turn into a real liability. The GFC has demonstrated the drastic impact on investment markets and valuation of retirement assets. Australian superannuation funds lost around 27% of value during the GFC. If we stress the contingent liability of $20.6billion in Scenario B, a future 25% decline in the market value of retiree assets transferred to government, could result in an actual liability of $5.15billion reducing the value of assets to meet annuity obligations to $15.45billion.

Table 6.1 Hypothetical Net Debt with Contingent Liabilities from Public Annuities

Whole of Government Liabilities	**Scenario A $million**	**Scenario B $million**
	Worst case	Base Case
General Government Net Debt Est. 2012-13[31]	188,175	188,175
Assets backing public annuities based on $1.03 trillion Superannuation (Mar 2009[32]**)**	103,000	20,600
Total estimate debt plus contingent annuity liability		208,775

Sources: Budget Papers and APRA

[31] Australian Government, Budget Paper No.1, Statement 10 *2009-10*, Commonwealth of Australia, Canberra.
[32] APRA Quarterly Superannuation Performance March 2009 (issued 25 June 2009)

The obligation to meet the contractual payments under annuities provided by the Government would be a new contingent liability for the Government. The risks relating to investment, inflation and longevity would be real and will be burdensome as the population ages with a greater proportion being dependent on the Government sector for income from the annuities. **A policy of public provision of annuities will represent a further allocation of scarce Government capital to this service provision to retirees. As with any commercial initiative the cost of capital must be a major factor in evaluating the merits of public provision of annuities.**

Some argue that the Government has the infrastructure to provide annuity products to retirees. To avoid a negative reaction from rating agencies to an announcement of taking on new commercial risks, the Government would have to demonstrate it has or could acquire the experience, skills and infrastructure to provide annuity products. Establishing such a venture would likely be considered a new and significant risk to the Commonwealth's long term rating.

The Government established the Future Fund in 2006 to manage funds to assist in meeting its unfunded liabilities for defined benefit pensions of Commonwealth public servants. The Future Fund has progressively built a capability to manage its asset base. Theoretically the skills and resources of the Future Fund could be increased to provide adequate capability to manage a Government commitment to provide annuity product through the public sector. Centrelink has a national infrastructure to assist in administering a new form of Government provided annuity product.

The history of Australian governments being directly involved in the financial services sector has not been stellar. The collapse of financial institutions owned by Australian state governments in the 1980's such as State Bank of Victoria, Tricontinental Corporation and State Bank of South Australia are examples of the significant risk government can take on when using the balance sheet of government in the financial services sector.

6.2 The Merits of Private Sector Delivered Annuities

In contrast, the private sector in Australia is much better placed in terms of experience, skills and infrastructure to provide annuity products. Australia's insurance and investment markets comprise a competitive landscape of local and global insurance companies and financial services firms who could relatively easily mobilise to provide a choice of annuity products.

The financial services and superannuation markets in Australia are well regulated and could take responsibility for overseeing and regulating an expansion of the annuity market as part of a revised retirement income policy. Australia already has an established and tested regime of prudential supervision of both life insurance and superannuation. APRA and other regulatory bodies of Government have the skills and experience to administer an expanded market of private sector annuity providers. The fact that Australia has this regulatory infrastructure already in place would allow the Government to relatively quickly implement a policy of private sector annuities as part of a revamp of its retirement income policy.

Mercer[33] note Australia's success in developing private delivery of retirement accumulation products has promoted low fees, wide choice for employees and value added benefits such as low cost banking products education and effective online and telephone support.

In implementing a policy of including an annuity component in retirement income policy it seems logical to utilise the infrastructure in the private sector. Competition among private sector providers would generate a wide selection of competitively priced annuity products with competition driving ongoing innovation, product enhancement and customer service.

The IMF[34] believes the financial markets have a key role to play in managing aged-related risks. The 2006 report by Groome, Blancher and Ramlogan argues governments should encourage and influence market developments to appropriately share the aged-related risks between the private, public and household sectors.

ASFA adds weight to the case for annuities to address longevity risk in a report by its Director of Research Ross Clare[35]. The report suggests there are two choices:

- Force retirees to defray their longevity risk; or
- Provide adequate well-priced products that encourage and reward retirees for defraying their longevity risk.

ASFA goes further to argue that "requiring an amount of superannuation savings to be taken as a lifelong income stream would better integrate the Age Pension and the superannuation system and provide greater protection against longevity and inflation risks."

The ASFA report states the government should direct its energies to promoting the development of the post-retirement income market, rather than directly managing annuities. ASFA considers the lack of long term government index bonds which could back longevity insurance products as an impediment to this market's development. Taxation disincentives also exist for life annuities compared to other retirement products. The preference by Australians to retain access to their capital during their decumulation phase can be addressed by changed incentives.

6.3 The Impact of the Government Being a Major Asset Manager

The Government's response to the proposal for annuities as part of its future retirement income policy could have a significant impact not only on the contingent liability position of the Government but also the operations of the Australia capital markets and the economy more generally.

Australia's capital and investment markets are among the most developed and sophisticated in the world but are still small reflecting the size of the Australian economy and population.

[33] ibid
[34] Aging and Financial Markets W.Todd Groome, Nicolas Blancher and Pameshwar Ramlogan F&D (a quarterly magazine of the IMF) September 2006 Volume 43, Number 3
[35] Affording our old age, Superfunds July 2009 www.superannuation.asn.au

If the Commonwealth Government were to directly provide annuities it would have to become a major market maker in the primary domestic equity, fixed income, property and derivative markets. This would arise simply due the quantum of funds it would need to invest to back the long term obligations under the annuities. This is in addition to the already significant impact the Commonwealth Government will have as a borrower to fund the increased deficit and new infrastructure plans. Such an active and significant role in asset markets would likely be viewed negatively by international investors and rating analysts who currently view Australia as an open well regulated capital market free from government intervention.

The development of a competitive world class annuity market will in turn enhance the strength of the local capital markets, in itself a qualitative ratings factor. As the impact of longevity risk on the economies of Europe and Japan becomes a more pressing consideration for global investors, this early response will allay concerns that the AAA credit rating is under threat. Highly jittery international investors will be looking for markets with long term stability not short term returns.

The financial links between social security and fiscal policy call for action and clear policy to set in place a framework to cope with Australia's ageing population and the increasing life expectancy of the population. S&P warns that "policy drift that relies on an economic miracle to take away the pain of ageing populations will be totally insufficient"[36] A policy of introducing private sector annuities as part of the Government's retirement income policy would be seen by rating agencies as being a decisive forward looking policy to protect the public finances as ageing and longevity play out in the population.

S&P also cautions that a "muddling through" approach is likely to lead to deterioration in economic prospects could "endanger the sources of growth and fiscal revenue". The current speculation in the Australian media of a policy of having retirees with small superannuation balances transfer those funds to the Government in return for a top up of their Aged pension is likely to be seen a "muddling through policy".

A policy of public provision of annuities to retirees, while addressing ageing and longevity, is likely to be viewed by rating agencies as failing adequately safeguard public finances by imposing both large contingent and real risks to future fiscal policy. Rating agencies are looking for 'AAA/Aaa' rated countries to have policies that generate budget surpluses. Policies that weaken the fiscal position or potentially introduce structural budget deficits are likely to lead to rating views with downgrades to the Outlook of the sovereign rating or the rating itself.

A policy of public provision of annuities either for all retirees or those with small superannuation balances can be expected to be considered by rating agencies as a sub optimal use of the Government's capital to maintain fiscal solvency.

[36] S&P "What a Difference a Year Makes: Standard & Poor's 2007 Global Graying Report" September 2007

Attachment 1 - Summary of Key Ratings Factors

The key rating factors analysed by Moody's, Fitch and S&P are similaiar with slight differences of emphasis. The following describes the general approach:

▪ Resiliancy to Withstand Shocks

These factors consider the ability of the sovereign to meet its obligations in the face of "adverse economic, financial and political events without having to impose intolerable economic sacrifice on its population." [37]

Political Risk & Institutional Strength

The stability, transparency and predictability of the political institutions are important considerations as they impact on economic policy making and the legal and social framework. Consideration is given to:

- Transparency in economic policy decisions and the degree of consensus on key goals of political action;
- Levels of governance, independence of central banks, and regulatory and supervisory frameworks for financial system; and
- Public security and geo-political risk.

Economic Structure

The structure of the economy can be a significant indicator of the sovereign government's resilience to shocks.

- Established market economies tend to be more highly rated than public sector dominated economies. A market economy is considered less susceptible to policy problems and more respectful of creditor's rights.
- The economic scale is significant as small economies can be easily buffeted by external forces whereas large economies can withstand much greater shocks.
- The level of innovation and investment in human capital are factored into the assessment economic structure.
- The level of domestic savings relative to GDP can also be strong signal of the level of resilience and flexibility in the economy.
- Across all agencies, there is a high correlation between ratings and GDP/ capita.

Economic Growth Prospects

Broadly equitable income distribution and a growing standard of living can both support public sector debt and better withstand economic and political shocks.

- Sustainable economic growth, with governments that take advantage of upturns to prepare for risks associated with inevitable downturns considered favourably.
- High growth rates usually seen in the middle rankings rather than 'AAA' ratings. Higher rated highly developed economies tend to have lower growth trends.
- The change in real GDP per capita is considered a key quantitative indicator of these factors.

[37] "Rating Methodology: Sovereign Bond Ratings", Moody's Investors Services, September 2008.

