Australian Government

Review of retirement income stream regulation

Discussion Paper
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CONSULTATION PROCESS

Request for feedback and comments

Interested parties are invited to lodge written submissions on the issues raised in this paper.

Submissions will be made available on the Treasury website unless you clearly indicate that you would like all or part of your submission to remain confidential. Automatically generated confidentiality statements in emails do not suffice for this purpose. A request made under the *Freedom of Information Act 1982* for access to a submission marked confidential will be determined in accordance with that Act.

Closing date for submissions: 5 September 2014

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FOREWORD

The Government is committed to Australia's three-pillar retirement system: an aged pension as a safety net, a compulsory system of retirement saving through superannuation, and tax incentives for voluntary savings.

The Government encourages as many Australians as possible to actively plan and save for their retirement, to take full advantage of the benefits the superannuation system provides and to work toward a self-funded retirement.

Increasingly, Australians are looking for options to better manage the financial risks they face in retirement, such as market risk, inflation risk and the risk that they may outlive their retirement savings. Longer life expectancies and greater expectations of retirement argue for a greater choice of products to provide retirement income.

This discussion paper seeks feedback on the regulatory barriers currently restricting the availability of relevant and appropriate income stream products in the Australian market.

For example, it appears that the current regulations have restricted the development of deferred lifetime annuities—income stream products that allow retirees to achieve income security in their later years. This discussion paper forms the basis for consultation on facilitating these products by extending concessional tax treatment to them.

The paper also seeks to consult on the minimum payment amounts for account-based pensions. The Government understands that the turbulence in financial markets over the past five years has placed the capital value of account-based pensions under significant pressure, which the current minimum annual payment requirement has increased.

We are committed to providing self-funded retirees with confidence that their funds will not run out because of inappropriate forced withdrawals from their pension products. I welcome views on whether the current minimum payment amounts are adequate and appropriate in light of current financial market conditions.

This process will give effect to two of the Government's superannuation election commitments. I welcome comments on the issues and questions raised in this paper.

Senator the Hon Mathias Cormann
Minister for Finance
Acting Assistant Treasurer

INTRODUCTION

Australia's retirement income system is based on three pillars: the Age Pension, compulsory private savings, and voluntary private savings. While the Age Pension acts as a safety net, the main role of superannuation is to improve the retirement income of Australians.

As Australians live longer, the needs of retirees over the course of their retirement will change. With an ageing population, the demands placed on the system to deliver income in retirement will increase.

People face a number of risks in retirement such as investment risk, inflation risk and, increasingly, longevity risk—the risk of outliving one's retirement savings. The Age Pension currently provides a form of longevity insurance. It is also possible to purchase an income stream to supplement the Age Pension or as an alternative to it if people are not entitled to a part pension due to the level of their income and assets.

Retirees are likely to benefit from increased choice in retirement income stream products that can help them manage effectively the variety of risks they face in retirement. Product development and innovation is essential to ensure there is a range of products available that can cater to retirees' different needs and preferences.

That is why the Government has a commitment to review the regulatory barriers restricting the availability of income stream products in the Australian market.

The Government's related superannuation election commitment is to review the minimum payment amounts for account-based income streams, to assess their appropriateness in light of current financial market conditions.

Given their interaction, this discussion paper provides a basis for consultation on both issues.

In addition, on 14 December 2013, the Government announced it would not proceed with the previous government's unlegislated measure to facilitate the provision of deferred lifetime annuities and that it would instead consider the proposal as part of the review of the regulatory arrangements for retirement income streams. This paper also provides a basis for consultation on extending concessional tax treatment to deferred lifetime annuities.

1. THE REGULATORY ARRANGEMENTS FOR SUPERANNUATION INCOME STREAMS

1.1 THE SCOPE OF THE REVIEW

1. There are a number of different elements which form the regulatory arrangements for superannuation income streams. For example, there are specific rules in the superannuation law which define what a superannuation income stream is; there are prudential requirements (such as those in relation to capital adequacy) imposed under the *Life Insurance Act 1995*; there is the tax law, and there are the means tests used to determine entitlement to income support (such as the Age Pension).

2. The purpose of this paper is to review the rules in the superannuation law (the annuity and pension rules) which set out what a superannuation income stream is in order to identify any rules that may restrict the availability of retirement income stream products. The paper also seeks feedback on ways to reduce or remove any barriers without undermining the policy objectives that motivate them.

