Investment & Financial Services Association Ltd
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Langton Crescent
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Dear Tony

IFSA response to the small fund pensions paper

Thank you for the opportunity to comment on the discussion paper on pensions in small superannuation funds.

IFSA has made its core positions clear in a number of public submissions and hearings. IFSA strongly supports the integrity of Australia's retirement incomes system. We have previously placed on record our support for the closure of opportunities used to circumvent the intent of policy settings. To the extent that the 2004 Budget 'integrity measures' regulations aim to close further unintended loopholes in system rules, IFSA supports that aim.

We are making further and more detailed comments in this submission, principally because the implications of the discussion paper extend well beyond small funds into public offer superannuation funds and income stream products offered by IFSA member companies.

IFSA's most crucial concern is that policy and legislative change arising from this process does not lead to new product types or to unnecessarily complex changes to existing products. As we discuss below, most of the objectives of this process can be met through simple changes to existing products, some of which (e.g. increase in term for market linked income streams) would require no changes to products themselves. Significant change will create costs to product providers – which, as we discuss, can be avoided. It is our view that new products should not be introduced to deal with Government's concerns about certain practices in self managed superannuation funds (SMSFs). If new products are need in the market, these should be examined on the basis of detailed research on the needs of retirees as a whole, not just those in SMSFs.

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A pivotal point here is that most or all of retirees' objectives for income streams from small superannuation funds can be met by a judicious combination of allocated and term allocated pensions.

Any review of this area must start from the recognition that SMSFs are funds in which the members are also trustees and consequently dealings within the fund are not at arm's length. This is a critical distinction when considering regulations that apply to large and small funds alike. SMSFs are also not subject to prudential supervision by APRA. It is important to note that some small funds do (or can) have an arm's length arrangement: Small APRA Funds (SAFs) have an approved trustee, which is subject to prudential supervision by APRA. Two IFSA member companies offer SAF arrangements – one has around 5500 SAFs while the other has around 1200.

Retiree needs in small funds

It is worth considering regulation of pensions in small super funds in the light of retirees' real needs for income and flexibility. One of the key reasons many people turned to small superannuation funds in the pension phase was to be able to use growth assets as part of a balanced investment portfolio, while still qualifying for 'complying' status under tax and social security rules. Because of the limitations and guarantees that then applied to complying income streams, these were effectively limited to interest-based investments in retail funds (life companies). These guarantees also meant that on-market complying income streams could offer very little flexibility or control to retirees. The changes to tax and social security rules to give complying status to market linked income streams (term allocated pensions or TAPs) removed this limitation from 20 September 2004.

Anecdotal evidence from IFSA member companies is that there is already a significant use of TAPs among self-managed superannuation funds. We expect this use to continue to grow as financial planners become more familiar with TAP use. Take up of TAPs has been increasing steadily since September 2004 (as yet not all industry data are showing in research reports).

A combination of allocated pension and term allocated pension can give retirees who are affected by tax and social security rules the combination of portfolio flexibility and control in on-market products that was previously only available in SMSFs and SAFs. For many retirees, this will mean that their needs can be met through on-market, arms' length income streams.

The introduction of market linked income streams provides an effective solution for many retirees whose total superannuation assets lie somewhere between the social security assets test threshold and the pension RBL. This solution can be effected though an SMSF, a SAF or a retail fund. Consequently, IFSA does not believe this group will be unduly affected by the regulation preventing small funds from offering a defined benefit pension.

General issues

Defined benefit funds and income streams

The 2004 regulations prevent superannuation funds with less than 50 members providing defined benefit pensions. This means a small superannuation fund

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established after 12 May 2004 will not be able to offer a defined benefit pension. The underlying rationale for this measure is sound: defined benefit arrangements are based on the principle of pooled risk, and below a minimum pool size there would be no real risk pooling.

Superannuation and tax legislation had not previously prevented small funds from providing defined benefit pensions. While small funds' ability to offer defined benefit pensions may be seen as a loophole, it has nonetheless been permitted under the law. The process has been that a small fund offers its member a lifetime pension, the rate of which is set by an actuarial calculation to ensure the underlying funds are at least sufficient to meet the income stream offered. Tax legislation then values the pension by multiplying the annual income by a pension valuation factor. This strategy is tax effective where the value of a retiree's superannuation assets exceeds the pension reasonable benefit limit.

The actuarial standards developed to apply to pensions paid from small superannuation funds were effectively silent on the translation of assets held into annual income paid. If government were minded to restore lifetime pensions in small funds, this experience suggests it would be advisable for government to set valuation and incomes parameters in regulation.