▪ Government Financial Robustness

The next group of factors considers the strength of the government's finances and its susceptibility to event risk. It should be noted that the measures reviewed by the agencies include "general government" which includes state & local as well as national government. This provides a better base for comparison otherwise highly centralized systems (such as France) would look more highly indebted than more decentralized systems (Canada). Sovereign creditworthiness needs to reflect the demand for public services and the intergovernmental revenue sharing relationships across all systems.

Fiscal Flexibility

The focus is on general government revenue, expenditure and borrowing flexibility and trends rather than absolute levels of deficit or surplus.

- Broad tax base with the ability to adjust tax rates without constitutional, political or administrative problems. The ability to sell assets as a means of accessing capital to repay debt is also considered under revenue flexibility.
- Effectiveness of expenditure programs that provide services demanded by the population, and investment in infrastructure and education level adequate to support sustained growth. While these investments may result in high deficits, they are considered positive as they underpin growth.
- Pension obligations reflect a growing fiscal pressure. S&P has specifically stated that "some highly rated sovereigns could begin to come under downward rating pressure in the medium term if there are insufficient fiscal adjustments and structural reforms to counter the financial problems of the ageing societies". [38]
- Appropriateness of the fiscal and monetary policy mix.
- Surplus/ deficit trends in light of monetary policy and external factors. The focus is on flexibility not absolute levels as it may be appropriate to have high deficits if the debt burden is low and infrastructure needs are significant or when counter cyclical measures are required.
- Therefore the key ratio of General Government Balance/ GDP (%) is not relevant in isolation.

General Government Debt Burden

Given sovereign government's unique taxing and monetary powers as well as the diversity of domestic capital markets, debt levels (Net General Government Debt to GDP) are not highly correlated to ratings over the medium term.

- The strength of the domestic capital markets to provide long term and low cost market based financing may enable a sovereign to support a higher debt to GDP ratio than a sovereign without a strong domestic capital market that is more reliant on external funding or other more variable sources.
- In the Gulf States for examples, low debt to GDP ratios reflecting strengthening balance sheets has led to upgrades but not as much as might be expected due to political risk, lack of economic diversity and low levels of transparency.
- Debt to revenue metrics are generally treated warily. A low number may indicate either a positive in the ability to raise taxes or a negative in the weak tolerance for taxes.

[38] "Sovereign Credit Ratings: A Primer" Standard & Poor's 29 May 2008.

- Interest payments as a proportion of total revenues provide a measure of debt affordability as does the degree to which a government's policy choices are constrained by debt servicing obligations.
- A strong track record in honouring debt obligations is valued.

Contingent Liabilities

Consideration is given not only to direct government obligations but also to a range of contingent obligations that have shown to have significant impacts on government finances, especially in recent times.

- The robustness of the financial sector is a key contingent liability of sovereign governments. The performance of this sector during the recent financial crisis, and the rescue packages provided by sovereigns around the world, has shown how finance sector quickly becomes a real liability of government.
- Contingent liabilities in the form of unfunded pension obligations are considered significant. Responses to address these impending obligations are a key policy area reviewed by the ratings agencies. "Governments have many ways to alter the net present value of pension liabilities, such as postponing retirement age, increasing contributions and lowering pensions."[39]
- The financial health of non-financial public sector entities (NFPSE) is also taken into consideration. NFPSE's are frequently instruments of government policy that are established to serve policy ends. If these entities are unproductive, unprofitable or weakly capitalised they are likely to require government support and therefore should be treated as contingent liabilities of the government sector. Even when these entities are highly efficient and productive, their debt levels should be factored into the analysis of overall government debt levels. Large public sectors are therefore viewed with caution – especially any NFPSE that have required subsidies, capital injections, enjoy monopoly positions, have access to preferential funding or pay higher prices to suppliers.

Monetary Flexibility

The effectiveness and appropriateness of monetary policy is an important consideration, in the context of fiscal policy, exchange rate regimes, and the debt of finance sector and capital markets.

- This assessment becomes increasingly complex in a more inflationary environment where sources of inflation come from outside the domestic economy.
- The change in CPI is a key indicator with higher inflation levels generally correlated to lower ratings
- The state of the domestic capital markets is also a considerable factor. Governments are less likely to default on debt when it is held by a wide cross section of domestic investors rather than where it is held by a few major banks or even offshore investors. Measures of the depth of the capital markets can be a consideration in the rating.

[39] "Rating Methodology: Sovereign Bond Ratings", Moody's Investors Services, September 2008.

External Liquidity

The ability for a sovereign government to generate foreign exchange is a key factor in assessing credit quality (both for local currency and foreign currency ratings). The factors considered include:

- Where there is substantial external debt burden (public and private sector combined) then movements in exchange rates, interest rates, foreign investor sentiment and other offshore factors have a greater impact on management of external liquidity
- Gross external financial needs are measured through ratio's such as: Current Account payments plus short term liabilities to non residents) /Current account receipts plus foreign exchange reserves
- High foreign currency reserves and more liquidity are more important at the lower rating levels where a significant portion of debt is linked to foreign currencies.

External Debt Burden

The external balance sheet (resident's assets and liabilities) as compared to Balance of Payment flows shows the broadest measure of a countries external financial situation. Key factors considered include:

- External Debt (net of reserves and financial sector assets) /Current Account Receipts
- Maturity profile, currency composition, interest rate sensitivity and the level of private sector (and especially financial sector) debt
- Robust domestic sources of finance, sounds domestic financial sector, and productive Foreign Direct Investment all minimize risks of high debt burdens.

Attachment 2 - Standard & Poor's Sovereign Rating Criteria

Sovereign Ratings Methodology Profile

Political risk
- Stability and legitimacy of political institutions
- Popular participation in political processes
- Orderliness of leadership succession
- Transparency in economic policy decisions and objectives
- Public security
- Geopolitical risk

Income and economic structure
- Prosperity, diversity and degree to which economy is market oriented
- Income disparities
- Effectiveness of financial sector in intermediating funds; availability of credit
- Competitiveness and profitability of nonfinancial private sector
- Efficiency of public sector
- Protectionism and other nonmarket influences
- Labour flexibility

Economic growth prospects
- Size and composition of savings and investment
- Rate and Pattern of economic growth

Fiscal flexibility
- General government revenue, expenditure and surplus/deficit trends
- Revenue-raising flexibility and efficiency
- Expenditure effectiveness and pressures
- Timeliness, coverage and transparency in reporting

General government debt burden
- General government gross and net (of assets) debt as a percent of GDP
- Share of revenue devoted to interest
- Currency composition and maturity profile
- Depth and breadth of local capital markets

Offshore and contingent liabilities
- Size and health of non-financial public sector enterprises
- Robustness of financial sector

Monetary flexibility
- Price behaviour in economic cycles
- Money and credit expansion
- Compatibility of exchange-rate regime and monetary goals
- Institutional factors, such as central bank independence

External liquidity
- Impact of fiscal and monetary policies on external accounts
- Structure of the current account
- Composition of capital flows
- Reserve adequacy

External debt burden
- Gross and net external debt including deposits and structured debt
- Maturity profile, currency composition and sensitivity to interest rate changes
- Access to concessional funding
- Debt service burden

Attachment 3 – Rating Analysis of No Change to Government Policy

S&P Long Term Scenarios of Selected AAA/AA Rated Sovereigns

	Net general govt debt (% of GDP)					General govt balance (% of GDP)¶					Hypothetical ratings			
	2010	2020	2030	2040	2050	2010	2020	2030	2040	2050	2007	2020	2030	2040
Australia	-4	-8	5	36	78	1.2	-0.2	-2.6	-5.2	-8	AAA	AA	A	Spec.
Austria	47	42	54	80	105	-1.3	-1.7	-4.1	-5.4	-5.8	AAA	AAA	A	BBB
Belgium	66	44	50	85	134	0.3	-0.8	-4.2	-7.6	-10.2	AA	AAA	BBB	Spec.
Canada	18	5	9	26	48	1.2	0.2	-1.6	-3.1	-4.1	AAA	AAA	A	A
Denmark	12	-8	-23	-33	-39	2	2	2	2	2	AAA	AA	AA	AA
Finland	-16	-26	-20	6	39	2	1.4	-1.4	-3.4	-5.1	AAA	AA	BBB	Spec.
France	56	58	77	115	167	-1.8	-3.4	-5.8	-9.2	-11.8	AAA	AA	A	Spec.
Germany	56	43	48	68	99	-0.6	-1	-3	-4.9	-7.2	AAA	AAA	AA	A
Ireland	1	-3	14	57	132	1.3	-0.6	-3.7	-8.3	-14.2	AAA	A	BBB	Spec.
Japan	92	105	163	253	397	-3.6	-10.4	-13.5	-19.5	-28.1	AA	Spec.	Spec.	Spec.
Luxembourg	-28	-12	32	107	197	0.8	-2.4	-8.2	-14.3	-19.6	AAA	A	Spec.	Spec.
Netherlands	36	33	54	102	161	0	-2.1	-5.7	-9.9	-12.6	AAA	A	Spec.	Spec.
New Zealand	-3	-17	-6	35	93	2	1.1	-2.8	-6.8	-10.2	AA	A	Spec.	Spec.
Norway	171	-263	-285	-223	-97	19.2	17	9.2	-2.7	-10.7	AAA	AAA	Spec.	Spec.
Portugal	62	74	115	206	355	-2.9	-6	-10.2	-18.4	-28.6	AA	BBB	Spec.	Spec.
Slovenia	23	40	85	178	326	-2.1	-4.9	-10.1	-18.3	-27.8	AA	BBB	Spec.	Spec.
Spain	16	-3	-1	51	151	1.6	1.2	-2.7	-9.7	-15.9	AAA	AAA	BBB	Spec.
Sweden	-17	-24	-16	14	51	1.9	1.3	-1.7	-4.4	-6	AAA	AAA	A	Spec.
U.K.	40	47	67	106	162	-2.2	-3.3	-5.5	-8.8	-12.4	AAA	AAA	A	Spec.
U.S.	55	62	98	161	242	-2.1	-5.1	-10	-15.2	-20.7	AAA	A	Spec.	Spec.