1.2 OVERVIEW OF THE RETIREMENT INCOME STREAMS MARKET IN AUSTRALIA

3. At a basic level, financial products to provide retirement income can take the form of a guaranteed product (such as an annuity), an investment product with a structured drawdown (such as an account-based pension) or a combination of both. These different types of products are discussed below.[1]

Account-based products

4. Account-based products are the dominant income stream product in Australia. An account-based product is essentially a managed investment with a minimum annual drawdown required by regulation. The minimum drawdown amount depends on the age of the product holder and ranges from 4 to 14 per cent of the value of the pension account balance at 1 July of each year.

5. The relative popularity of account-based income streams is likely to reflect a number of factors. In particular, these products:

   - are flexible and give people control of their capital. The product holder has wide discretion over the drawdown rate (subject to satisfying the minimum payment requirement) and can access the assets in the account balance at any time, features which retirees value highly;
   - offer estate planning advantages over more traditional guaranteed products. On the holder's death, the whole of the account balance can transfer to their dependants or to their estate;
   - allow the holder to select the risk/return profile of the assets held;

1 A superannuation fund will offer a pension through its trust deed whereas a life insurance company will offer an annuity under a contractual arrangement.

- are simple and transparent. As an investment product they closely resemble a superannuation account in the accumulation phase; and
- are less costly for providers than guaranteed income streams as there is no need to hedge or hold capital against investment or longevity risk.

6. On the other hand, a defining feature of account-based products is that the holder bears the full extent of the risks—in particular, investment and longevity risks—associated with the product:
   - investment risk—because the income available is a function of the performance of the underlying portfolio of assets; and
   - longevity risk—because payments are not guaranteed to continue for the remainder of the holder's life.

Guaranteed products (non-account-based products)

7. In comparison with account-based income streams, guaranteed income stream products (which pay a guaranteed income for a defined period of time) represent a much smaller part of the overall income streams market.

8. These products can be payable either for life or for a fixed term. In providing such income streams, life insurance companies in Australia typically bear the full extent of investment risk by guaranteeing to make payments at the contracted level for the term of the product. Such guarantees have associated capital requirements, that is, requirements to have adequate capital backing to ensure the life insurance company can meet its obligations under a wide range of circumstances. In the case of lifetime guaranteed income streams, the provider also bears longevity risk (because the payments continue for as long as the product holder is alive), meaning that there is again a need for capital to back the product.

9. Superannuation funds paying defined benefit pensions face a number of prudential requirements that have the objective of enabling the fund to meet its liabilities as they become due. For example, the fund must obtain regular actuarial certification as to whether there is a high degree of probability that the fund will be able to pay the pension as required under the fund's governing rules.

Fixed term products

10. Fixed term income streams comprise the majority of the guaranteed market in Australia. This segment of the market includes short term (one to five year) income streams which pay a pre-determined residual capital value[2] of between zero per cent and 100 per cent at the end of the term. The residual capital value is constrained by the requirement to make annual payments at the minimum rates applicable to account-based income streams, although applied to the original purchase price rather than the account balance. The residual capital value can be rolled over at the end of the term to buy a new income stream at the prevailing interest rate.

2 A pre-determined capital amount payable to the recipient when the income stream ends.

Lifetime income streams

11. Guaranteed income streams payable for life represent only a small share of the income streams market in Australia. This is likely to reflect a number of factors:

    - The preference retirees have for ready access to capital and their desire to leave a bequest are not well catered for by lifetime products.
    - The majority of retirees already receive a significant part of their retirement income in the form of a lifetime annuity through the Age Pension.
    - Despite the statutory capital requirements that apply to these products, there may be a risk that the provider could fail.
    - Pricing can be complicated. When pricing these products, providers need to take account of selection risk (the fact that purchasers tend to be those with longer than average life expectancies) and the capital backing necessary to support the lifetime guarantees. This means that lifetime income streams may appear not to provide a comparable return to products not offering such guarantees.

Hybrid products

12. A number of hybrid income stream products have emerged onto the market in recent years, partly in response to investment losses experienced by retirees due to the global financial crisis (GFC). These products combine features of an account-based product with an income guarantee which is triggered in certain circumstances—for example, if the account balance is exhausted or falls below a certain level. The guaranteed income component of the product is typically provided by a life insurance company and is typically paid for by a guarantee fee.

