



# **Review of retirement income stream regulation**

**Submission by UniSuper**

**5 September 2014**



## About UniSuper

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UniSuper is the superannuation fund dedicated to people working in Australia's higher education and research sectors. With more than 448,000 members and \$41.3 billion funds under management (as at June 2014), UniSuper is one of Australia's largest superannuation funds and has one of the very few open defined benefit schemes. We have a strong history of providing retirement incomes to members for over 30 years.

This submission has been prepared by UniSuper Management Pty Ltd (ABN 91 006 961 799), which acts as the administrator of the Trustee, UniSuper Limited (ABN 54 006 027 121).

We welcome the opportunity to discuss the submissions further and to provide additional information in respect of our comments. Should you have further queries, please contact Benedict Davies on (03) 9910 6670 or [benedict.davies@unisuper.com.au](mailto:benedict.davies@unisuper.com.au)

## Overview

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UniSuper has a long history of providing retirement incomes to its members, and we currently offer the “full-suite” of pension products allowed by law. We are strongly committed to developing new retirement income stream products and we have undertaken considerable research of pooled risk schemes overseas. We believe that key features of pooled risk schemes operating overseas could – and should – be brought to Australia and hence we advocate the removal of legislative impediments to their development.

UniSuper recently made a submission to the Financial System Inquiry<sup>1</sup>, suggesting that the Committee make bold recommendations to offer Trustees, acting under a best interests duty, as much flexibility as possible to develop new retirement income products to address the needs of their members.

We echo these comments in this submission.

We believe that Trustees should be surveying not only what currently happens in Australia but also what happens overseas. In our first submission to the FSI<sup>2</sup>, we encouraged the Committee to take note of the retirement systems of the Netherlands, Denmark and Canada. We believe these countries have well-functioning, collective, risk-pooling retirement schemes that could fill a gap in Australia’s retirement income system.

We do not believe, however, that the Government needs to – or indeed should – endorse particular retirement schemes or products. Instead, we believe the outcome should be recommendations for a framework that would facilitate the development of a whole range of retirement products by giving the industry more flexibility. We feel this flexibility would encourage innovation in the industry and would be in all likelihood a better approach than getting government and policy makers to “pick winners”.

Ultimately, the responsibility for developing new products should rest with Trustees – acting under a best interests duty – to understand and respond to the changing needs of their membership. We support the introduction of a retirement income framework, similar to the Insurance Management Framework, that would put Trustees at the forefront of developing appropriate retirement income strategies and products for their membership rather than government-set defaults or the mandating of one form of retirement income product over others.

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<sup>1</sup> [http://fsi.gov.au/files/2014/08/UniSuper\\_Management\\_Pty\\_Ltd.pdf](http://fsi.gov.au/files/2014/08/UniSuper_Management_Pty_Ltd.pdf)

<sup>2</sup> <http://fsi.gov.au/files/2014/04/UniSuper.pdf>

## Regulatory arrangements for superannuation income streams

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### Question 1

What types of income stream products would enable retirees to better manage risk in the retirement phase (in particular longevity risk and investment risk)?

The move away from the pooling of risk, as exists in defined benefit funds, to account-based pensions has moved key risks to individuals. One significant risk is that retirees outlive their savings, and the most commonly used post-retirement product, the account-based pension, does little to address this risk. Collective arrangements, offering lifetime income streams, such as defined-benefit pensions or annuities, require risk pooling and pensioners / annuitants share these risks with others.

We submit that some form of risk pooling – whether directly within a fund or indirectly via capital markets or reinsurance – is required to address longevity risk.

It is important to note that another – and possibly more important risk – is sequencing risk, a significant form of investment risk. This has received little focus in policy discussions to-date and needs to be considered when appraising the design of alternative retirement income products. Sequencing risk can be thought of as the "worst returns in the worst order".<sup>3</sup> For defined contribution-style plans, sequencing risk is heightened the greater a member's portfolio balance; therefore, this risk is typically at its highest as a member approaches retirement and in the early years of retirement i.e. late accumulation and early drawdown. This can be thought of as a "portfolio size effect".<sup>4</sup>

It should be recognised that collective pooled schemes, such as defined benefit schemes, are generally better placed to deal with these risks. That is because the main advantage of a defined benefit scheme is the cost effective smoothing of investment returns, achieved through the collective sharing of risk. While the terms of this Discussion Paper strongly focuses on annuities, we submit that other collective risk-sharing arrangements, such as defined benefit and actuarially-calculated lifetime income streams, have a significant role to play in addressing the key risks described above.