Source: "What A Change a Year Makes: Standard & Poor's 2007 Global Graying Progress Report", Standard & Poor's 19 Sept 2007

ACCESS ECONOMICS

Public and private pension provision in Australia

27 August 2009

Report by Access Economics Pty Limited for

Challenger Financial Services

Commercial-in-Confidence

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Executive Summary

Challenger Financial Services asked Access Economics to report on the cost of capital implications of alternative ways of addressing the problem of longevity risk for retirees.

Many retirees tend to take too much of their retirement income by way of lump sums and too little as annuities, and hence run down their capital 'too early'. In part, that is due to:

- **Short-sightedness**, given that life expectancies have risen more than most recognise. The average man can expect to live about 9.4 years longer than his Dad, and the average woman some 7.1 years longer than her Mum.
- **The age pension**, which shifts some of the risks of running short later on in retirement back on to taxpayers by guaranteeing a minimum income.
- **Complexity**, with many retirees opting for simpler products rather than annuities in the face of financial fine print and difficult-to-understand investment choices.
- **Lack of choice**, with the range of products on offer here less than in some other nations.
- **Control of capital**, as retirees have shown a preference for retaining control of their own capital to cover any large unexpected costs such as a home renovation or ill health.

The market failure of short-sightedness and the fiscal blowback from longevity risks to public age pension costs point to the potential need for policy action. Accordingly, some observers argue there are major advantages in the Government providing longevity risk products: in effect, allowing or compelling people to buy 'top up' age pensions direct from the Government.

This is seen as having two key advantages:

- The Federal Government – and its AAA rating – has greater access to capital markets at lower costs than do private providers, providing buyers of these annuities with the equivalent of a 'free lunch'.
- Proponents argue that Governments may also have access to economies of scale in administration and delivery not as readily available to private providers of pension products. (Others argue that this is unlikely to be material, given that the full cost of running an efficient life office is low, and scalable.)

This report assesses the first of the above two points. It finds that government provision of such products would indeed benefit buyers of these annuities.

It would not, however, benefit Australia as a whole.

Somebody pays

Why not? Because an iron rule of economies is that "somebody pays".

Labelling borrowing as 'public' or 'private' does not change the inherent risk in the transaction, but only who bears that risk.

Hence the marginal transaction – paying upfront now for an income stream to follow – is the same regardless of whether done publicly or privately. That suggests that, over time, public provision would either draw directly on the Budget or tend to dilute the cost of capital advantage to public sector borrowing as a whole.

Consider two economies:

- One has zero net government debt, and all private borrowing is subject to the full risk inherent in its underlying economic activities.
- The second economy is identical to the first, with the exception of a blanket government guarantee on all debt transactions, funded through an efficient income taxation system.

The first economy faces credit defaults on occasion, which are absorbed as costs by creditors. It therefore must endure a higher (pre-tax) private cost of capital to cover those risks.

The second economy has no such defaults, as all credit risk is borne by the government. This economy enjoys a lower (pre-tax) private cost of capital. However, all taxpayers face higher costs and the level of economic activity is also constrained by that higher tax burden.

That example highlights the basic point that some of the costs of default risk can be covered by governments, but only at the cost of externalising the risks toward other parts of the economy.

That makes creditors happy (in this case the buyers of the government annuities), as they are facing reduced risk, but has wider consequences for all. However, the initial apparent 'savings' on interest payments are in fact matched by costs elsewhere in the economy over time – it is just that the savings are more obvious and the costs more diffuse.

If it was otherwise, then that would suggest a 'free lunch' available to all economies simply by re-branding some or all of their private debt as public debt. While there may be short run circumstances where re-branding might offer advantages, as a long run proposition it is dubious.

No free lunch?

Hence the basic view in this area is that labelling something as public rather than private borrowing simply shifts costs rather than eliminating them.

Yet there may be a potential caveat to that basic view. At the margin, if the world wants more Australian Government guaranteed debt than is currently on issue, then issuing more under this type of program would indeed offer a 'free lunch' of sorts to Australians if the Government were to borrow more in its own name (and the private sector less).

Moreover, given the currently limited supply of Australian Government backed debt, there may be an argument that there is a degree of excess demand for new issues of Commonwealth Government Securities (CGS).

However, if such a 'free lunch' is potentially on the table, there are other ways to eat it.

The Government could expand *gross* debt without lifting its *net* debt. This could be achieved by, for example, issuing debt in exchange for a portfolio of assets (similar to the existing Future Fund), or in exchange for matching debt from foreign governments.

This would expose taxpayers to greater financial risk, but would exploit the 'good deal' potentially available on CGS without the need for additional net debt.

Are today's starting points for debt the issue – or tomorrow's?

Moreover, there is a caveat on the above caveat. That is, even if markets have a degree of unmet thirst for Australian Government guaranteed debt as of today, there is less likely to be any such unmet demand in coming decades, when Government debt is projected to rise.

That is important because markets tend to be less forgiving of governments which already have higher debt ratios.

While Australia's net public sector debt position is currently very strong relative to that of other developed nations, that strength is facing pressure in both the short and long term:

- Short term, the Federal Budget is in deficit, and is likely to remain so for some time.
- Longer term, the intergenerational pressures associated with an ageing population threaten to produce significant primary deficits over coming decades.

Moreover, the range of emergency measures adopted during the global financial crisis mean that the contingent liabilities on the Federal Government's balance sheet have just ballooned.

The Federal Government's debt is still set to remain very low by OECD standards. That said, and other things equal, the deterioration underway in the current and future creditworthiness of Australian Governments adds to the reasons to believe that there is no economy-wide 'free lunch' to be had in the Federal Government directly selling annuity products to Australians.

Borrower or guarantor?

As noted above, the Federal Government is in a good position to manage default risk, but that management comes at a cost.

That applies not only to the direct borrowings of the Federal Government, but also to any private borrowings sheltered under a government guarantee.

In turn, that raises the possibility of the key beneficiaries of a government guarantee (private borrowers and lenders) paying a fair price through a levy arrangement for the insurance provided by any such government guarantee.

Note that in the case of a universal guarantee, this would result in no change to the overall cost of capital in the economy – only a shifting of risk away from less creditworthy pursuits toward those with less inherent credit risk.

If the guarantee were less than universal, it would instead provide an effective subsidy to those borrowers covered by the guarantee at the expense of those without similar protection.

Given that, there may be a case for public sector guarantees for privately provided annuity products, with that public guarantee coming at a cost to the private provider – that is, a solution analogous to the current guarantee for bank and State borrowing.

In turn, that could be an option for the customer – that is, they could choose to buy a guaranteed or non-guaranteed product, and private providers could purchase guarantees to match the mix of demand they faced.

In sum

Australians do need to change the way they take their retirement incomes to match our rising life expectancies – less needs to come by way of lump sums, and more by way of annuitised income, with that combination helping to ensure that our retirees don't outlive their means.

How to achieve that?

There are obvious benefits for retirees if they can ride on the back of the Federal Government's ability to borrow cheaply.

However, any such good news for retirees from that quarter would be offset by rising costs to others. Labelling borrowing as 'public' or 'private' does not change the inherent risk in the transaction, but only who bears that risk.

Or, in other words, the initial apparent 'savings' would disappear over time – public annuity provision is more likely to, for example, either add marginally to the overall cost of public sector borrowing and/or add marginally to the overall cost of commercial bank borrowing used to finance Australian home and business loans.

Access Economics
27 August 2009

1 Introduction

This report:

- Examines the pros and cons of public rather than private provision of guaranteed income streams; and
- Looks at the potential impacts of compulsion in either case.

The focus is on the underlying economic concepts rather than detailed modelling of the outcome of any particular policy proposals.

Policies aimed at reducing retirees' longevity risk – the risk that they live longer than their retirement savings do – have drawn the attention of the Henry Review into *Australia's Future Tax System*.

Australians have traditionally shied away from retirement income streams which guarantee an income for life, and have instead preferred to access their super in a lump-sum.

In part, that preference is likely to be due to a combination of:

- **Short-sightedness**, given that life expectancies have risen more than most recognise. The average man can expect to live about 9.4 years longer than his Dad, and the average woman some 7.1 years longer than her Mum, yet average retirement ages have only been inching up. Many people may not realise the extra years in retirement that they will enjoy and the extra savings they will therefore need to set aside.
- **The age pension**, which shifts some of the risks of running short later on in retirement back on to taxpayers by guaranteeing retirees a minimum income. The potential for the age pension to act as a backstop against longevity risk would be expected to form part of any rational retirement plan. Reliance on the age pension backstop shifts longevity risk onto other taxpayers. Some of the longevity risk is also borne by family members who receive reduced inheritances.
- **Complexity**, with many retirees opting for simpler products rather than annuities in the face of financial fine print and difficult-to-understand investment choices. Retirees' desire to "keep things simple" is understandable[1].
- **Lack of choice**, with the range of products on offer in Australia less than that of some other countries.
- **Control of capital**, as retirees have shown a preference for retaining control of their own capital to cover any large unexpected costs such as a home renovation or ill health. In many cases, control of capital is also important for estate planning, and so that retirees can maintain links with their children for as long as possible[2].

