Sydney

Level 15, 255 Pitt Street
Sydney NSW 2000 Australia
GPO Box 3698
Sydney NSW 2001
www.challenger.com.au

Telephone 02 9994 7000
Facsimile 02 9994 7777

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Tax White Paper Task Force
The Treasury
Langton Crescent
PARKES ACT 2600

Email: bettertax@treasury.gov.au

## Tax White Paper Supplementary Submission on Retirement Incomes

This is a response to the extension of the deadline for Tax White Paper submissions to seek further views on the retirement income system. It follows consultations by Treasury on the Review of Retirement Income Stream Regulation and provides further views from Challenger on three issues:

1. Minimum drawdown rules;
2. Suitable products for inclusion in a Comprehensive Income Product for Retirement (CIPR); and
3. The means test arrangements for CIPRs which should be on a look through basis reflecting their annuity and asset backed components.

## Minimum Drawdown Rules

Currently an aged based minimum drawdown schedule and other SIS pension rules are used to ensure that the tax preferred status of superannuation pensions is not used for unreasonable tax deferral or estate planning purposes at the expense of providing retirement income.

The current SIS superannuation pension rules and in particular the minimum drawdown schedule restrict the introduction of a greater range of longevity products, for example DLAs (deferred lifetime annuities) and GSAs (Group Self Annuities). In the current low interest rate environment the minimum drawdown schedule also makes it difficult to offer lifetime annuities with CPI indexation.

Treasury are consulting with the industry on reforming these arrangements by providing two categories of pension products:

- Category A, which replaces the minimum drawdown requirements with a capital depletion rule restricting access to capital over time to a regulated maximum; and
- Category B, which does not restrict access to capital and continues to be subject to minimum drawdown requirements.

## Category A

Category A would provide new flexibility in the following forms:

- No minimum payments;
- No restrictions on deferral periods;
- Full variability of annual payments; and
- Restricted access to capital would be allowed but not required.

**Melbourne** Level 19, 31 Queen Street PO Box 297, Flinders Lane, Melbourne VIC 3000 Telephone 02 9994 7000 Facsimile 02 9994 7777
**Brisbane** Level 9, 241 Adelaide Street GPO Box 3234, Brisbane QLD 4001 Telephone 07 3136 5400 Facsimile 07 3136 5407
**Perth** Level 5, 50 Georges Terrace, Perth WA 6000 Telephone 08 9261 7412 Facsimile 08 9321 5277
**Adelaide** Level 7, Suite 714, 147 Pirie Street Adelaide SA 5000 Telephone 08 7071 7042 Facsimile 08 8227 0395

Category A would assume longevity protection with restrictions on access to capital in the following forms:

- Commutation amounts;
- Death benefits;
- Withdrawal from the product (surrender); and
- RCVs (residual capital values).

The rules for Category A would provide for the bulk of capital to be drawn down over the course of the person's retirement, unless they commuted or died early in retirement.

### Death benefits

In a choice environment death benefits or guarantees are necessary to overcome behavioural biases associated with purchase of pooled longevity products because many individuals put undue focus on the lower probability of dying early than the higher probability of outliving their savings. The probability of death soon after preservation age or the age of eligibility for the Age Pension is quite low.

