

**ATTACHMENT 9 – THE RATING OF AUSTRALIA AND THE PROPOSAL FOR
PUBLIC PROVISION OF ANNUITIES**

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

The Rating of Australia and the Proposal for Public Provision of Annuities

Contents

1. About CDC Pty Ltd	3
2. Executive Summary	4
3. Factors Affecting the Rating of Australia.....	6
3.1 Current Sovereign Credit Ratings of Australia.....	6
3.2 Sovereign Criteria	8
3.3 Why are Foreign Currency Ratings Different to Local Currency Ratings?	10
4. The Significance of Longevity Risk in the Rating of Australia	11
4.1 Longevity Risk - Ratings Agency Considerations	11
4.2 Impact of a “Do Nothing” Policy on the Drivers of Australia’s Rating.....	13
4.3 Comparison to the Retirement Income Policy and Ratings of Peer Group.....	16
5. Rating Agency View of Public Provision of Annuities	22
5.1 Additional Risks likely to be a Concern.....	22
6. Rating Implications of Public versus Private Sector Annuities	26
6.1 Risk to Government of Direct Provision of Annuities.....	26
6.2 The Merits of Private Sector Delivered Annuities	28
6.3 The Impact of the Government Being a Major Asset Manager	29
Attachment 1 - Summary of Key Ratings Factors	31
▪ Resiliency to Withstand Shocks	31
▪ Government Financial Robustness.....	32
Attachment 2 - Standard & Poor’s Sovereign Rating Criteria	35
Attachment 3 – Rating Analysis of No Change to Government Policy.....	36

1. About CDC Pty Ltd

Chris Dalton Consulting Pty Ltd (CDC Pty Ltd) is a boutique credit risk research and advisory firm. 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 times¹. 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 issues² 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 issues³ 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 possess 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 Services⁴

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 published separate criteria that describes their approach to rating sovereign governments. 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

Resiliency to Withstand Shocks

- Political Risk & Institutional Strength
- Economic Structure
- Economic Growth Prospects

Government Fiscal Discipline

- Fiscal Flexibility
- General Government 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 criteria.

A note on sovereign credit ratings

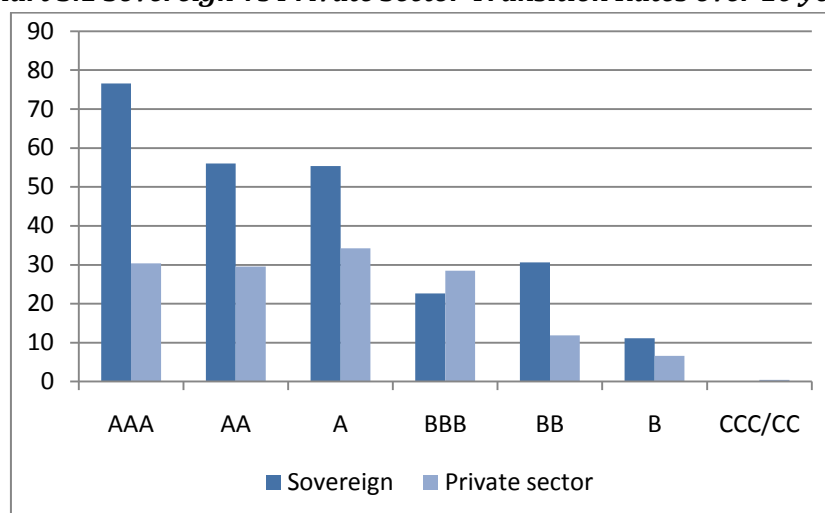
While credit ratings attempt to be “absolute” measures of the probability of default (and in some cases recovery), sovereign credit ratings are considered more as a “relative” measure of credit quality. Corporate default ratings can be quantified on something close to an absolute scale based on many 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 significant 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 significant 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 reflects 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 population⁶.

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 2050⁷.

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.