[1] There is a discussion on this point in the RBA Financial Stability Review, March 2009.

[2] B.D. Bernheim, R.J Lemke, J.K. Scholz, *"Do Estate and Gift Taxes Affect the Timing of Private Transfers?"* (p3), NBER 2003.

Of the five reasons given above for why Australians might avoid annuities, only the first reason is a pure "market failure" – short-sighted expectations. With life expectancies continuing to rise, there is a growing risk that individual retirees spend their super savings too quickly and that more generally Australians fail to plan effectively for their later retirement years, relying on the age pension to support them later in life when their super is gone. If individuals underestimate their retirement years, but fund providers have an accurate (and higher) estimate of retirement years, then commercially offered annuities would be expected to struggle in the market place for want of customers. Evidence of such market failures would suggest that there might be a case for a corrective policy intervention.

The second reason – the potential for age pension costs to blow out – is not a market failure per se. However, it also offers a fiscal rationale for why the Federal Government might also want to consider a policy intervention.

The dual rationales of short-sightedness and fiscal protection underpin current retirement incomes policies. If these rationales were considered strong enough to justify further policy intervention so as to internalise some longevity risk to retirees, then the policy intervention could take a number of forms.

Two 'polar' approaches are possible – one simple, one ambitious:

- *First*, retirees could be required to use part of their super payout to buy a guaranteed income stream from a pension provider. As with the 9% SG, this would aim to overcome short-sightedness and provide a larger pool of investment funds to control costs and promote innovation in pension products. The Government's role here could be as 'simple' as passing legislation.
- *Second*, an alternative approach (a version of which may be considered by the Henry Review) would be to allow retirees to 'buy' a guaranteed income from the Government, either using their super payout, or by staying on in the workforce for longer (and hence providing a boost to the economy, and to tax revenues). The Government's role here could be expansive – for example, the Government could act as a full service provider by offering retirement financial planning advice, collecting and investing retiree's investment funds and providing annuities. Private sector involvement could be zero.

There are obviously a range of sub-options that might be considered between these two polar proposals.

However, rather than consider detailed options for potential implementation, the focus of this report is to address the public sector cost of capital proposition which has been put forward in support of public annuity provision.

This proposition argues that Government can borrow at a lower cost than the private sector.

If the proposition is true, then that will affect the design of any proposal that aims to address longevity risk.

2 The current system

It is useful to distinguish between **individual longevity risk** and **systemic longevity risk**:

- For **individuals**, the risk is that they outlive their planned life expectancy, and hence their financial means. This risk can be eliminated by individual retirees banding together in a funding scheme where fund outflows (that is, retirees' annuities) are covered (in net present value terms) by fund inflows (retirees' contribution to the fund). Individual retirees are unlikely to live the precise average life expectancy – those living longer than the average will benefit from a lifetime annuity at the expense of those living shorter than the average. Longevity risk – both upside and downside – is therefore shared between the scheme's retirees.
- For **governments and private pension providers**, the risk is that the 'whole population' life expectancy or fund investment returns will change in an unexpected way. If the size of the fund pool is insufficient to pay fund outflows, then the annuities scheme will collapse without outside support or a change in the terms of the fund. Such a systemic risk could result for example from unexpectedly rising life expectancies or lower than expected long term rates of return from the fund's investments.

The Government provides an age pension, which it boosted further in the Federal Budget:

- This provides a degree of cover for longevity risk for individuals, though the retirement income adequacy of the pension by itself is low.
- Lower adequacy and higher pension reliance will persist while the superannuation system is immature and/or while super incentives fall short of encouraging adequacy for specific groups.
- Hence the age pension of itself is not sufficient to meet the demand for longevity risk products in Australia.

Yet the private provision of retirement income products is patchy, as the Henry Review has noted in its interim report on retirement incomes:

> *"The market in Australia for products that provide either a lifetime, or deferred income stream is not as developed as in some other countries"*
>
> *"Better retirement income products should be available for purchase so a person can ensure an income higher than the Age Pension throughout their retirement"*
>
> Australia's future tax system – The retirement income system: Report on strategic issues

2.1 Current system – the Government age pension and its effect on private provision

While not universal, the Government age pension (including part pensions) casts a wide net:

- Access Economics longer term modelling indicates that many people – including many well off people – will eventually qualify for part pension, while those who don't are not a particular public policy concern.
  - Even 'more attractive' annuity products may not be attractive to this group, as their asset base and income flows are likely to cover both their longevity risk and bequest motives regardless of their individual longevity outcomes.
- The age pension does comprehensively insure against longevity risk, but at a low income replacement rate for most, and in a manner which encourages the shifting of the risk burden to the government, all the more so to the extent people are short-sighted as to their life expectancy.

That said, there are features of the age pension which make it an attractive backstop against the risk of living longer than expected:

- The pension is indexed to CPI inflation, and maintained at a minimum ratio to Male Total Average Weekly Earnings (MTAWE), meaning its real value will increase over time.
- The longer one lives, the lower one's capacity may be to enjoy spending. A number of studies – both here in Australia and overseas – have shown that discretionary spending declines over the later years of retirement. At the same time, those areas where costs increase with age, such as health and aged care, are largely covered by government services. That is likely to mean a lower retirement income 'adequacy' threshold for those who do outlive their peers.

3 Public sector provision and the cost of capital

Part of the Henry Review discussion on longevity risk focuses on the private versus public provision of annuities.

The Review rightly identifies the Federal Government as Australia's main provider of longevity insurance through the age pension.

Does that mean that the Government may also be able to offset the risks inherent in offering an income guarantee more effectively than the private sector (especially if the Government has to insure private sector guarantees)?

Such a possibility partly revolves on the stronger ability of the Government to pool risks, aided by its lower cost of capital compared to the private sector.

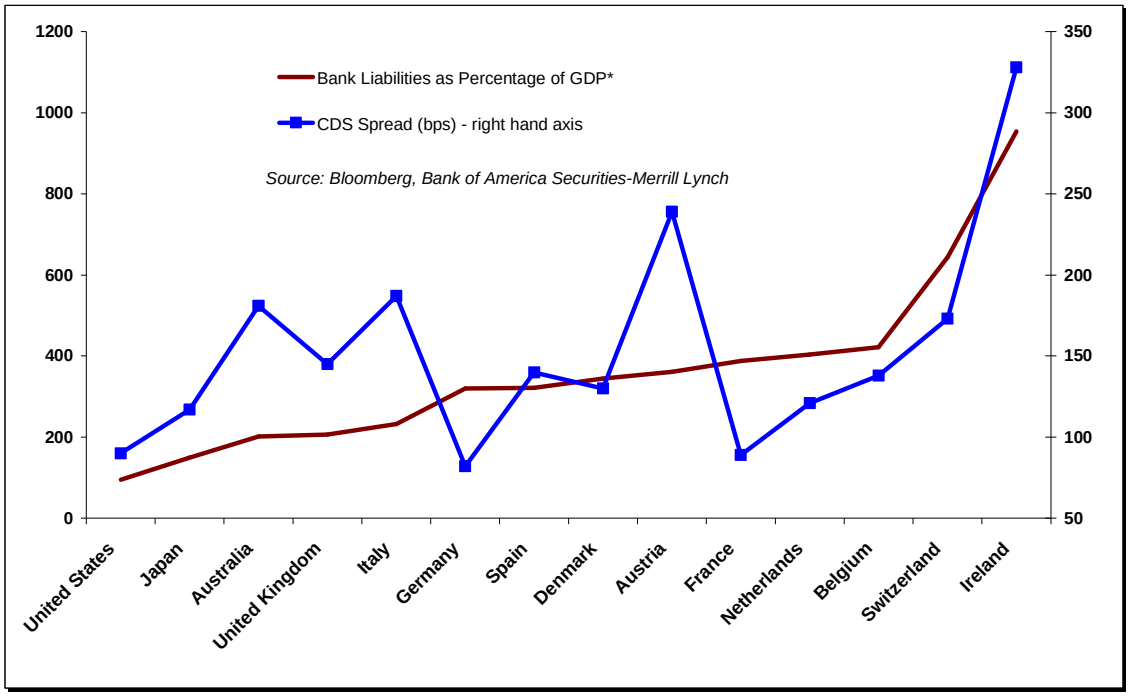
This section examines both the financial and economic costs of public sector borrowing, noting that:

- If markets are well informed, the cost of capital advantage enjoyed by governments is likely to be eroded as more borrowing increases the risk attaching to government debt.
- Even if markets do not fully adjust, the resulting risks are then passed to taxpayers – as higher taxes or lower spending if governments are forced to default debt.

3.1 Public borrowing and the cost of capital

Governments cannot borrow forever without paying a cost penalty.

Figure 3.1: Links between borrowing levels and borrowing costs



While governments in general enjoy low borrowing costs, those with greater levels of debt are considered at greater risk of default – and must pay higher borrowing costs as a result.