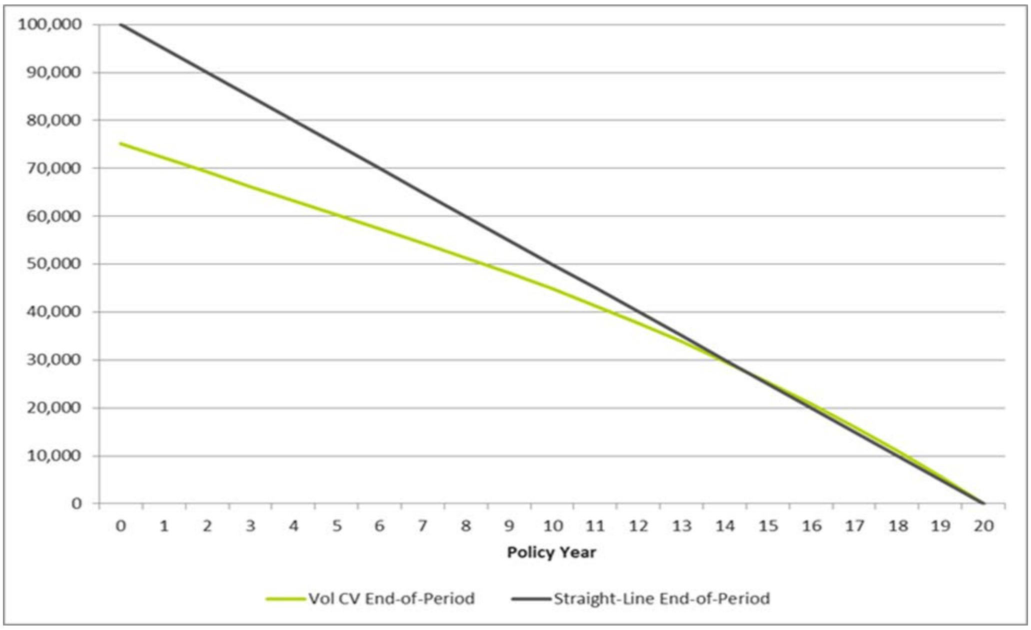
Actuarial investigations of the effect on pricing of offering a 100% death benefit to lifetime annuitants for a period up to life expectancy show a relatively small trade-off with retirement income. Death is a rigorous test so permitting death benefits up to 100% of the nominal value of purchase price for such a period will not jeopardise the objective of ensuring superannuation tax concessions are not used for undue tax deferral or estate planning purposes at the expense of retirement income.

### Commutation and surrender values

The capital depletion rule sets a maximum for commutation and surrender values as a straight-line with a gradient equal to purchase price divided by the term of the product or life expectancy. This is a maximum and product providers will not be required to provide the maximum.

Providers of longevity risk products are unlikely to offer a known set of commutation values over time such as those provided by the capital depletion rule because of the cost of providing a long period of optionality. To avoid that cost, commutation or surrender values would be offered on an interest rate adjusted basis. Surrender values calculated in this way have no cost to the policy and so are not at the expense of retirement income.

**Figure 1: Minimum Surrender Values for Fixed Term RCV0 Annuities**




Source: Challenger

Under APRA prudential standards fixed term annuities must have a minimum surrender value. The APRA prudential standard also requires that lifetime annuities that have death benefits also have surrender values. The surrender values are calculated on the difference between the rate of the annuity, current market rates and the remaining term of the annuity. Figure 1 shows the minimum surrender values for a fixed term RCV0 annuity under current market conditions for a 65 year old male. Surrender values are the net present value of future payments and for most of the term are below the maximum requirement for Category A. However, toward the end of the term the surrender value will exceed the limit set by the capital depletion rule by a very small amount. The same issue arises for minimum surrender values for lifetime annuities which have a death benefit. For the avoidance of doubt about the treatment of surrender values, and to include both fixed term RCV0 annuities and lifetime annuities in Category A, it will be necessary to allow surrender values to exceed the capital depletion rule but only where that is required by an APRA prudential standard.

## Longevity pooling

The purpose of Category A is to accommodate a greater range of pooled longevity products.

Because lifetime annuities and DLAs provide a high level of income security Category A would best be confined to guaranteed longevity products. However, it could also accommodate GSAs (Group Self Annuities) which meet the capital depletion rule if adequate pooling is provided.

Longevity is highly idiosyncratic so it is not possible to provide reliable pooling without a sufficiently large pool of lives. This rules out pooling within an SMSF or small APRA regulated fund. This does not stop members of SMSFs or small APRA regulated funds using part of their retirement balance to obtain longevity protection. They can do this by participating in effective pooling arrangements outside the fund by purchasing a lifetime annuity, which would provide a guarantee and also inflation protection if they so choose.

## Fixed term RCV0 annuities

RCV0 (Residual Capital Value 0%) long tenor (life expectancy) fixed term annuities by their nature pay-down capital over time and are treated as doing so on a straight-line basis over their term for both tax and social security purposes.

As a fixed term product to life expectancy they do not provide full longevity protection. At least half of retirees would outlive them. Nevertheless they have a prudentially regulated guarantee and provide a secure but partial form of longevity protection. Some superannuation funds use fixed term annuities with terms that exceed average life expectancy by 5 years as a component of their pension offerings. Allowing for payments beyond life expectancy increases the probability that the income stream will last for the retiree's full lifetime.