Estate planning

IFSA supports sound estate planning – it is a fundamental component of a complete financial plan. We do not consider that the 2004 regulations compromise estate planning principles. These principles are to ensure that, as death is often unexpected, the transmission of remaining assets is orderly and secure.

IFSA research, undertaken in 2001, showed that Australians approaching retirement have a strong preference that any superannuation balance that might remain on death should go to their estate. However, the same sample indicated that they did not necessarily plan to leave superannuation unspent on death – leaving the family home appeared to satisfy the bequest motive. People in our sample did not intend to live less well in retirement to create a larger estate.

From this research, we can surmise that the most attractive aspect of complying income streams in small funds has been that any superannuation balance would pass to an estate on <u>early</u> death. Term allocated pensions, complying fixed term income streams and allocated pensions all pass any remaining amount of capital to an estate on early death. Both allocated pensions and term allocated pensions can be offered through an SMSF or a SAF.

IFSA suggests that some of the estate planning motive attributed to SMSFs and SAFs can now be met by a combination of allocated pensions and term allocated pensions, whether through a small fund or through a retail fund.

There are issues of concern to public policy in estate planning in small funds. Where estate planning is referred to in the context of lifetime pensions in small funds, and particularly where the regulations have been criticised, a very different process may be at play than in on-market lifetime annuities. The SMSF process appears to involve the accretion of assets to transmit to the next generation. Accumulating and

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transmitting assets via estate is, of course, a perfectly proper practice. What is not appropriate is the use of concessional tax arrangements intended for other purposes to shelter those assets while they accrue, and/or the indefinite deferral of tax on transmission of those assets via an estate.

A particular issue that arises with lifetime pensions in small funds, and especially in single member funds, is that the risk pooling essentially takes place between the retiree and her or his heirs - via the fund's reserve. This process ensures that a significant proportion of retirement savings will pass to succeeding generations in almost all cases. In a genuine risk pool in an on-market annuity, the risk pooling takes place among the retirees in a given cohort, and is expended by the longest survivors of that pool. In a small fund, the purported pooling occurs via a necessarily conservative income calculation, and significant amounts thus pass into estates or to the next generation within the fund (i.e., reserves are distributed to the accounts of other members).

Consequently, policy for estates created in this way should be ideally to recoup the tax forgone by the Australian community in the concessional tax environment of superannuation. It is even more inappropriate that these monies should pass at low or no tax to succeed generations, compared to asset accumulation and holding options outside superannuation. Obviously, passing superannuation on to dependants in the concessional environment is entirely appropriate.

Valuation of pensions in small funds

The 'RBL compression' strategy used in small funds appears to be applied to achieve a lower value of the retiree's superannuation assets for taxation (RBL) purposes than would occur if the assets or interests were valued directly. A lower asset value for social security means testing can also be achieved this way, although some mitigation would occur if a deprived asset arises under social security law. Many commentators have opined that these outcomes appear to be the main motivation behind the use of defined benefit pensions in self-managed superannuation.

As the discussion paper points out, this issue can be resolved by using the asset value of the retiree's holding in a small superannuation fund to value her/his interest for RBL and asset test purposes. This would be an equitable approach, as it includes the value of all superannuation assets within the fund (and within the members' control in a SMSF) for tax and social security purposes.

To be effective, this valuation needs to include the value of a given member's share of the small fund's reserve(s), if any exist in the fund. IFSA suggests that the legislation require an equitable allocation of any reserves as a critical requirement for valuation. "Equitable allocation" should include consideration of valuation at commencement (or subsequent contribution) and income drawing.

Term and flexibility / income smoothing reserves

IFSA considers these issues can be addressed via simple changes to market linked income streams – see our comments below.

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Longevity risk and insurance

IFSA would be happy to support a project to examine options for longevity insurance in superannuation pensions, however we do not believe a scheme should be developed until further research is undertaken. A number of similar schemes have been proposed internationally, and some commercial products developed in Australia. None have met with any success, because this is a complex and difficult area, and because market demand has not eventuated.

The issue of longevity risk, and the ability of private pension systems to provide for it, has been a slow-burn issue in retirement income provision.

A key factor affecting the capacity of the private superannuation system to underwrite retirement incomes is the uncertainty of life expectancy of retirees. Future life expectancy is very hard to quantify, particularly because of likely future advances such as in genetic medicine. The longevity of a given age group (whole cohort) could well increase quite significantly, and this is a very different risk than intra-cohort longevity risk.

The challenge in market provision of retirement income stream products such as lifetime annuities is to match the premium charged for the benefit of security to the potential costs and risks the provider must bear. The uncertainty around longevity risk means it is difficult, if not impossible, to reinsure longevity risk. Much of the risk simply cannot be sufficiently quantified or priced. Providers effectively must carry this risk on balance sheet – and there are limits on private capacity to do this. The current volume of lifetime annuities is very small, and there is no real capacity for the market to take on more risk should demand increase.