Risk characteristics of income stream products

13. Two key risks people face in retirement are longevity risk and investment risk. Income stream products can be characterised according to who bears these risks.

14. Lifetime income streams insure the holder against both investment risk and longevity risk. By purchasing a lifetime income stream a person insures against the risk they will outlive their retirement savings and the risk associated with variability of investment returns. Purchasers of these products effectively trade off access to their capital for the certainty of receiving a guaranteed income for life. Guaranteed income streams payable for a fixed term insure against investment risk for the period of the term, but do not eliminate the possibility that the recipient will outlive their savings.

15. Holders of account-based income streams bear all the investment risk, but can manage their exposure by adjusting the mix of assets in the account. Longevity risk is typically managed by drawing down at the minimum rate. This can result in retirees forgoing income during their lifetime and passing on superannuation savings accumulated for retirement income purposes to future generations.

16. Some hybrid products insure against longevity risk and also involve some sharing of investment risk between the provider and the holder. The provider in effect underwrites investment performance by providing an income guarantee in the event the account balance is exhausted due to poor investment returns.

1.3 THE ANNUITY AND PENSION RULES

17. Superannuation income streams receive concessional tax treatment. Specifically, income derived from assets supporting a superannuation income stream is exempt from tax (the 'earnings tax exemption'). This tax exemption is not available to superannuation assets in the accumulation phase, earnings on which form part of the assessable income of the fund and are taxed at a statutory rate of 15 per cent.

18. In general, the earnings tax exemption is the cause of a number of the restrictions on income stream products, given the need to design various rules around it to constrain the exemption.[3]

19. To qualify for the earnings tax exemption, a superannuation income stream product must meet a set of standards contained in Regulations 1.05 and 1.06 in Part 1A of the *Superannuation Industry (Supervision) Regulations 1994* (the annuity and pension rules).

20. The rules are designed to ensure that superannuation income stream products are used for their intended purpose of providing a regular source of income in retirement rather than simply as vehicles to accumulate or preserve wealth.

21. A basic principle underpinning the rules is that an income stream should represent a series of regular payments over the recipient's lifetime or a fixed term. A related principle is that an income stream should not provide excessive scope for deferral of income.

22. The design of the rules aims to strike a balance between integrity (protecting against abuse of the earnings tax exemption), allowing people choice and flexibility, and ensuring that the rules are objective, transparent and as simple as possible to understand.

23. As part of the 'Better Super' changes in 2007, changes to the annuity and pension rules moved away from detailed and prescriptive rules towards a simpler approach based on general principles governing product characteristics. However, to cater for existing products, the earlier, more complex, rules were also left in place.

3 The *Australia's Future Tax System* (AFTS) review recommended that earnings in superannuation funds be taxed at a uniform rate of 7.5 per cent, regardless of whether they are on assets in the accumulation or pension phase (recommendation 19). The absence of a tax concession specific to the pension phase would reduce the need for prescriptive rules. As such, the AFTS review also recommended removing rules that restrict product innovation (recommendation 21(c)). Without restrictive rules, there would be minimal regulatory restraints on the design of longevity insurance products.

Table 1: Summary of annuity and pension rules

Account-based pensions	Guaranteed income streams
Minimum annual drawdown	Regular payments (or a minimum annual drawdown for a short-term annuity)
Transfer only on death	Transfer only on death
No capital top-up	No capital top-up
Cannot be used to secure a borrowing	Cannot be used to secure a borrowing
	Variability of annual payment limited to adjustments made under an indexation arrangement
	No residual capital value (unless minimum drawdown met)

Complying with the rules

24. In the case of account-based products, the rules specify that a minimum amount must be paid from the product each year. The minimum payment amount is calculated by applying an age-based percentage factor to the value of the account balance at 1 July of the relevant year.

25. Guaranteed income streams can comply with the rules in one of three ways.

- By meeting a more detailed set of rules designed to ensure that the capital supporting the product is converted into a series of regular payments, either over the recipient's lifetime or a reasonable term. This includes restrictions on the variability of annual payments and a requirement that the income stream cannot have a residual capital value.
- By meeting minimum annual payment requirements somewhat similar to those that apply to account-based income streams, but calculated with reference to the original purchase price of the product. Under this approach, the income stream can offer a residual capital value provided it does not conflict with the minimum annual payment requirement. (These rules are mainly of relevance to short term annuities).
- By meeting the standards for so-called 'complying' lifetime income streams. (Under the regime in place prior to the Better Super changes of 2007 noted above, 'complying' income streams were subject to more stringent regulatory requirements and in return qualified for additional tax and social security concessions).