Based on our research, we also believe that many of the benefits of traditional defined benefit schemes can be applied equally to alternative arrangements provided that there is investment pooling and the associated collective sharing of risks.

### Alternative risk-sharing schemes overseas

Pension systems around the world have either been exploring or implementing a new approach to the sharing of risk known under a variety of names including defined ambition, collective defined contribution, or more simply, pooled risk schemes. We believe these developments offer real promise of a new way for superannuation funds to offer their members a retirement income payable for life that collectively shares many of the risks

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<sup>3</sup> Finsia Research Report, "Sequencing risk: A key challenge to creating sustainable retirement income", October 2012

<sup>4</sup> Basu A & Drew M, 'Portfolio size effect in retirement accounts: what does it imply for lifecycle assets allocation funds', *Journal of Portfolio Management*, Volume 35, Number 3 (pp 61-72)

inherent in account-based pensions and reduces the volatility of retirement income outcomes for members.

The UK government has undertaken substantial industry consultation on this issue and the *Pensions Scheme Bill 2014* (UK) is currently being debated<sup>5</sup>. The Bill includes a framework for new shared risk pensions.

Canada is also well down the path to shared risk schemes, having developed “the New Brunswick model” in 2012. The New Brunswick model builds on ideas that were initially developed in the Netherlands and the adoption of this new approach came after a recommendation by New Brunswick’s Pension Task Force in 2011.<sup>6</sup> The New Brunswick government argues that this model is “more secure, transparent and affordable”<sup>7</sup>

As the model was being developed, Canadian pension plans, like many schemes around the world, had recently faced the challenges associated with low interest rates, changing demographics (i.e. longer life expectancy and an aging population) and volatility in capital markets. This combination of factors had the potential to affect the long-term sustainability of some Canadian pension schemes. The shared-risk model appears to be better placed to address these issues because of its focus on robust risk management to promote benefit stability and scheme sustainability.

The new rules allow existing New Brunswick pension plans to offer shared-risk pensions with a target benefit, usually based on an enhanced career average earnings formula. Member benefits are based on a career average salary, with a base benefit that has an extremely strong probability of being achieved. In addition to the base benefit, additional ‘ancillary’ benefits may be provided, including indexation for cost of living changes. Indexation is not normally guaranteed; instead, it is applied to pensions each year subject to the position of the fund. It is this type of in-built pressure release valve that makes schemes more capable of withstanding capital market shocks.

### **Collective shared-risk schemes offer lifetime pensions and are double default products that should be encouraged**

Defined benefit schemes, as well as newer defined ambition schemes overseas, seamlessly manage the transition from working income to retirement income because they typically pay a lifetime pension on retirement. These products can be thought of as double default products i.e. default products under modern awards as well as being products that include a default retirement income as a key part of their design.

We strongly encourage Treasury to recommend the removal of legislative impediments to the development of risk-sharing schemes, such as Defined Ambition and Collective Defined Contribution (CDC) schemes. Our responses to questions two and three further highlight certain aspects of the SIS regulations that are a significant impediment to the development of innovative retirement income arrangements.

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<sup>5</sup> <http://services.parliament.uk/bills/2014-15/pensionschemes.html>

<sup>6</sup> <http://www.gnb.ca/0062/pensiontaskforce/pensiontaskforce-e.asp>

<sup>7</sup> <http://www2.gnb.ca/content/gnb/en/corporate/promo/pension.html>

## Question 2

Do the annuity and pension rules constitute an impediment to the development of new products and if so, what features of the rules are of most concern from a product innovation perspective?

Yes, the definitions in SIS Regulation 1.06 (and allied definitions in tax and social security law) are unwieldy. While the rules have evolved over many years, they currently include rules that were historically important in defining complying pensions but now act as an impediment to product development.

While some of the existing pension standards continue to be important as integrity measures or for consumer protection, many of the requirements no longer serve a purpose other than to define pensions or annuities, thus designing products. We submit that product design should ultimately be a matter for Trustees acting under a best interests duty and that legislative restrictions should be removed.