Given the level of uncertainty, answers are not likely to appear quickly. Dialogue about the respective roles of the private market and government in income stream provision could help expose the implicit assumptions in public policy.

Outside the small lifetime annuity market and remaining lifetime defined benefit pensions in public and corporate superannuation plans, longevity risk is ultimately met by the age pension. Given that retirees themselves overwhelmingly prefer account based income streams to lifetime annuities, those who survive longer than their capital will then qualify for age pension. This income trend matches many retirees' expectations that, health and personal care costs aside, their consumption needs will be lower in very old age, and could perhaps be met from the age pension. The treasury Retirement Incomes Modelling group increased its estimate of future pension outlays from 4.6% GDP to 5% GDP in 2003, as a consequence of new longevity estimates.

In the long run, the benefits of increased longevity will flow into national income. As national income rises, government revenues will also rise from both consumption and income taxes. General productivity rises should also flow into equity investments. However, long term fixed interest investments, such as those that fund lifetime annuities, are least likely to benefit.

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Residual Capital Value

The discussion paper suggests that one option would be to require that annuities and pensions have no residual capital value (RCV).

IFSA strongly opposes this suggestion.

There is a small but significant ongoing use of on-market, arm's length annuities with RCVs above zero. Anecdotal evidence is that they are used by retirees (in particular by risk-averse retirees) to give predictable income over a set period while preserving a target amount of capital. This residual capital is usually applied to a subsequent income stream.

The value of these income stream purchases in the following quarters was:

Quarter to:	$million
December 2004	94
September 2004	115
June 2004	93
March 2004	108

Since these income streams do not have complying status, they do not give rise to avoidance problems.

Allocated pensions

Minimum / Maximum drawdown

IFSA strongly recommends that the factors for minimum and maximum annual income from allocated pensions be reviewed to reflect increase life expectancy. The discussion paper points out that the pension valuation factors have not been updated since 1992, despite subsequent changes to the Australian Life Tables. We strongly agree that the factors are now significantly out of date.

Revised drawdown factors in APs will address some of the concerns people using small superannuation funds have sought to resolve via DB pensions – namely that retirement savings may run out early. A revision to reflect longer life expectancy will help people using APs in small funds and on-market offerings spread their capital drawdown over the whole of retirement.

Market linked and other complying income streams

The discussion paper canvases a number of income flexibility and term issues around pensions from small funds. It is clear that these can be addressed effectively through changes to the rules for market linked income streams.

Where appropriate, the changes recommended below should be applied to other complying income streams.

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Longer terms

IFSA recommends that the maximum term for MLIS / TAP be extended to address concerns that income will not last long enough.

We suggest that the new maximum term be life expectancy at commencement age, less 8 years, rather than the current age less 5 years. Where a TAP with automatic reversion to a spouse is purchased, the maximum term should be the life expectancy of the longer liver at commencement age less 8 years.

Longer terms are the most significant change to complying income streams, because they will have most impact on annual income and asset longevity.

Refresh to TAP Terms

IFSA recommends that TAP purchasers be able to refresh the term of their income streams at appropriate intervals.

Refreshing the term based on life expectancy would give TAP products part of the desired features of a lifetime income stream, but with the benefits of higher earnings from a more growth-oriented investment portfolio. Currently, TAP users can commute and re-start their income stream at any time, and so could achieve this result - but this is a burdensome process. The ability to refresh would avoid this administration cost.

The commute / restart also involves significant advice and disclosure burdens, the costs of which are ultimately borne by the retiree. Additional burdens are imposed on the ATO too with reporting, calculations and assessment of rolled over amount, and new assessment of new income stream.

IFSA suggests that the ability to refresh the term be available at five year intervals.

Commutation on first death

IFSA strongly recommend that social security rules be re-written to allow TAPs with automatic reversion to a spouse to be commuted to a lump sum on first death.

We made a strong case for this flexibility during the development of TAP rules in 2004. Briefly, this flexibility is desirable because death is by definition uncertain, and will in almost all cases change the survivor's life circumstances dramatically. The ability to commute to a lump sum is an important option at this point.

Adding this flexibility will provide some further comfort to retirees in small funds who might otherwise prefer to use a lifetime (defined benefit) pension.

Income flexibility

The discussion paper suggests that some income flexibility might be made available in TAP / MLIS. We would note that moderate income flexibility will have a lower impact on annual payments than will a modest extension to the available term of a TAP.