26. Other requirements common to all income stream types are that:

- payments must be made from the income stream at least annually;
- the income stream cannot transfer to another person except on the death of the recipient;
- the capital supporting the income stream cannot be added to by way of contribution or rollover after the income stream has commenced; and
- the capital value of the income stream and the income from it cannot be used as security for a borrowing.

Impact on product development

27. The rules limit the range and features of products that providers can offer. To qualify for the earnings tax exemption, the rules that apply to account-based income streams require a minimum annual payment and the rules applying to annuities include restrictions over the term of the product, variations in annual payments, residual capital value and commutation value.

28. For example, the rule that restricts variations in annual payments to adjustments made under an indexation arrangement in practice limits such products to those that pay a pre-determined level of income each year, and where the amount paid can only vary from year to year under an indexation arrangement.[4] This rule, for example, excludes products that seek to insure against longevity risk by pooling investors and which, as a result, pay benefits that change with the number of surviving pool members.

    28.1. The difference between a pooled annuity and a life annuity offered by an insurer is that participants of a pooled annuity fund bear some longevity risk, while life annuitants do not. If a member of the pool dies, other members benefit from a change in their income.

29. The basic purpose of the indexation rule is to prevent abuse of the superannuation taxation concessions through excessive deferral of income. While removing the rule entirely would open up opportunities for abuse, perhaps a relaxation of the restrictions could allow for pooled products, provided they offer no residual capital value, commutation or guarantee (although they could still offer a reasonably high level of confidence about the level of longevity protection).

Consultation questions

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)?

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?

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?

Question 4: Would such changes lead to new products being brought onto the market?

4 An indexation arrangement is defined in the regulations and means an arrangement that results in the total amount of the pension payment in each year: increasing by the same percentage factor; or being adjusted in line with movements in the Consumer Price Index (CPI); or being adjusted in line with movements in an index of average weekly earnings published by the Australian Statistician; or being adjusted in accordance with movements in CPI or average weekly earnings but with an increase capped at a maximum level; and ensures that, unless the Australian Prudential Regulation Authority otherwise approves, an adjustment is made at least annually to the amount of the pension payments.

2. DEFERRED LIFETIME ANNUITIES

30. One retirement income stream product that could help retirees insure against longevity risk which is precluded by the annuity rules (and the income tax rules) is a deferred lifetime annuity (DLA).

31. A DLA is an annuity that is purchased for an up-front premium where the payments do not commence immediately—for example, the product might be purchased at age 60 with payments commencing at age 85 and continuing for life.

32. As part of this review, the Government is considering the possibility of extending to DLAs the same concessional tax treatment that applies to investment earnings on assets supporting superannuation income streams, to facilitate their provision and help people insure against longevity risk.

33. This part of the discussion paper focuses specifically on the proposal to provide DLAs with concessional tax treatment.

2.1 THE POLICY PROPOSAL

34. Income derived from assets supporting superannuation income streams that are currently in the payment phase is exempt from tax. As discussed in Part 1 of this paper, eligibility for the earnings tax exemption is limited to income stream products which meet a set of rules (the annuity and pension rules) contained in the *Superannuation Industry (Supervision) Regulations 1994*.

35. These rules require that superannuation income streams must make payments at least annually. As a DLA does not satisfy this requirement in the period before payments commence, it does not qualify as an income stream under the rules, and therefore is not entitled to the concessional tax treatment that applies to income derived from superannuation assets supporting income streams.

36. While extending concessional tax treatment to DLAs would facilitate their provision in the Australian market, it would be important to ensure that any changes are designed to help retirees insure against longevity risk (rather than simply accumulate or preserve wealth) and have regard to the fiscal cost of the extended tax concession.

37. DLAs would be payable for life from an age specified in the annuity contract. The remaining policy design features that the rules accommodated would need to strike a balance between protecting the earnings tax exemption and limiting its fiscal cost while providing sufficient flexibility so as not to limit product development. The following discussion focuses on what design features are appropriate for DLAs.

2.2 Design issues

Purchasing a deferred lifetime annuity

38. Currently, to meet the definition of a superannuation income stream, products must be purchased directly with superannuation money—that is, money rolled over from a superannuation fund.