Under current market conditions a CPI indexed fixed term annuity to life expectancy will not meet the minimum drawdown rules so the products used for these purposes are currently not able to be indexed. Inclusion in Category A would allow retirees to choose a fixed term annuity which is guaranteed to manage inflation risk.

## Account based products without adequate pooling

ABPs (Asset Backed Pensions) and other products without an adequate pooling mechanism should not be included in Category A because their structures are inherently in conflict with meeting the capital depletion rule. Inevitably there will be proposals from some product providers and SMSF advisers for deferred ABPs. These will be structured to avoid the minimum drawdown rules for the purpose of tax deferral and estate planning. Providers may formulate rules which restrict access to capital, but without an effective pooling mechanism which absorbs death benefits that would otherwise be paid above the maximum, there will undoubtedly be pressure on the integrity of the capital depletion rule. All such products should be placed in Category B where they will continue to be subject to minimum drawdown requirements.

## Indexation arrangements

Since 1 July 2007 lifetime annuities have met the SIS pension rules if they are paid at a:

- Fixed rate;
- Fixed rate of increase (with a maximum prescribed by APRA under prudential standards);
- Indexed by inflation (eg. CPI); or
- Indexed by wages (using an ABS wage index).

Since the introduction of these rules no annuities have been sold with ABS wage indexation because of the lack of appropriate hedging instruments which would reflect movements in general wage increases.

We understand that under Category A life offices will be permitted to offer a guaranteed market index linked lifetime annuity provided it meets the capital depletion rule.

Category A should contain pooled products which meet the capital depletion rule, in particular:

- DLAs (deferred lifetime annuities);
- ILAs (immediate lifetime annuities);
- Fixed term RCV0 annuities with long tenors; and
- GSAs (Group Self Annuities) with appropriate pooling.

## Category B

Category B should contain those products which do not meet the capital depletion rule and so are excluded from Category A:

- ABPs (Asset Backed Pensions);
- VAs (variable annuities) which have full access to capital;
- Fixed term RCV0 annuities with short tenors;
- Fixed term annuities with an RCV;
- Lifetime annuities with features that do not meet the capital depletion rule; and
- GSAs without adequate pooling or which don’t meet the capital depletion rule.

Category B products would be required to meet minimum drawdown requirements as they currently do:

- Lifetime annuities in the first year;
- Fixed term RCV0 annuities in the first year;
- Fixed term annuities with an RCV in all years;
- ABPs in all years;
- VAs that do not meet the capital depletion rule in all years; and
- GSAs that do not meet the capital depletion rule in all years.

## CIPRs

The FSI (Financial System Inquiry) recommended that:

*“The Government should require superannuation trustees to pre-select an option for members to receive their superannuation benefits in retirement. Details of the pre-selected option would be communicated to the member during their working life. At retirement, the member would either give their authority to commence the pre-selected option or elect to take their benefits in another way. This approach would simplify decisions at retirement and deliver better outcomes for retirees. No income stream would commence without the member’s instruction.*

*The pre-selected option should be a comprehensive income product for retirement (CIPR) that has minimum features determined by Government. These features should include a regular and stable income stream, longevity risk management and flexibility. CIPRs would be low cost and include a ‘cooling off’ period. Their design could vary with the member’s known characteristics, such as the size of their superannuation benefits, and take account of the possibility of cognitive impairment at older ages.*

*A combination of underlying products would likely be required to provide these features; for example, an account-based pension paired with a product that provides longevity risk protection. To offer these products, funds may need to partner with another provider, such as a life insurance company.*

*Regulatory impediments to developing retirement income products, which include tax policy settings, need to be removed. These changes should not discourage the use of CIPRs or other products that provide longevity risk protection."* (Final Report of FSI page 117).

The Final Report of the FSI noted that: *"Despite the heterogeneous nature of retirees, at least 94% of pension assets are in account based pensions, which provide flexibility but lack risk management features and may not deliver high levels of income from a given accumulated balance."* (FSI Final Report page 120). The Henry Review noted that, *"an allocated pension cannot ensure security of retirement on its own*." (AFTS Final Report page 118).

As noted by the FSI, CIPRs should be a combination of an account based pension, which would provide flexibility, paired with a product that provides longevity risk protection.