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IFSA suggests that income flexibility is in effect the same as allowing a smoothing reserve, but is a much simpler mechanism. It can also be designed to remain proportional to the remaining balance under the current fixed annual drawdown, limiting the build up of inappropriately large reserves for estates.

If flexibility is to be provided, IFSA strongly recommends that it be as simple as possible, and that it affect as few of the MILS variable as possible.

The proposed model would allow for an annual income amount between the previous year's income and the amount given by the formula for the current year. This approach is feasible, but might involve more complexity than a simpler approach

IFSA sees and alternate way to achieve the same result, more simply. All that is required is the ability to multiply of the result of the current annual calculation by a factor. If plus or minus 5% is the desired variability, the factor would be a number between 0.95 and 1.05, and so on.

Use of the factor, and the actual factor selected, should be entirely optional for both funds and retirees.

The resulting formula would be:

> **AB/PF x factor**
>
> Where the factor is a number between (desired lower factor) and (desired upper factor).

Commencing retirement income streams after retirement

IFSA strongly recommends that, following this review, retirees be able to commence income streams (in particular APs and TAPs) with ordinary money. The simplest way to achieve this, IFSA believes, is to provide a new contribution category for people aged over 65 to contribute after-tax money to a superannuation fund provided that the contributions are applied to an income stream that commences immediately.

These retirees have largely missed out on the benefits of the compulsory superannuation system and, aside from significant exceptions (such as those who were employed for long periods by a public sector employer or a large private sector company with comprehensive superannuation arrangements), generally do not have significant funds within the superannuation system.

The recent rule changes relating to acceptance of contributions fin respect of those who are over age 65 and perform some level of work is a valuable improvement for a category of the "over 65s", but a far more significant improvement would be to enable all people over 65 to contribute to superannuation provided they immediately applied the contribution towards an income stream benefit.

The Government would need to satisfy itself of the revenue and social security implications of this measure, but it is suggested that there is a strong prospect that it will form the view that any costs are outweighed by the benefits. The measure would be a major initiative with considerable electoral appeal amongst retired Australians. In my view it could be implemented relatively quickly, in 2005. The measure would

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enable all superannuation funds, large and small, to be used to provide regular income for current retirees, and could be regarded as a positive development not unrelated to the Government's current review of small fund pension offerings.

Term Allocated Pensions for Retirees

As part of our advocacy for the implementation of TAPs, IFSA sought measures to facilitate TAP investment by retirees over age 65.

The Social Security Act changes introduced last year did not distinguish between TAPs funded from superannuation and non-superannuation sources, but the tax/superannuation legislation did. For tax purposes, a TAP may only be funded from superannuation sources. Retirees over the age of 65 cannot contribute to superannuation.

As a consequence, the only means by which these retirees can invest in an income stream that attracts partial assets test exemption is to purchase a "complying" lifetime or life expectancy annuity from a life office. In other words, they are faced with:

- investment in a product which produces a return which, albeit fixed, can be expected to be inferior to the sort of returns produced by market-linked products; and
- a lack of competition (if one compares the limited number of life offices as compared to fund managers or large super funds generally).

Treasury acknowledged these and other underlying reasons for the introduction of TAPs. These reasons apply equally to those who are retired and do not have superannuation.

There are two ways of dealing with this issue:

- introduction of a non-superannuation TAP vehicle for tax purposes, such as a life annuity (albeit that this does not address the competitive issue raised above), along with attendant prudential controls; or
- introduction of a relatively simple amendment to superannuation legislation enabling people over 65 who cannot otherwise contribute to super to do so provided they immediately commence a TAP.

From the Government's perspective, a key purpose of providing the incentive for people to acquire partially assets test exempt income streams is essentially to ensure that they draw down of their own savings capital in a steady, regular way throughout their retirement.

From the retiree's perspective, the partial assets test exemption may be of particular appeal in a variety of circumstances, including to address plans to downside their home or otherwise change their residential arrangements.

Allocated Pensions for retirees

IFSA suggest that contribution into an AP that commences immediately should be available to retirees, because many of the same principles apply. Note that, whilst for many of these retirees ordinary APs would not provide significant tax or social

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security advantage (many pay no tax given the CGT discount and SATO and there is no assets test exemption) they have the appeal of significant administrative simplicity as a means by which retirees can receive a regular source of income.

From a public policy perspective, access to APs after retirement would assist retirees who receive significant capital sums to draw income from that capital in an orderly manner and across their remaining retirement years. In essence, an allocated pension is a way of receiving regular income payments without having to realise particular assets and cope with CGT and other tax implications as a consequence. Again, it is a means of encouraging steady, regular drawdown of savings capital throughout the course of retirement.

Thank you for the opportunity to make these comments. Please contact me if you would like to discuss any of the points raised in this submission.

Regards,

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