39. To be consistent with other superannuation income stream products, it would be appropriate that DLAs only be purchased with superannuation money once a condition of release has been met (such as retirement on or after preservation age). Allowing people to purchase DLAs with non-superannuation money would entail a revenue cost as money that would otherwise have been taxed would be moved into a tax-free environment.

40. Consistent with existing arrangements, purchasers would benefit from tax-free annuity payments where aged 60 or over.

41. A related issue concerns how DLAs would be purchased. The typical model of a DLA involves the product being purchased with a single up-front payment—for example, a retiree would pay a one-off amount of $50,000 in return for the promise of an income stream commencing at age 85.

42. However, staggered purchase options could also be allowed. For example, a DLA could be purchased through the payment of annual premiums during the deferral period (as an alternative to the purchase of multiple single premium DLAs).

43. On the one hand, allowing retirees to purchase a DLA through annual premiums could be more acceptable to some retirees and could increase the product's attractiveness by reducing the need to part with a lump sum, something which people may be reluctant to do.

44. On the other hand, an annual premium approach would reduce the efficiency of the DLA product by reducing the benefits of compounding investment returns. This would result in smaller annuity payments, all else equal.

Consultation questions

Question 5: Should people only be able to purchase a DLA with superannuation money?

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?

Question 7: Should there be an upper limit on the amount that can be invested in a deferred lifetime annuity?

The length of the deferral period

45. By their nature, DLAs can involve a considerable period of time between the purchase of the product and when payments commence (the deferral period). Leaving the length of the deferral period to product providers/purchasers to determine would be consistent with

ensuring that the product is flexible enough to accommodate the range of different needs and preferences of retirees.

46. However, not setting a minimum deferral period would allow product providers to offer DLAs with very short deferral periods—for example, two or three years. Such an arrangement would be akin to an immediate annuity with a 'drawdown holiday' in the first few years of the product in exchange for higher annual payments (compared with an immediate annuity that commences straight away).

47. An argument in favour of a minimum deferral period is that it would align the design of the product with its intended use—that is, as a form of longevity insurance that provides a source of income in the event that the policy holder outlives their life expectancy (and allows the holder to draw down on their other savings with greater certainty up to that point).

48. A minimum deferral period could be expressed in terms of a period of years, or a minimum age at which payments can commence, or a combination of both. For example, the minimum deferral period could be expressed as the shorter of 20 years or the number of years to age 85.

    48.1. This would mean that for a person who purchased the product at age 65, the deferral period would need to be at least 20 years (that is, payments could not commence until age 85). For a person who purchased the product at age 75, the deferral period would only need to be 10 years (that is, the payments could commence at age 85).

    48.2. Such a combination would recognise that a minimum deferral period expressed only in terms of a period of years may disadvantage older people who buy the product later in life, but could be inconsistent with idea that DLAs should not be a means of offering an immediate annuity with a 'drawdown' holiday in the first few years of the product.

49. Another option could be to set the minimum deferral period with reference to the person's life expectancy (determined by reference to the Australian Life Tables). For example, the minimum deferral period could be set as the number of years to the person's life expectancy.

50. There is also an issue as to whether a maximum deferral age should be specified—that is, an age past which annuity payments cannot be deferred. While such a requirement would be consistent with the rationale of ensuring superannuation money is used to fund retirement, it may not be needed if the design of the product is such that there is no advantage to the holder from indefinitely deferring payments. Where the product is non-commutable and provides for no, or only a limited death benefit (an amount paid to the product holder's dependants or estate on death), it is unlikely a person would purchase a DLA that commenced from an age where there was only a minimal chance of receiving a return on their money.

Consultation questions

Question 8: Should there be a minimum deferral period for a DLA? If so, what would determine the period?

Question 9: Should there be a maximum deferral age or period? If so, what should it be?

Commutability

51. To ensure that DLAs are only used for genuine longevity insurance purposes, it seems appropriate that the product be non-commutable. If DLAs could be commuted, that is, converted back to a lump sum after purchase, it would open up the potential for DLAs to be used as a way to avoid drawing down on one's superannuation.

Annuity payments

52. DLAs would be payable for life from the age specified in the annuity contract. Payments would be guaranteed by the annuity provider and could be either a fixed amount or indexed.

Consultation question

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?

Death benefit

53. Another design issue is whether the product issuer should be able to offer a death benefit—that is, whether a lump sum of a specified amount could be payable to the product holder's dependants or estate on their death.