There are a number of means by which Government could influence the minimum requirements for CIPRs:

A. They could be determined solely by trustees, that is not by government, with a probable result being a limited change to existing superannuation pension offerings for many retirees;
B. Prescriptively by regulation, which would be cumbersome given the range of needs of individual retirees, stifle future innovation, and could imply vicarious liability of government in the event of adverse outcomes;
C. Broad parameters set by Government;
D. Determined by trustees with a statutory obligation that they attend to the requirements to provide: regular and stable income; longevity and inflation risk management; and flexibility. This could be achieved by amending section 52(2)(f) of the SIS Act, as recommended by the Cooper Review.

A combination of approaches C and D would be effective, C providing general guidance in relation to the use of a range of products or product features to meet retirees' needs and D providing obligations on trustees to manage risk and provide stable income with some financial flexibility.

Broad minimum requirements could be specified by the Government in one of two ways:

1. A combination of account based pension features and pooled longevity products which could come from either Category A or Category B; or
2. A combination of products at least one of which must come from Category A and at least one of which must come from Category B.

The latter would provide a more robust solution for providing both longevity protection and flexibility.

Because retirees are not heterogeneous, public offer superannuation funds will need to develop a number of CIPR solutions to meet the differing needs of the various segments of their membership. This is a function that trustees are best placed to manage.

## Means Test Treatment of CIPRs

## Existing means test arrangements

Account based products, which give unlimited access to capital, are subject to deeming. Fixed term annuities with tenors of five years or less are also deemed.

Long tenor RCV0 annuities, both fixed term and lifetime, are income tested on the basis of income received minus an annual amount which is calculated by dividing the purchase price by the term of the annuity or life expectancy. This is known as the deductible amount. These arrangements take account of the loss of access to capital and the actual annuity rate being paid, including any indexation factor.

It would be inappropriate to apply deeming to lifetime annuities because they pay a fixed rate, subject to indexation, whereas the deeming rate is periodically adjusted in response to changes in market conditions and will from time to time rise above the rates paid on in force annuities. The probability of such discrepancies would severely reduce retirees' willingness to utilise guaranteed longevity protection.

## AGA report for FSI

The FSI commissioned a report from the AGA (Australian Government Actuary); *"Towards More Efficient Retirement Income Products"*. Amongst other things, this report compared the means test treatment of ABPs and lifetime annuities on current rules, as well as GSAs, deferred GSAs and DLAs on a theoretical basis.

These theoretical comparisons assumed:

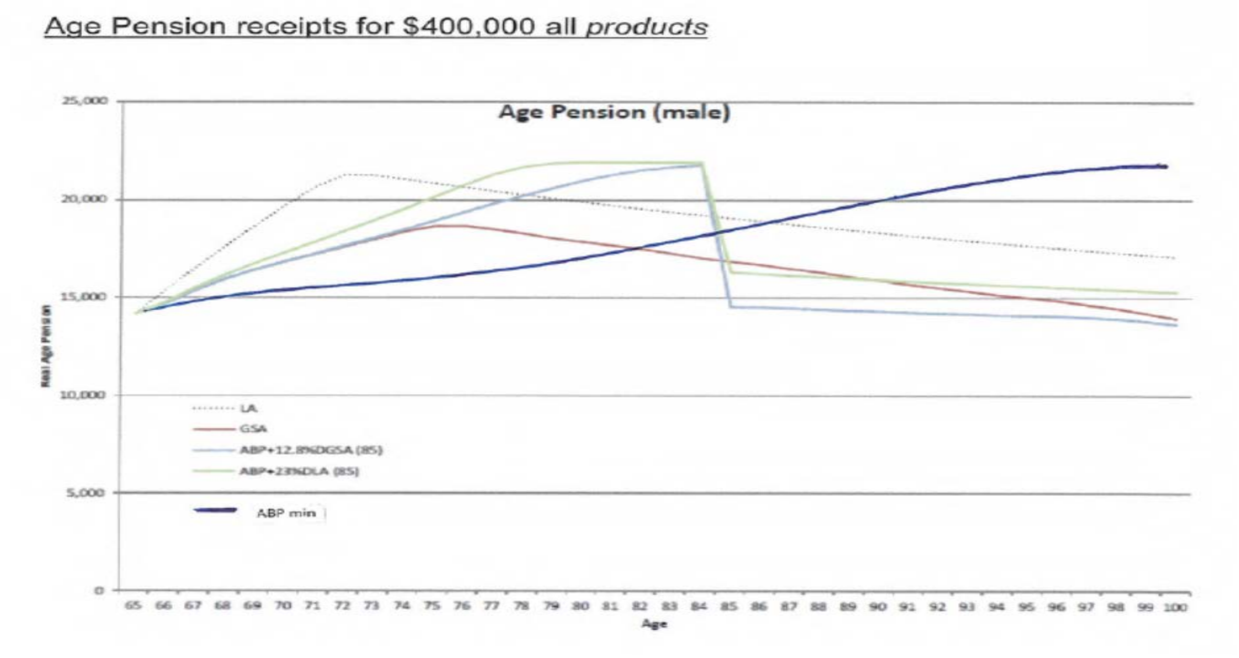
- The application of the income test to the GSA is on the same basis as a lifetime annuity, that is the actual payment less an amount for a return of capital. The assets test would apply to the GSA's notional balance. Deferred GSAs are treated as providing no income during the deferral period.
- The DLA was given an asset value equal to the purchase price during the deferral period with no reduction for return of capital. In the payment phase, the DLA is treated in the same way as a lifetime annuity. DLAs were treated as providing no income during the deferral period.