The chart above shows the size of national banking systems relative to national income, and matches that against the assessment being made in markets of the likelihood of default.

It is an illustration of the links between borrowing levels and borrowing costs – a linkage which is also important for governments, not just private sector borrowers.

Eventually, taking on additional debt will lead markets to rethink their assessment of a Government's financial position:

- That is more likely to be true when the government is borrowing to finance investments in business assets (rather than borrowing to smooth the impact on tax revenues and expenses through the business cycle, or borrowing to fund infrastructure which will provide long term benefits to taxpayers).
- Markets tend to hold the view that government activities are better risks than business activities.
- However, when governments borrow in order to fund the purchase of business assets (as would be the case for a public annuity offering), then that view is diluted.
- Sophisticated markets are able to look through the public sector 'label' placed on borrowing to the assets underneath, attaching similar levels of risk to those for private borrowers.

Governments which borrow to fund public sector investment in more risky assets are, other things equal, likely to be subject to higher borrowing costs.

A shift in the mix of services funded by borrowing can therefore influence the level of risk – both real and perceived.

Importantly, any resulting increase in borrowing costs would apply across the entire stock of existing government debt, meaning that a small change in the market's assessment of risk might translate into a larger impact on overall borrowing costs.

In the case of public annuity provision, the marginal transaction would be the same regardless of whether it was done publicly or privately.

That suggests that, over time, public provision would either draw directly on the Budget or tend to dilute the cost of capital advantage to public sector borrowing as a whole.

That raises the possibility that increased borrowing costs on all Government debt would offset the borrowing cost advantage on new debt – effectively negating the cost of capital advantage of public provision.

If it was otherwise, then that would suggest a 'free lunch' available to all economies simply by re-branding some or all of their private debt as public debt.

While there may be short run circumstances where re-branding might offer advantages, as a long run proposition it is dubious.

The global financial crisis helped to show that 'hiding' the ultimate owners of debt in order to gain a 'lower' cost of capital is not sustainable and ultimately damaging – it was sub-prime home owners regardless.

That means **debt sustainability matters** and that governments cannot borrow in a manner which steadily increases overall leverage in perpetuity.

Doing so would threaten fiscal sustainability, and hence external stability, the government's credit rating and the cost of credit.

The Federal Government recently implemented a number of measures aimed at maintaining stability and confidence in the financial sector. Three of these measures are examined here. They all focus on Australian Government guarantees aimed at ensuring the continued flow of funding for particular purposes (and incidentally provide potential funding models for a government guarantee of private pensions). In two of these measures, these guarantees have come with an explicit "price" of a fee premium based on the credit rating of the borrower.

First, there is a guarantee for deposits and for wholesale debt securities issued by authorised deposit-taking institutions (Table 4.1).

Table 3.1: Deposit and wholesale funding guarantee

Credit Rating	Debt Issues Up to 60 Months
AA	70bp
A	100bp
BBB and Unrated	150bp

Source: The Treasurer, 24 October 2008.

Second, the Federal Government has also provided guarantees of State debt with the price of the guarantee rising both with a lower credit rating and with new (or marginal) borrowing (Table 4.2).

Table 3.2: Guarantee of State and Territory borrowing

Credit Rating	Fee (existing stock)	Fee (new issuance)
AAA	15 basis points	30 basis points
AA+	20 basis points	35 basis points

Source: The Treasurer, 12 May 2009.

Third, the Government also established a special purpose vehicle (SPV) to help provide wholesale financing to those motor vehicle dealers financed by two private financiers which exited the Australian market as a result of the global financial crisis. The SPV was established as a financing trust, with the joint support of the Government and the four largest Australian banks, to provide liquidity to car dealer financiers through the securitisation of eligible loans provided to car dealers. The expectation was that the SPV could be required for up to a year[3].

There are differing views on when these measures will terminate, though the RBA clearly sees the first guarantee as a temporary response to the global financial crisis (see Appendix B).

[3] RBA, Financial Stability Review, March 2009.

In setting the premiums on the bank guarantee the Government considered a range of factors. In particular:

> *"the premiums were set at a level that was between the then current market price – which was viewed as the product of very stressed conditions – and the price that was thought likely to prevail when more normal market conditions returned."*

If the premium is set too low then that would have encouraged "moral hazard" from banks – that is, they could borrow at a funding advantage where taxpayers wore the risk. In the current crisis, the Government set the premiums in recognition of the temporary market imperfections caused by "very stressed [financial] conditions".

Such an approach has been supported on other occasions by a number of academic papers which state that, in the absence of market imperfections, the cost of capital for public projects should be the same as the cost of capital for comparably risky private ventures[4].

There are hints that the premiums in Table 3.1 may be too low. The RBA Governor Glenn Stevens recently chided Australian banks for having been responsible for 10% of the entire world's issuance of government-guaranteed bank debt over the past nine months (Appendix B). It is also evident in his comments:

> *"But the longer-term question is whether ... we would really want to keep moving in the direction of a world where the bulk of debt is government-issued or government-guaranteed. It seems to me that that could easily be a world in which investors end up being no more discerning about risk and return than the buyers of [collateralised debt obligations] a few years ago, and in which banks themselves ultimately rely on the guarantees to an inappropriate or even dangerous extent."*

The three measures mentioned above are of interest because they provide potential funding models for guaranteeing private pensions and provide examples of current Australian Government thinking in this area. The first and third models indicate very different levels of Australian Government involvement:

- The first – the deposit and wholesale funding guarantees provided to the banks – represents a minimalist approach from the Australian Government where the funding is channelled through existing private agents which pay a fee for the guarantee. This relatively hands-off role from the Australian Government is facilitated by the fact that these private agents are already closely regulated by APRA (just as providers of guaranteed lifetime annuities are subject to prudential regulation).
- The SPV approach has the Australian Government playing a stronger hands-on role in ensuring adequate funding (for car dealerships). A more hands-on role from the Government was probably needed because foreign-owned car dealership financiers were relatively unregulated, so a replacement financing vehicle needed to be built within the Government tent and a few highly supervised private players.

There would seem to be two messages here.

[4] See for example, the research noted by Grant S and Quiggin J (2001) *Public investment and the risk premium for equity*, http://www.uq.edu.au/economics/johnquiggin/JournalArticles03/EPEconomica03.pdf.

First, if the Australian Government was to provide funding support in the form of guarantees for providers of private annuities then it would likely insist on maintaining very close supervision of private industry. That said, the existing supervision of this sector is already notable – a factor which has hampered the annuity market in Australia in the past (including high effective reserve ratios). If the Australian Government felt that current very close regulation was less desirable for some reason, then the Government might consider an alternative funding model where it took on the risk, but it minimised private sector involvement.

Second, industry could also expect to pay a premium that reflected the borrowing advantage that the Australian Government has as a result of its credit rating.

That said, for now the increased borrowing already announced by the Federal Government is unlikely to threaten the immediate sustainability or Australia's credit rating.

Adding the debt for other levels of government to the Federal debt, total government net borrowing rises to about 14.2% of GDP, which is below the 21.7% median AAA estimate published by Standard & Poor's (S&P) in February 2009.

Are the official estimates of the Commonwealth debt path likely to be accurate?

In one sense the debate over Federal Government debt projections is academic – debt will keep rising while deficits continue to linger, and the difficulty of substantially reining in spending in coming years suggests that there is a risk that the latter linger for longer than the official forecasts allow.

That said, some perspective is useful here.

There is the potential for net debt in Australia to move rather higher than the official forecasts allow. While that would still be rather smaller as a share of GDP than in most other developed countries (for example, the IMF predicts 80% net debt for countries such as the US, UK, Germany and France by 2014), the discussion in Section 3.4 below notes that there would be problems were Australia's net debt ratio to go over 60%.

3.2 Potential economic costs of increased public borrowing

An iron rule of economies is that "somebody pays".

Labelling as 'public' or 'private' borrowing does not change the inherent risk in the transaction, but only who bears that risk. Some of the costs of default risk can be covered by governments, but only at the cost of imposing those risks on other parts of the economy.

That makes creditors happy, as they are facing reduced risk, but it also has wider consequences.

To see this, it is useful to consider why markets show a strong preference for government debt over private borrowing.

The key reason behind that preference is a simple one – governments are generally seen as less likely to default on repayment of a loan than corporations.

That is because governments have unique advantages when it comes to avoiding default: they can force taxpayers to bear the costs of repaying a loan in the event of financial trouble.

Both of the above involve passing on some or all of the costs of repaying debt to taxpayers. Governments enjoy superior credit ratings to private firms in part because they have the ability to pass on the cost of servicing that debt to taxpayers.

Assuming taxpayers have the capacity to pay back debt, credit markets are not concerned by any potential costs associated with higher taxes, or reduced government spending. Such a transfer of costs is a key benefit for debt investors, who are only interested in recovering their money.

It does, however, come at a price – lower living standards for taxpayers and collateral damage to the economy as higher taxes discourage investment and workforce participation.

Indeed, to the extent that these external costs are not considered by ratings agencies, they reflect a key difference between the cost of capital as measured by the market, and the true 'social' cost of capital in the economy as a whole.

Where credit markets do not fully adjust to reflect the new state of government finances, this potential for 'collateral damage' (which is not reflected in borrowing costs as measured by credit markets) is making up the difference.

Or, in other words, any initial and apparent 'savings' on interest payments are likely to be matched by costs elsewhere in the economy over time.