54. One of the impediments to the take up of income stream products such as lifetime annuities is the desire of holders to leave a bequest. The ability to offer a death benefit that would be payable to the holder's estate would to an extent address this impediment and may lead to a greater take up of DLAs than would otherwise be the case.

55. A counter argument is that the purpose of DLAs is to fill a gap that exists in the market for longevity insurance products, and that the payment of a death benefit to the estate of the product holder would be inconsistent with this objective. It would also be inconsistent with the rationale of superannuation money being used to fund retirement. People considering the purchase of a DLA could satisfy a bequest motive by also purchasing another product, such as an account-based pension. This would leave DLAs to be used purely for longevity insurance purposes.

56. If a death benefit were to be allowed, consideration also needs to be given to what, if any, restrictions there should be on the size of the benefit that could be paid.

57. No restriction on the size of a death benefit would leave DLAs open to use for estate planning purposes—that is, there would be scope for the person's estate to appropriate some of the benefit of compounding of tax-free investment returns in the deferral phase. This would be inconsistent with the purpose of the measure.

58. Some limit on the size of a death benefit would therefore seem appropriate. A limit could be expressed as a proportion of the purchase price of the product—for example, if a death benefit is offered it could not exceed the purchase price of the product, some percentage of the purchase price, or the original purchase price less the total of all, if any, payments paid to the holder.

59. Within these constraints, it could be left to product providers to determine whether a death benefit would be offered and the size of any such benefit. Purchasers could be given a choice of whether to have a death benefit, with an associated trade-off in terms of lower annuity payments.

Consultation question

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?

3. THE MINIMUM PAYMENT AMOUNTS FOR ACCOUNT-BASED INCOME STREAMS

60. A key feature of the regulatory arrangements for account-based pensions is the requirement to make a minimum payment each year. The minimum payment amount is a function of an age-based percentage factor and the value of the pension account balance at 1 July.

61. The purpose of this part of the paper is to form the basis for consultation on the minimum payment amounts to assess their appropriateness in changing financial market conditions.

3.1 THE CURRENT MINIMUM PAYMENT AMOUNTS

62. The current minimum payment factors are shown in the table below. The table also shows the payment factors under the temporary reduction in the drawdown amount provided in recent years in response to the effects of the global financial crisis (GFC).

Table 2: Minimum payment percentages

Age	Normal minimum payment percentages (no drawdown reduction)	Minimum payment percentages for 2008-09, 2009-10 and 2010-11 (after 50% reduction)	Minimum payment percentages for 2011-12 and 2012-13 (after 25% reduction)
Under 65	4	2.0	3
65-74	5	2.5	3.75
75-79	6	3	4.5
80-84	7	3.5	5.25
85-89	9	4.5	6.75
90-94	11	5.5	8.25
95 or more	14	7	10.5

63. These minimum payment factors for account-based pensions were introduced in 2007 as part of the Better Super package of changes. The factors replaced the previous minimum (and maximum) payment limits for what were then called allocated pensions.

64. As is the case with the annuity and pension rules more broadly, the minimum payment requirement should be seen in the context of the concessional tax treatment of superannuation income streams. The minimum payment rule aims to:

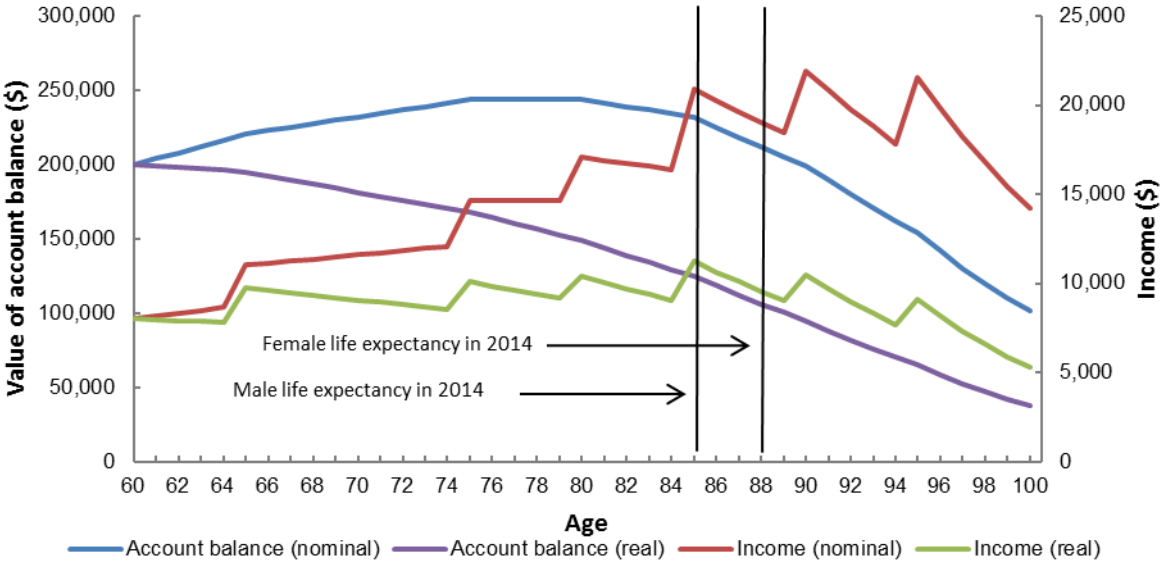
- Ensure the account-based product is being used to provide an income stream in retirement.
- Facilitate the provision of a steady level of income over time.
- Ensure funds are withdrawn from the concessionally taxed superannuation environment over time. That is, the minimum drawdown represents a minimum rate at which money held in an account-based product must be transferred out of the superannuation system, either to be consumed or re-invested.

65. Drawing down an account-based income stream at the minimum drawdown rate can be thought of as minimising the 'efficiency' of the product in providing retirement income. That is, it minimises, in expectation, the amount of money in the account-based product used for

retirement income. Conversely, drawing down at the minimum rate and leaving funds within the superannuation system maximises the tax concession on the invested money.

66. The minimum payment factors for account-based income streams were set having regard to average investment returns and average life expectancies at various ages. An account-based product drawn down only at the minimum rate can be expected to last beyond the person's lifespan, however long they live. Chart 1 below illustrates a drawdown scenario for a male and female commencing an account-based income stream of $200,000 at age 60 drawing down at the minimum payment amounts with investment returns of 6 per cent per annum. The chart shows the account balance at various ages and the income drawn down each year in both real and nominal terms.

Chart 1: Drawdown profile for an account-based pension



Note: The analysis assumes an average nominal investment return of 6 per cent and inflation of 2.5 per cent.

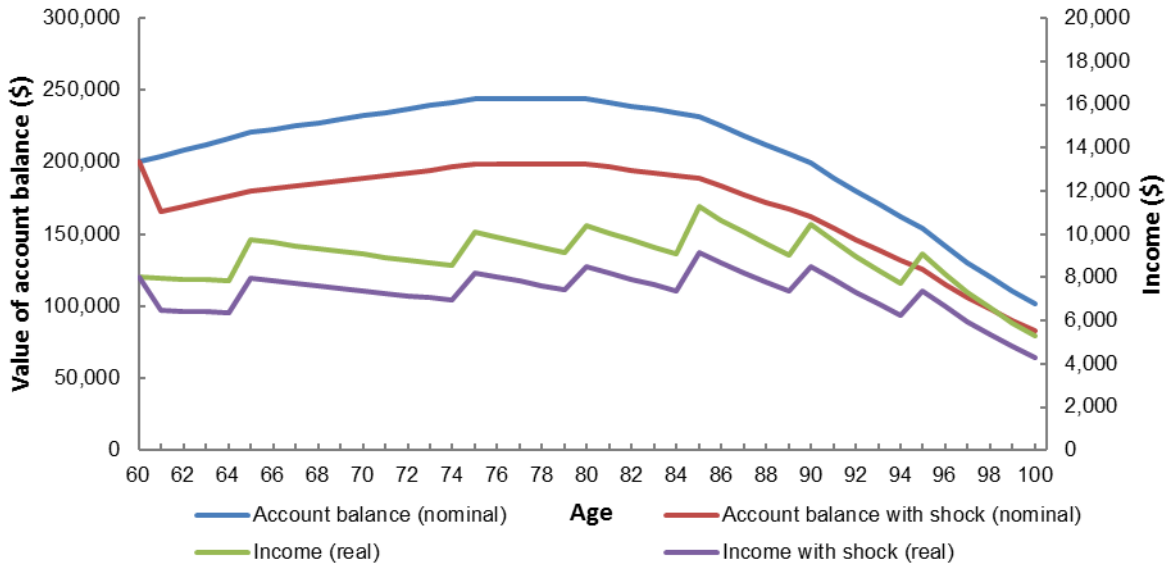
3.2 INVESTMENT VOLATILITY

67. During the GFC concerns were expressed about the minimum drawdown requirement. There were suggestions that it required people to withdraw money from their fund faster than planned (because the minimum payment amount is based on the account balance at the beginning of the year and asset values had fallen). This fed into a fear of 'running out' of money over the retiree's lifetime, the possibility that accounts would not return to pre-shock levels quickly, and the possible need to sell assets in order to meet the payment requirement.