While non-commutable DLAs should be treated as a risk product and not subject to the means test during the deferral period, as noted by the Henry Review; *"given the unique nature of deferred annuities, there is a case that they should only be means tested when they start to pay an income, unless a person can access the capital before this time"* (AFTS Final Report page 126), the AGA's means test treatment would be workable for DLAs generally.

The AGA paper noted that the means testing arrangements do not appear to be product neutral and proposed two principles for dealing with this:

1. It would be desirable that two people with the same means should have the same age pension outcome.
2. It would also be desirable that if a person's means do not change from year to year their age pension outcome should not change.

### Figure 2: Pension Receipts for Lifetime Annuities, DLAs, GSAs and deferred GSAs




Source: Australian Government Actuary

The AGA paper noted that:

- ABPs are the dominant retirement product in Australia and involve an unavoidable trade-off between living standards during early retirement and the risk of running out of money.
- Both lifetime annuities and GSAs involve some loss of flexibility for retirees compared to ABPs.
- Product combinations consisting of pooled longevity products and ABPs can deliver more retirement income than an ABP alone and retain a degree of flexibility.

The FSI said 94% of retirement products sold are ABPs but these do not have the features necessary to manage the principal risks in retirement. Both the FSI and AFTS found that a combination of products are required to provide for retirees needs. While in a choice environment many retirees may choose only one retirement product, the purpose of CIPRs is to facilitate more retirees using a combination of products which better meet their needs. CIPRs should include in different combinations, depending on retirees' circumstances, an ABP and a pooled longevity product. The latter might be immediate or deferred.

While it is appropriate for means testing to be assessed on a product type basis to reflect different product features (e.g. depletion of capital, longevity protection, indexation and prudential backing) and to assist with addressing behavioural biases which exist with the take up of certain retirement income products, the effect of means testing outcomes will be on an overall portfolio basis which will include the combination of products used.

Once a superannuation balance is divided into products with different purposes in providing retirement incomes, and different risks, the products do not provide the same means.

Retirees using a combination of products to meet their retirement needs can expect that their incomes will vary from year to year, including by market performance and indexation of both annuity income and Age Pension entitlement.

Importantly the AGA noted that deferred products result in a "cliff shift" in the effect of the age pension means test. This "cliff shift" is the result of both deferral of income and preparedness of retirees to risk part of their capital to earn mortality credits. These mortality credits provide the added benefit of providing longevity protection to those who they predecease.

The AGA's graphs show that the current means test treatment for ABPs results in a lower early draw on the age pension but that draw grows steadily as retirement progresses. Pooled longevity products exhibit the reverse profile with a higher draw on the age pension early but which declines as retirement progresses. This is most marked by the"cliff shift" for deferred products at the point where they start to pay long surviving retirees an income.

A CIPR should be means tested on a look through basis, to the components of the product. This will deal with the components appropriately and provide a more even stream of age pension income over retirement.

## Conclusion

Challenger appreciates the continuing opportunity to contribute to the process for developing retirement incomes policy. We would be pleased to provide any further information or data you may require. We look forward to the opportunity of providing efficient longevity insurance to Australian retirees as soon as the legislative and regulatory impediments can be removed.

Yours sincerely

D. A. Cox

David Cox

Head of Government Relations