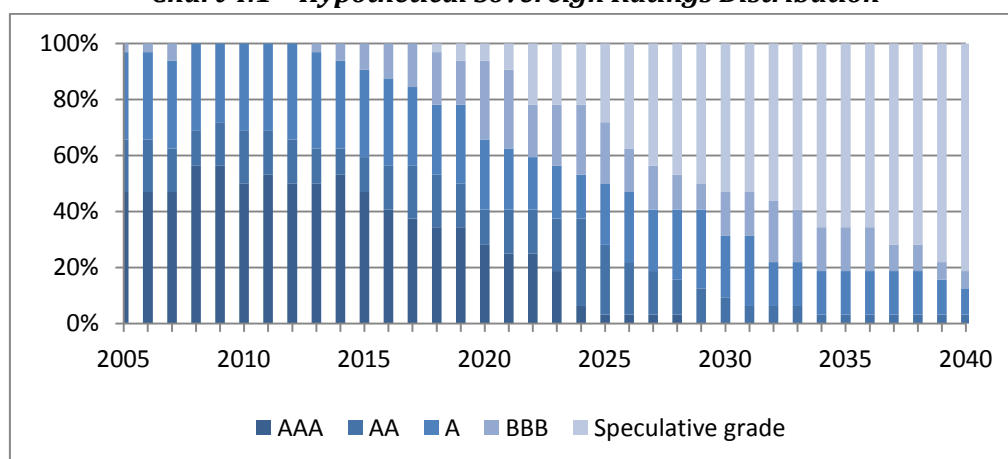
The key elements of age-related spending considered by S&P were the aged pension, healthcare and long-term care.

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

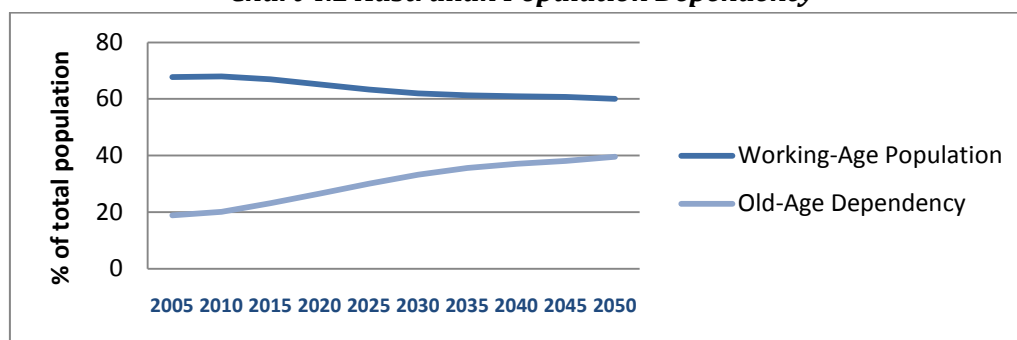
From the mid 2020’s there will be a rapid reduction in the population of working Australians supporting an increasingly ageing population. The demographic profile in Australia shows the old age dependency ratio (population over 65 to working age population) more than doubling over the next 40 years. 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 Grayling 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 Australia¹⁵ 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
	5	0	5	0	5	0	5	0	5	0
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 Economist¹⁸, 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.