Therefore, only those pension standards that serve as integrity measures or as consumer protections should be maintained. The remaining standards in SIS Regulation 1.06, for example, hamper product development and should be rewritten or removed (see Question 3).

## Question 3

What changes could be made to the annuity and pension rules to accommodate a wider range of income stream products while having regard to the need to protect against abuse of the earnings tax exemption and to promote appropriate and prudent retirement income objectives?

Account-based pensions are fairly straightforward and there are far fewer restrictions on those compared to lifetime pensions. Therefore, our comments focus on lifetime pensions in SISR 1.06(2). UniSuper currently pays two types of lifetime pensions: defined benefit pensions and purchased lifetime pensions (which we call Commercial Rate Indexed Pensions or CRIPs).

The SIS pension regulations (SISR 1.06) contain a complex mix of rules. Some of the rules are integrity measures and are essential protections for members. However, some of the requirements arguably are not integrity or consumer protection measures and simply have the effect of legislating product features. We submit that only the integrity and consumer protection measures are necessary; the other rules act merely as impediments to the development of new products.

**Integrity measures vs product design measures - lifetime pensions SISR 1.06(2)**

<b>Sub-Regulation</b>	<b>Comment</b>	<b>Recommendation</b>
a) Annual pension payment	A pension is by definition an annual payment	Retain
b) Size of payment is fixed	<p>This is not primarily an integrity measure, it effectively designs products. The size of payments could be varied based on the performance of the fund / pool. This is a feature of some shared risk schemes overseas.</p> <p>It should be recognised that these rules do not explicitly allow trustees to reduce pension payments following a commutation that is permitted in other sections of the regulations eg release of excess contributions &amp; Division 293 tax.</p>	Remove
c) CPI indexing requirements	This is not primarily an integrity measure, it effectively designs products. The size of payments could be varied based on the performance of the fund / pool eg New Brunswick scheme	Remove
d) Residual capital value	Historically this had been an integrity measure for complying with tax and social security rules. This is no longer the case. If new lifetime pensions come onto the market, Centrelink treatment (eg asset testing & income testing) should look to the product's features rather than compliance with this regulation	Remove
e) Commutation rules	These rules are necessary for integrity. They could be simplified further and need to clearly allow for commutations to meet all ATO imposed super tax liabilities eg Division 293, excess contributions etc	Simplify
f) Reversionary rules	This is primarily an integrity measure	Retain
g) Non transferrable	This is primarily an integrity measure	Retain
h) Cannot be used as security for a borrowing	This is a potential impediment to members getting access to a lump sum to pay for aged care later in life. The consumer protection issues are better addressed through credit law rather than super law. Ultimately, as any borrowing here is not bringing early access to super, members should have the discretion to access their retirement savings in ways that suit them best.	Review

#### Question 4

Would such changes lead to new products being brought onto the market?

Yes. The existing rules are unwieldy and a major impediment to developing new products or refurbishing old products, such as Term Allocated Pensions. There needs to be far more flexibility to allow trustees to develop new products to respond to member needs.

### Deferred lifetime pensions & annuities

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We believe that deferred retirement income products – both annuities paid by a life office and pensions paid by superannuation funds – have a significant role to play in the Australian marketplace. While they are not a panacea for all the risks faced by members, they do address longevity risk better than account-based pensions.

Both superannuation funds and life offices should be permitted to offer these products to their members / customers. Therefore, our comments below relate to both deferred lifetime annuities (DLAs) paid by life offices and deferred lifetime pensions (DLPs) paid by superannuation funds.

We note that super funds and life offices are structurally different and regulated differently. This distinction remains important because products and operational activities of each type of entity are different and it remains appropriate that a super fund's pension promise is not prudentially regulated within the same framework as a life office's guarantee.

#### Question 5

Should people only be able to purchase a DLA with superannuation money?

No. But it must be recognised that if “ordinary monies” can be used to purchase deferred retirement income products, this gives an advantage to annuity providers that is not available to super funds because super funds have additional restrictions placed on them under contribution caps, work tests and a prohibition on accepting personal contributions once a member turns 75

#### Question 6

Should people only be able to purchase a DLA for an up-front premium or should other purchase options also be allowed? If an annual premium approach is allowed, what should be the consequences if the premium payments cease?