Consider two economies:

- One has zero net government debt, and all private sector borrowings are subject to the full risk inherent in their underlying economic activities.
- The second economy is identical to the first, with the exception of a blanket government guarantee on all debt transactions, funded through a relatively efficient income taxation system.

The first economy faces credit defaults on occasion, which are absorbed as costs by creditors.

It therefore must endure a higher (pre-tax) private cost of capital to cover those risks.

The second economy has no such defaults, as all credit risk is borne by the government. This economy enjoys a lower (pre-tax) private cost of capital. Instead, all taxpayers face higher costs and the level of economic activity is also constrained by a higher tax burden.

The above example highlights the basic point that some of the costs of default risk can be covered by governments, but only at the cost of externalising the risks toward other parts of the economy. Creditors face reduced risk, but at the cost of wider consequences for all.

3.3 Is there a free lunch for the economy as a whole?

Hence the basic view in this area is that labelling something as public rather than private borrowing simply shifts costs rather than eliminating them.

Yet there may be a potential caveat to that basic view. If the world wants more Australian Government guaranteed debt than is currently on issue, then issuing more under this type of program would indeed offer a 'free lunch' of sorts to Australians if the Government were to borrow more in its own name (and the private sector less).

Markets like public debt – often with good reason. Even in the case of a serious default, governments have a habit of surviving. While companies disappear after defaulting on debts, governments often return to financial health and therefore to bond markets. This gives rise to 'repeated game' scenario – ensuring governments think much more seriously about default than companies do.

Moreover, given the currently limited supply of Australian Government backed debt, there may be an argument that there is a degree of excess demand for new issues of Commonwealth Government Securities (CGS).

However, if such a 'free lunch' is potentially on the table, there are other ways to eat it.

The Government could expand *gross* debt without lifting its *net* debt. This could be achieved by, for example, issuing debt in exchange for a portfolio of assets (similar to the existing Future Fund), or in exchange for matching debt from foreign governments.

This would expose taxpayers to greater financial risk, but would exploit the 'good deal' potentially available on CGS without the need for additional net debt.

Indeed, we may already be enjoying some of the benefits of this 'free lunch', as any excess demand would depress the cost of the existing CGS market – an advantage which would be diluted by new issuance.

3.4 What level of debt is sustainable?

It is clear that governments cannot borrow in perpetuity without affecting their long term fiscal sustainability.

As noted in the Federal Government's *2007 Intergenerational Report*, accumulating debt is not a sustainable long-term solution, particularly in situations where budget deficits are expected to continue for a period of time, since at some point the debt needs to be repaid. In addition, the compounding effect of interest costs would see net debt rise very rapidly.

The IMF and World Bank have conducted extensive research into what level of debt is generally seen as sustainable.[5] They conclude that, irrespective of what probability of debt distress is considered tolerable, the empirical evidence suggests that debt thresholds should be established in light of the quality of a country's policies and institutions.

Table 3.3 presents this as an operational matrix, defining indicative policy-dependent debt limits based on the (rounded) results of Bank and Fund staff's empirical analyses.

[5] IMF and World Bank (2004) Debt Sustainability in Low-Income Countries—Proposal for an Operational Framework and Policy Implications, http://www.imf.org/external/np/pdr/sustain/2004/020304.htm.

While these thresholds are only indicative, they nevertheless provide a useful tool to indicate the point after which debt distress is more likely to eventuate. These limits are seen to provide a useful basis to guide future borrowing (and lending) decisions – perhaps with a conservative bias, given that the underlying NPV data in the empirical analyses are derived on the basis of historical discount rates.

It suggests that, for a country like Australia with strong institutions, a government debt in excess of 60% may become a worry in terms of sustainability.

- The IMF further recently commented that Australia is susceptible to downside risks such as falls in commodity prices, especially due to its relatively high level of external liabilities. By end 2008 net foreign liabilities for Australia were over 60% of income – though this includes private as well as public sector debt. [6]

Table 3.3: Indicative policy-dependent debt and debt-service thresholds (in %)

	Assessment of Institutional Strength and Quality of Policies		
	Poor	**Medium**	**Strong**
NPV of debt-to-GDP	30	45	**60**
NPV of debt-to-exports	100	200	300
NPV of debt-to-revenue	150	200	250
Debt service-to-exports	15	25	35
Debt service-to-revenue	20	30	40

Source: IMF and World Bank (2004).

3.5 Starting points for public finances

Given the discussion above, it is worthwhile examining the direct and indirect debt profile of the government as well as the broader costs of borrowing.

That is because there is a 'caveat on the above caveat'. That is, even if markets have a degree of unmet thirst for Australian Government guaranteed debt as of today, there is less likely to be any such unmet demand in coming decades.

That is important because markets tend to be less forgiving of governments which already have higher debt ratios.

While Australia's net public sector debt position is currently very strong relative to that of other developed nations, that strength is facing considerable pressure in both the short and long term:

- Short term, the Federal Budget is in deficit, and is likely to remain so for some time.
- Longer term, the intergenerational pressures associated with an ageing population threaten to produce significant primary deficits over coming decades.

[6] IMF (2009) World Economic Outlook (WEO) - Crisis and Recovery, April 2009, http://www.imf.org/external/pubs/ft/weo/2009/01/index.htm.

Moreover, the range of emergency measures adopted during the global financial crisis mean that the contingent liabilities on the Federal Government's balance sheet have just ballooned.

Other things equal, the deterioration now underway in the current and future creditworthiness of Australian Governments adds to the reasons to believe that there is no economy-wide 'free lunch' to be had in the Federal Government directly selling annuity products to Australians.

3.5.1 Direct debt

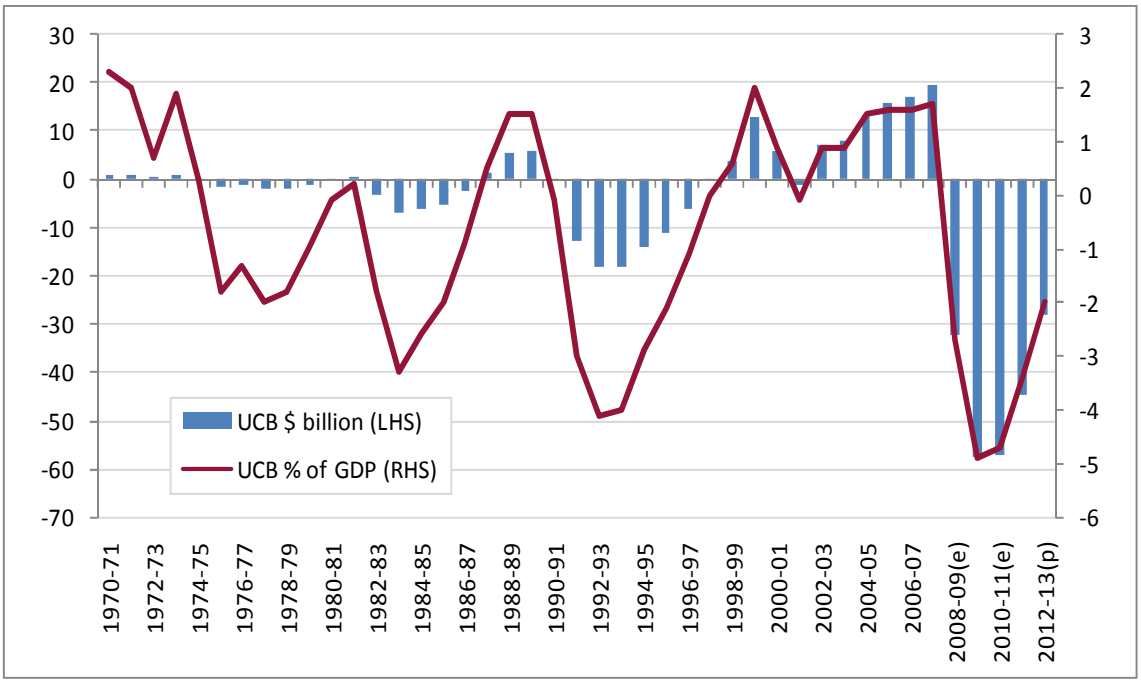
The 2009-10 Budget highlighted a marked turnaround in Federal Government finances:

- The 2008-09 Budget forecast underlying cash surpluses of around $80 billion from 2008-09 to 2011-12.
- In contrast, this Budget predicts deficits totalling $191 billion over the same period – a turnaround of $270 billion. The deficit for 2009-10 is $57.6 billion or 4.9% of GDP, larger than the previous peak of 4.1% in 1992-93 (and the peaks in the 1970s and 1980s).

As the global financial crisis hit in late 2008, government revenues were greatly reduced while there was more call on government spending – both through automatic stabilisers (such as more unemployment benefits) and through discretionary spending which aimed to prop up falling private economic activity.

The deterioration in revenue means that the Government is now borrowing notably.