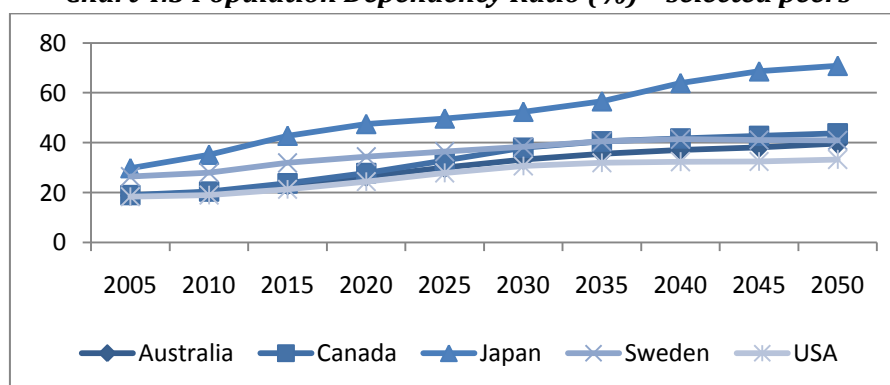
Source: S&P Global Graying Report 2007

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

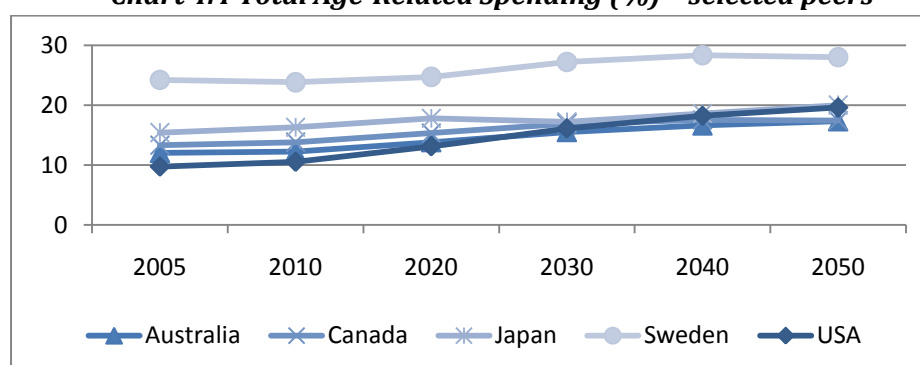
These changing demographics will have profound impact on government spending over the next 50 years. Sweden already has amongst the highest age-related spending in Europe. Its large general government sector, and the significant budgetary call of its public pension, is considered by the rating agencies 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 10% 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 have 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 Japan's 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 overlaid 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.

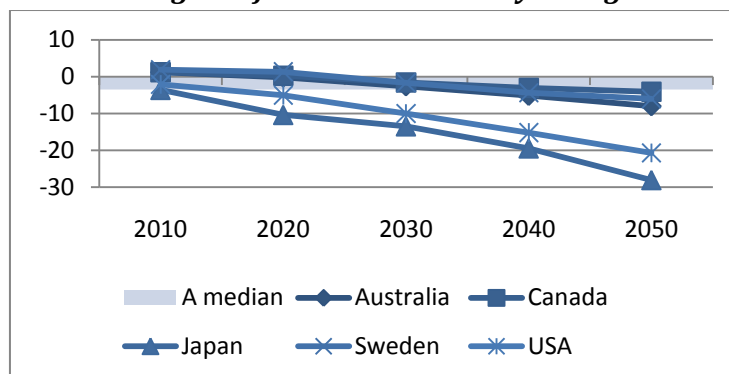
Japan's fast-aging population still poses enormous challenges for the economic system and the fiscal position of the country and it will show the most dramatic deterioration in financial profile under an estimated no policy change scenario. In Japan, the implications for public finances will be severe. 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 its 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.

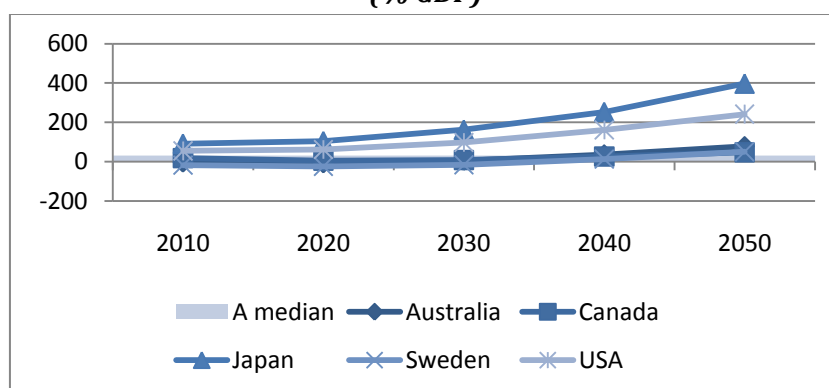
Chart 4.5 Forecast Budget Deficits under No Policy Change Scenario (% GDP)



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's²² 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

	Certain	Conditional	Uncertain
Contractual Obligation	Commonwealth Government Debt	Contingent Liabilities Banks and States	Federal Public Service Pension Liabilities
Firm Policy Commitment			Pensions Social Security and Medicare
Possible Policy Commitment		Implicit State and Local Government Debt	

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 Investments²³ 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 Mercer²⁵ 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 OECD²⁶ 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 OECD²⁷ 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's²⁸ 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 Economics²⁹ 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 2040³⁰. 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. 2012-13³¹	188,175	188,175
Assets backing public annuities based on \$1.03 trillion Superannuation (Mar 2009³²)	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.

Mercer³³ 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 IMF³⁴ 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 Clare³⁵. 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 similar with slight differences of emphasis. The following describes the general approach:

▪ Resiliency 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