Requiring only up-front premium purchases would act as a major impediment to Collective Defined Contribution (CDC) schemes. CDC schemes are conceptually a series of premiums i.e. contributions made over a person's working life that builds a retirement income (i.e. deferral principle) at retirement. CDCs could be developed in Australia by superannuation funds accepting employer and member contributions in exchange for a promised income triggered at retirement. Conceivably, these arrangements could be mirrored by life offices allowing customers to purchase multiple deferred annuities payable at retirement.

Consideration should also be given to allowing members to add to existing pensions i.e. already in-stream payments. This is a major administrative problem for super funds with

members wishing to add to existing pensions small amounts accumulated in other funds or additional contributions. We submit that no great mischief results from this, provided that members aren't contributing funds to pensions that are subject to grandfathering (e.g. most assets-test exempt income streams).

### **Question 7**

Should there be an upper limit on the amount that can be invested in a deferred lifetime annuity?

No. The amount of money committed to a deferred retirement income product should be up to the individual. If a person commits a very large sum, one of two things will happen: the sum on death will either pass into a collective pool (the tontine effect), or, if paid to the member's beneficiaries, will be taxed as a death benefit as currently happens with residual monies in super.

We see no great mischief in allowing members the option to choose how much insurance against longevity they wish to have.

### **Question 8**

Should there be a minimum deferral period for a DLA? If so, what would determine the period?

No. There is little need for a minimum deferral period. Members should be allowed to defer receipt of income for short periods, even as short as 12 months. Ultimately, product providers should be able to set their own rules here in response to market demand.

### **Question 9**

Should there be a maximum deferral age or period? If so, what should it be?

No. Provided that the existing tax rules apply for death benefits paid to "tax law" non-dependants, the end result is essentially no different to a standard superannuation death benefit sourced from a member's residual account-balance. If a member were to defer it to say, 100 years of age, in all likelihood this would be end up being paid as a death benefit and taxed accordingly.

### **Question 10**

Do the payment features described in paragraphs 51 and 52 strike the right balance in allowing people to insure against longevity risk while avoiding unnecessary restrictions on product development?

No. We submit that the features described in paragraphs 51 (i.e. commutability or non-commutability) and 52 (lifetime payments or term payments) are important product features that should ultimately be decided by members or trustees, as appropriate. Provided that existing tax rules apply to death benefits, we see no compelling reason to impose these restrictions.

### Question 11

Should providers of DLAs be able to offer a death benefit? If so, should there be restrictions on the size of the death benefit that could be offered? If so, what restrictions?

Yes, a death benefit should be a permissible product feature of a deferred retirement income product. In many cultures, bequest motives are a significant concern and the inability to make a payment to dependants or to an estate would be an impediment for many people to commit monies to a deferred retirement income product.

From a policy perspective, provided that the existing death benefit tax rules apply, there appears to be little compelling reason to introduce such a restriction.

## Minimum payments for account-based pensions

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### Question 12

Are the current minimum payment amounts for account-based products appropriate to achieve the objectives outlined above, given financial conditions can change?

No. The minimum payment rules should be simplified.

We submit that a flat 4% should be considered for members above preservation age. This flat rate should apply until age 75. We believe that this allows members to protect to “self-insure” their longevity risk i.e. not consume too much of their capital in early retirement and allow members some protection against the worst effects of sequencing risk, allowing them to retain more in superannuation in early retirement.

While we believe a flatter, lower rate of withdrawal is particularly important for the “first” ten years of retirement, once members reach higher ages, roughly 75, we accept that there may be good public policy reasons for an increase to the minimum withdrawal requirement.

### Question 13

Should there be an automatic mechanism for adjusting the minimum drawdown amounts in response to significant adverse investment market performance? If so, what should that mechanism be? How would this also satisfy the rationale for setting minimum payment amounts?

No. Ministerial discretion should be used, occasionally.

### Question 14

Should the minimum drawdown amounts also increase in response to very strong market performance? Would the mechanism be similar to that for decreases? Would this satisfy the rationale for setting minimum payment amounts?

No.

**Question 15**

For how long should the change remain in place? Should it be left in place only for the year in which the shock occurs, or until balances have 'recovered' by a particular extent?

We submit that the temporary drawdown relief that was in place during the economic disturbances of 2008 are best handled by Ministerial discretion that should only be used sparingly. This should not be an on-going policy of adjusting withdrawal amounts in response to economic and financial market cycles.