Figure 3.2: Official forecasts of the underlying cash Budget (UCB) balance

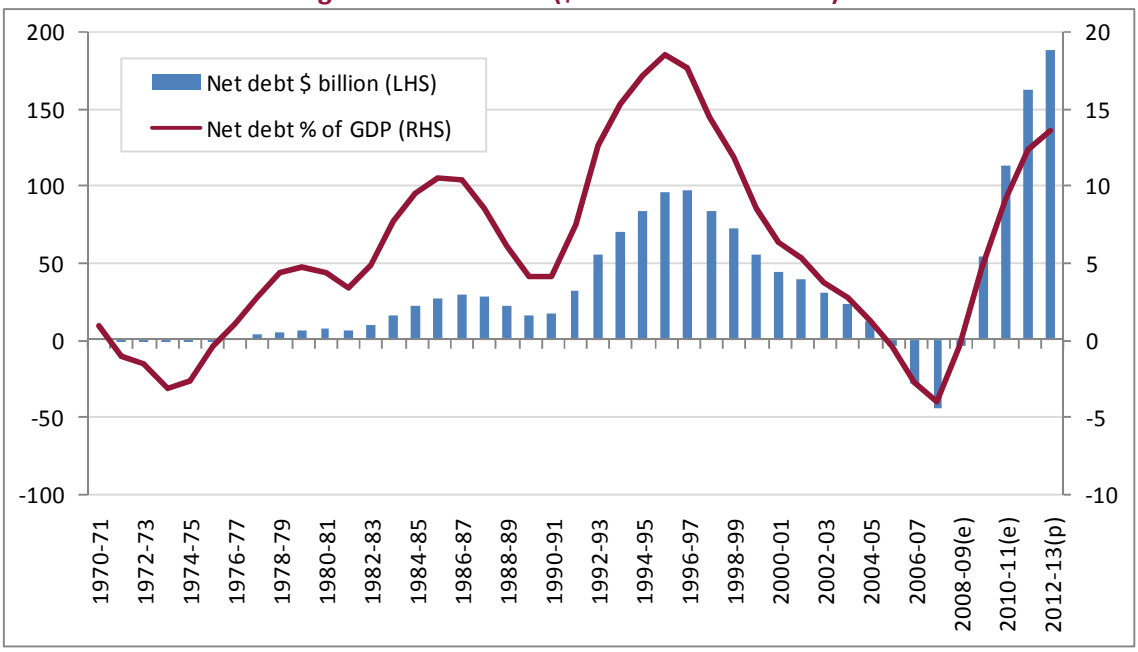


Source: Commonwealth 2009-10 Budget Paper 1, Statement 10.

The result is borne out in Figure 3.3, which sees net debt at $188.2 billion or 13.6% of GDP by 2012-13. (Since the Budget the Government has noted it estimates net debt to return to zero

by 2022.) The total stock of Commonwealth Government Securities (CGS) on issue at 30 June 2010 is projected to be $169.9 billion, an increase of $58.0 billion on 30 June 2009.

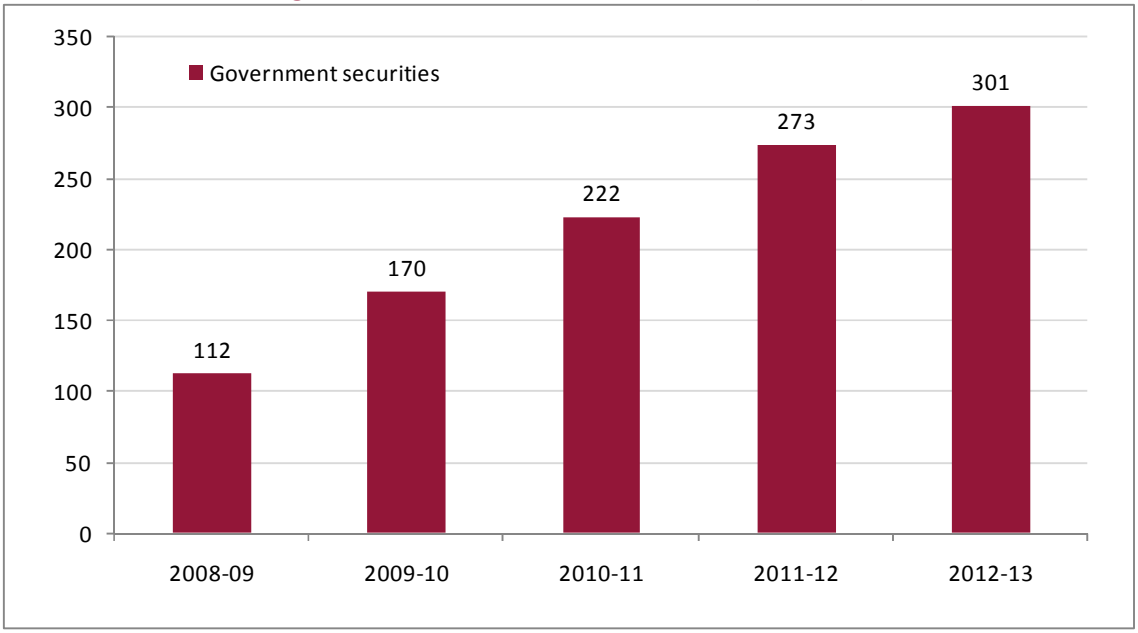
Figure 3.3: Net debt ($ billion and % of GDP)



Source: Commonwealth 2009-10 Budget Paper 1, Statement 10.

On official forecasts, the total stock of CGS on issue (which is a proxy for gross government debt) is expected to peak at $301 billion by 2012-13 (over 20% of GDP). It is likely that this elevated level of debt will be with Australia for some years to come.

Figure 3.4: Government bond issuance ($ billion)



Source: Commonwealth 2009-10 Budget Paper 1, Statement 9.

3.5.2 Broader or contingent liabilities

In addition to the sizeable direct debt the Federal Government has taken on board in the wake of the global financial crisis, there has also been an increase in indirect or contingent liabilities

Contingent liabilities represent possible costs to the government arising from past events or decisions which will be confirmed or otherwise by the outcome of future events that are not within the Government's ability to control. They include loan guarantees, non-loan guarantees, warranties, indemnities, uncalled capital and letters of comfort. These possible costs are in addition to those recognised as liabilities in the consolidated financial statements of the Australian Government general government sector.

The government reports on its significant contingent liabilities in general terms as part of its *Statement of Risks* released with the Budget. Many contingent liabilities are not quantified – for example, the guarantee on State borrowing. Further, items that are quantifiable generally have a relatively remote chance of actually occurring. Nevertheless they should be taken into account when looking at the overall borrowing and debt exposure of the government.

Table 3.4 below provides an overview of the contingent liabilities the Federal Government is exposed to where approximate values could be obtained. The recent economic turmoil associated with the global financial crisis has added markedly to these contingent liabilities mainly as a result of guarantees of bank deposits. **The result is quantified contingent liabilities of around $930 billion at present. This is around 78% of GDP in 2009-10. When outstanding gross debt is taken into account together with the contingent liabilities, this takes the total government potential exposure to over 90% of GDP in 2009-10.**

Table 3.4: Summary of significant contingent liabilities

Liability	Approximate amount ($ billion)
Attorney-General's	
Indemnities relating to the Air Security Officer program	$2.0
Defence	
Defence and Defence Materiel Organisation - Indemnities	$3.2
ASC Pty Ltd — Australian Government indemnities provided to Electric Boat Corporation under the services agreement	$0.0
Litigation cases	$0.1
Finance and Deregulation	
Australian Industry Development Corporation - Guarantee	$0.1
Litigation	$4.3
Sale of Sydney Airports Corporation - Indemnity	$0.5
Foreign Affairs and Trade	
Export Finance and Insurance Corporation - guarantee	$3.0
Health and Ageing	
Guarantee Scheme for aged care accommodation bonds	$7.7
Medical Indemnity Exceptional Claims Scheme	$0.0
Human Services	
Medicare Australia litigation	$0.1
Immigration and Citizenship	
Systems development — liability limit	$0.2
Infrastructure, Transport, Regional Development and Local Government	
Code Management Company — indemnity	$0.1
Innovation, Industry, Science and Research	
Liability for damages caused by Kistler space activities	$2.2
Liability for damages caused by space activities	$3.8
Treasury	
Guarantees under the Commonwealth Bank Sale Act 1995	$5.3
International financial institutions - Net Liability	$8.7
Reserve Bank of Australia — guarantee	$77.0
Standby loan facility for the Government of Indonesia	$1.5
Australian Business Investment Partnership	$26.0
Car dealer financing — OzCar	$0.6
Financial Claims Scheme - Deposit guarantee	$650.0
Guarantee of deposits in authorised deposit-taking institutions	$19.7
Guarantee of wholesale funding of authorised deposit-taking institutions	$104.1
Terrorism insurance — commercial cover	$10.0
Total	**$928.0**

Source: Commonwealth 2009-10 Budget Paper 1, Statement 8.

4 Conclusions and implications

Given the direct and indirect costs of government borrowing, it is unclear that the public sector has or will continue to have a cost of capital advantage over the private sector:

- Such a conclusion is supported by a number of papers which state that, in the absence of market imperfections, the cost of capital for public projects should be the same as the cost of capital for comparably risky private ventures.[7]
- Such a conclusion is further likely to hold even more over the long run as other fiscal pressures like health and aged care come to pass and increase their call on government borrowing. These pressures will be most pronounced at precisely the time that a greater call on government resources would be needed to militate against longevity risk arising from an ageing population.

The government is in a position to manage default risk to the benefit of specific creditors, but that management comes at a cost.

That applies not only to the direct borrowings of the government, but also to any private borrowings sheltered under a government guarantee.

That raises the possibility of the key beneficiaries of a government guarantee (private borrowers and lenders) paying a fair price (through a levy arrangement) for the insurance provided by the government guarantee.

Note that in the case of a universal guarantee, this would result in no change to the overall cost of capital in the economy – only a shifting of risk away from less credit-worthy pursuits toward those with less inherit credit risk.