68. The government at the time responded by halving the minimum payment factors for the 2008-09 year. This reduction in the amount required to be drawn down was initially intended as a temporary measure in response to the sharp fall in equity prices that occurred in 2008-09. This first reduction, which was announced part way through the year, recognised that the calculation of the minimum payment amount for 2008-09 was based on account balances as at 1 July 2008 when asset values were higher. The drawdown reduction was progressively extended in subsequent years to provide more time for pension account balances to increase after GFC-related capital losses.

69. The impact of a first year 'investment shock' on an account-based product is simulated in the following chart. The chart compares the account balance (in nominal terms) at various ages, as well as the annual income payments that would be made if the account was drawn down at the minimum required rate, of an account which experiences a first year investment shock and one that does not. For the account which experiences the shock, the analysis assumes that 50 per cent of the account is allocated to equities which experience a negative return of 30 per cent in the first year of drawdown. No drawdown reduction is assumed.

Chart 2: Impact of first year investment shock on account-based pension



Note: The analysis assumes that for the account which experiences the shock, 50 per cent of the account is allocated to equities which experience a negative return of 30 per cent in the first year of drawdown. The rest of the account experiences a return of 4 per cent. For all other years, and for the account that does not experience the shock, the analysis assumes an average nominal investment return of 6 per cent and inflation of 2.5 per cent.

70. Under this scenario (which makes no allowance for any offsetting rebound in equity prices in subsequent years), the current minimum drawdown factors allow for a significant asset balance to be retained in the pension account at older ages.

    70.1. Investment markets have improved since the GFC with the annual return for a conservative balanced portfolio in superannuation averaging approximately 7 per cent over the three years to 30 November 2013.[5]

71. The Age Pension acts as a buffer during downturns, whereby people may become eligible for the pension and existing pensioners may receive an increase in the level of their pension. A reduction in the amount required to be drawn down is of most benefit for those who are less reliant on the income from their account-based product—that is, those with large account balances or with investments outside of superannuation. People who are less well-off and who need to draw income from their superannuation pension derive less or no benefit. It appears that most people draw down at the minimum applicable rate and that the proportion of retirees drawing down at the minimum rate rises significantly with age and assets.[6]

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5 SuperRatings January 2014 www.superratings.com.au/latest-returns/returns.

6 Rothman, G P, and H Wang, 2013, *Retirement income decisions: Take up and use of Australian lump sums and income streams*, 21st Colloquium of Superannuation Researchers, University of New South Wales.

Consultation question

Question 12: Are the current minimum payment amounts for account-based products appropriate to achieve the objectives outlined above, given financial conditions can change?

Adjusting the minimum payment amounts

72. If the minimum payment amount should fluctuate in response to market conditions, it would be possible for the government of the day to alter the amounts (as occurred during the GFC) as appropriate, or for the calculation of the minimum payment amount to automatically reflect changing market conditions. If the latter, it would be necessary for the minimum drawdown amount to be a function of at least one new exogenous variable that captured or acted as a proxy for market conditions.

73. An advantage of an 'automatic' response would be that it could increase certainty amongst retirees that the amount required to be drawn down will change with changed circumstances. Disadvantages would include increased uncertainty about the amount required to be drawn down, increased regulation and compliance costs for superannuation funds and retirees, an unpredictable cost to the budget and, unless the process was made truly independent, it would not remove government discretion to intervene.

74. Any automatic response would need to consider the following issues:

    - Whether standard percentage factors are retained in 'normal' market conditions during which investment returns fluctuate such that any change would only be triggered in response to 'significant' shocks.
    - Whether the minimum drawdown amounts should increase as well as decrease in response to a significant fluctuation in investment returns.
    - The amount by which the standard percentage factor changes in response to the significance of the shock.

Consultation questions

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?

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?

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?

Question 16: What other issues need to be considered if the minimum drawdown amounts should fluctuate?