[7] See Grant S and Quiggin J (2001), op cit.

Appendix A: Government Guarantees on Deposits and Wholesale Funding

Source: RBA, Financial System Review, March 2009

On 12 October 2008, the Australian Government announced guarantee arrangements for deposits and wholesale borrowing, following similar announcements in some other countries. Further details of these arrangements – including the announcement of a guarantee fee on large deposits – were released on 24 October following advice from the Council of Financial Regulators. These arrangements were designed to support confidence of depositors in authorised deposit-taking institutions (ADIs) and to help ensure that these institutions continued to have access to capital markets and were not disadvantaged compared to banks in other countries where guarantee arrangements had been announced.

The guarantee on deposits is provided under two schemes, the Financial Claims Scheme and the Australian Government Guarantee Scheme for Large Deposits and Wholesale Funding (the Guarantee Scheme).

Under the Financial Claims Scheme, total deposit balances up to and including $1 million per customer held in eligible ADIs – Australian-owned ADIs and Australian-incorporated ADIs which are subsidiaries of foreign-owned banks – are automatically guaranteed by the Australian Government without charge. The Financial Claims Scheme is estimated to cover the entire deposit balances of over 99 per cent of depositors (by number) with eligible ADIs, as most depositors have relatively small balances.

For customers with total deposit balances over $1 million at a single eligible ADI, the ADI can access a government guarantee for that portion of the balance over $1 million through the Guarantee Scheme. To do so, the ADI must apply to the Scheme Administrator (that is, the Reserve Bank of Australia as agent for the Government). The ADI application must include details of the accounts on which the guarantee may be made available, and an undertaking to meet other conditions, including the payment of a risk-based monthly fee by the ADI on the amounts guaranteed. This fee is the same as that applying to wholesale funding (see below). Customers are not obliged to have the guarantee apply to the portion of their total deposit balances over $1 million, and the fee only applies to the amount of each customer's total deposits above $1 million that is guaranteed. In most cases, ADIs recover the fee from depositors.

Deposits with foreign bank branches are not guaranteed under the Financial Claims Scheme, given that branches are not locally incorporated entities and independently capitalised in Australia, but are instead part of the foreign bank incorporated overseas. Foreign bank branches are eligible to participate in the Guarantee Scheme, though there is no fee-free threshold and additional conditions apply. For example, approval requires an attestation that the parent bank is meeting prudential requirements in its home jurisdiction, and there are limits on the term and quantity of guaranteed liabilities based on the branch's liabilities outstanding prior to the Guarantee Scheme's introduction. The foreign bank branch must also undertake that the funds will not be used to directly support the parent bank.

The Financial Claims Scheme became effective on 18 October and the Guarantee Scheme became operational on 28 November. A temporary guarantee had applied from 12 October,

while the relevant legislation was being passed for the Financial Claims Scheme and the rules and operational infrastructure of the Guarantee Scheme were being established. Deposit guarantee arrangements will remain in place until 12 October 2011, ahead of which the Government intends to consider subsequent arrangements. The Government noted in its announcement that the Guarantee Scheme would be reviewed on an ongoing basis and revised if necessary.

Eligible ADIs are also able to apply to have their new and/or existing eligible wholesale funding securities guaranteed, for a fee, under the Guarantee Scheme. The guarantee for wholesale funding will operate until market conditions normalise and is subject to the same review procedures as for deposits. As with the guarantee for large deposits, access to the Guarantee Scheme is voluntary and subject to an approval process. A fee is payable on all guaranteed liabilities, with the fee levied monthly. While the same fee applies regardless of the term of the security, fees vary with the credit rating of the ADI.

Only senior unsecured debt instruments of a non-complex nature issued by ADIs are eligible for the guarantee. Eligible ADIs can choose to apply for the Government guarantee for particular securities, or programs, and have other securities unguaranteed. For short-term liabilities, eligible instruments are bank bills, certificates of deposit (including transferable deposits), commercial paper and certain debentures, with maturities up to 15 months. For long-term liabilities with terms to maturity of 15 months up to 60 months, eligible instruments are bonds, notes and certain debentures. Foreign bank branch access to the Guarantee Scheme for wholesale funding involves the same additional conditions and restrictions as outlined for deposits.

Explicit deposit insurance schemes have been common overseas for many years. Faced with the situation of heightened uncertainty and declining confidence in late September/early October 2008, a number of governments around the world responded by increasing the monetary cap on the amount of deposits guaranteed under such schemes. For example, in the United States, the cap on insured deposits with eligible institutions was increased temporarily from US$100,000 to US$250,000, while the minimum cap required in European Union (EU) countries was increased from €20,000 to €50,000. Some EU countries including Austria, Denmark, Germany and Ireland went further by providing a guarantee over all deposits, introducing unlimited caps. Most countries that introduced unlimited caps nominated a set period for the arrangements to apply, typically around two years.

Around the same time as they extended deposit protection arrangements, many governments also provided guarantees over wholesale funding, partly in response to the Irish Government's decision to do so. The details of the individual schemes vary considerably across countries, although the EU countries agreed to common principles so the approaches they have adopted are fairly similar. While most governments, both within the EU and outside, that provided support to wholesale funding markets did so by allowing private financial institutions to issue government-guaranteed debt, the approach taken in Austria and France differed in that a separate state-controlled agency was established to raise funding, which is then available to be on-lent to eligible private financial institutions.

The fees charged for the government guarantees on wholesale funding are typically based on the credit rating of the issuer (Australia, Canada and New Zealand), or credit default swap premiums (France, the Netherlands, Spain and the United Kingdom). In contrast, in the United States the fee charged is dependent on the term of the instrument but not the rating of the

issuer. The fee structure adopted in the Netherlands and New Zealand also depends partly on the term of issuance. In a number of countries, including Canada, New Zealand and the United Kingdom, the fee has been revised lower from initial settings, while in the United States it has been revised higher.

Most governments other than Australia's nominated a set deadline for the availability of the guarantee. While the EU guidelines permit schemes that accept applications for up to two years, the EU countries generally set an application deadline of the end of 2009. In Canada, the United Kingdom and United States, considerably shorter periods were set, though in each case the application cut-off date has since been extended, to the end of October 2009 in the United States and to the end of December 2009 in Canada and the United Kingdom. The instruments eligible for the guarantees generally were limited to a maturity of up to three or five years.

As in Australia, governments have typically restricted the offer of a guarantee to senior unsecured debt instruments that are non-complex in nature. They have also restricted the guarantee to debt issued by certain financial institutions. For example, in Ireland, the Netherlands and the United Kingdom, the guarantee is only available to those institutions that have a significant presence in those countries' financial systems. In the United Kingdom, eligibility is also dependent on an institution having raised, or planning to raise, Tier 1 capital by a certain amount, either by government subscription or from other sources.

Appendix B: Challenges For Economic Policy

Glenn Stevens' address to the Anika Foundation Luncheon, Sydney – 28 July 2009 (extract)

Part of the way ahead will, at some point, involve winding back the extensive government guarantees (and in some cases extensive public ownership) of financial institutions around the world. These measures were necessary last October in the extreme uncertainty of the time, and played a critical role in stabilising confidence in the core of the financial system, and re-opening key capital markets. But they are undesirable as a permanent feature of the landscape. Countries that issued very generous or even unlimited guarantees of deposits will want to make sure such steps truly were emergency measures, by scaling them back to a more sustainable set of deposit insurance arrangements. Likewise, it would be desirable that guarantees for wholesale raisings in capital markets lapse into disuse as conditions improve.

To date, in excess of US$800 billion of government-guaranteed debt has been issued in public markets by banks around the world. An unknown additional sum has been placed into private hands directly. Taking account of the additional debt governments are issuing for regular fiscal purposes, plus the funding for bank rescue packages, the shape of global capital markets is changing significantly. Government and government-guaranteed debt of one form or another is rapidly increasing globally. This has been accommodated so far because it has, by and large, matched investors' shifting risk preferences. Certainly people will worry, longer term, about increases in long-term interest rates potentially 'crowding out' private borrowers. To date, though, long-term rates remain historically pretty low for public borrowers, despite the prospect of very large debt issuance. They have increased somewhat, but this is best understood as an unwinding of the extreme risk aversion of 2008 and early 2009.

But the longer-term question is whether, even without adverse effects on borrowing costs, we would really want to keep moving in the direction of a world where the bulk of debt is government-issued or government-guaranteed. It seems to me that that could easily be a world in which investors end up being no more discerning about risk and return than the buyers of CDOs a few years ago, and in which banks themselves ultimately rely on the guarantees to an inappropriate or even dangerous extent. More generally, while some countries do need significant regulatory reforms in the financial sector, do we want to throw away the genuine advances of risk management and globalisation of the past generation?

Surely the better world for the decades ahead is one where a global financial system, having been stabilised at a time of crisis by public intervention (at major cost to shareholders and incumbent managers as well as taxpayers), plays its proper role of capital allocation and risk management. To be sure, it failed to perform as promised in the recent past. But it would be preferable, in my judgement, to work at making the system more effective in doing that job, than to retreat into the financial repression of an earlier state of the world. The banks of the United States and Europe are starting down this path on their wholesale issuance, having recognised that it is in their own interests to do so. It would make sense for Australian banks, which have accounted for 10 per cent of global issuance of government-guaranteed bank debt over the past nine months, to step up their efforts to do likewise.