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REVIEW OF PROVISION OF PENSIONS IN SMALL SUPERANNUATION FUNDS

SUBMISSION TO TREASURY

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1. INTRODUCTION & EXECUTIVE SUMMARY

1.1 Superannuation Industry (Supervision) Amendment Regulations 2004 (No 2) (or Statutory Rules No. 84 – referred to as SR 84 in this submission) sought to make several immediate and significant changes to the Superannuation Industry (Supervision) Regulations (the SIS Regulations).

1.2 One of these changes was to effectively prohibit funds with fewer than 50 members from providing new defined benefit pensions[1]. While this change affects **all** small funds (including small corporate funds), this submission considers the issue from the perspective of funds with fewer than 5 members – ie, self managed funds and small APRA funds. For ease of reference, these funds have been collectively referred to as self managed funds in this report.

1.3 Since the tabling of SR 84, the Minister for Revenue and Assistant Treasurer, Mr Mal Brough, has announced a review into the provision of pensions in small superannuation funds. The purpose of this submission, therefore, is to assist in that review process (referred to in this document as the "Treasury Review").

1.4 Throughout this submission, I have referred to the various regulatory bodies involved in this debate (including Treasury, the ATO, the Australian Government Actuary's Office etc) collectively as the "Government" for ease of reference. The views attributed to the "Government" have been deduced from public comment made by these bodies, Hansard transcripts of the two hearings by the Senate Economics Legislation Committee into this issue and statements made in the document outlining the terms of reference of the Treasury Review.

1.5 **The issues**. The Government has essentially questioned the appropriateness of the provision of defined benefit pensions from self managed superannuation funds on two grounds

- *Unintended benefits to taxpayers* – ie, are taxpayers who establish defined benefits from small superannuation funds able to access tax benefits that the Government did not intend them to? In particular, the Government has mentioned "RBL compression", social security and estate planning as areas for concern; and
- *Actuarial validity* – ie, is it simply actuarially unsound for a small fund, with no ability to pool mortality risk, to pay a defined benefit pension?

1.6 The Treasury Review therefore seeks to examine options for self managed superannuation funds that address these concerns.

1.7 **The opinion of the author**. My view is that many of the concerns surrounding defined benefit pensions within self managed superannuation funds are unfounded. In fact, they provide an extremely valuable income stream structure and the ability to provide them through self managed superannuation funds is of considerable benefit to both the individual pension recipients and the community as a whole. I have explored this in some detail in Section 3.

[1] Some limited grandfathering has been incorporated into the new rules. This has been ignored for the purposes of this submission as a recent draft determination from the ATO (SD 2004/01) suggests that it is unlikely to assist many (if any) self managed funds.

1.8 Furthermore, I do not believe that it is actuarially unsound to provide a defined benefit pension from a self managed superannuation fund. While these funds certainly present some unique challenges (and require actuaries to think more broadly than our traditional approach to risk management), they are entirely appropriate vehicles for a defined benefit income stream. I have specifically considered this issue in Section 4.

1.9 While I firmly believe that defined benefit pensions can be appropriately accommodated within self managed superannuation funds, this does not necessarily mean that the pre-SR 84 rules exactly achieved the Government's objectives (or at least, those objectives as I understand them to be).

1.10 In Sections 5, 6 and 7 I have therefore examined each of the Government's stated areas of concern (RBL compression, social security and estate planning) and :

- articulated my understanding of the "problem" perceived to exist by Government
- expressed my opinion as to whether that problem is real or perceived
- identified whether the use of a self managed fund confers any special advantage on taxpayers (ie, is this a problem that is peculiar to self managed funds or is it an issue affecting superannuation generally?)
- examined the solution (ie, does a ban on small funds really address the problem); and
- where applicable, offered alternative solutions.

1.11 My general conclusions in this regard may be summarised as follows:

- the most significant contributor to RBL compression is that there are significant flaws in the way in which defined benefit pensions are currently valued for RBL purposes. This is not confined to self managed funds but instead affects all defined benefit pension recipients to some extent. It is also a problem that can be easily fixed using other means;
- the social security concerns have, to a large extent, already been resolved by recent changes to the asset test exemption provided to these pensions; and
- I question whether all of the Government's estate planning concerns are valid and whether they too can be resolved in a better way.

1.12 Finally, in Section 8, I have drawn upon the various Sections in this submission to suggest some key features for future income streams.

2. WHAT ARE DEFINED BENEFIT PENSIONS?

2.1 Transcripts of the two Senate committee hearings indicated some confusion as to exactly what is meant by a "defined benefit pension". By way of introduction, I have therefore briefly outlined the range of pensions that fall into the defined benefit net.

2.2 SIS Regulation 1.06 defines 5 different pension types:

- Regulations 1.06(2) & (3) – lifetime pensions that assist in accessing the pension RBL and confer an asset test concession for social security purposes (referred to here as "**complying lifetime"** pensions);
- Regulations 1.06(4) & (5) – **allocated** pensions;
- Regulation 1.06(7) – pensions paid for a fixed term where that term is generally linked to the individual's life expectancy. These pensions also confer RBL and social security asset test concessions and are referred to as "**complying life expectancy**" pensions;
- Regulation 1.06(8) – the **new market linked** pensions;
- Regulation 1.06(6) – all other pensions. This could include a pension payable for life (referred to as a "**non-complying lifetime**" pension) or a fixed period (referred to as a "**fixed term"** pension).

2.3 Allocated and market linked pensions are not defined benefit pensions – they involve no guarantees to the pension recipients, the annual payment is simply calculated based on the pensioner's account balance and a statutory factor. I have referred to these types of pension as "**account based**" income streams.

2.4 All other types of pension involve some element of guarantee and, providing they are not fully insured, they are *defined benefit* pensions (hence universally precluded from the small fund environment by SR 84).

2.5 However, the group of defined benefit pensions is certainly not homogenous. It includes, for example:

- A 5 year fixed term pension of $10,000 pa (not indexed) with full repayment of initial capital at expiry. At this end of the pension spectrum, there is clearly no mortality risk. Furthermore, it would be theoretically possible to fully match the pension's assets to its liabilities – entirely removing investment and liquidity risk;
- At the other end of the spectrum – a complying lifetime pension indexed to inflation. This pension carries mortality, investment and liquidity risk;
- Somewhere in between – a non-complying lifetime pension, indexed to inflation and fully commutable at any time. This pension carries mortality and investment risk. However, it arguably carries little or no liquidity risk. In the event of a liquidity crisis, the pension could simply be commuted and a lump sum paid "in specie" to the pension recipient (this is discussed further in Section 3).

2.6 The difference between the various pension options available is critical when considering that the Government's concerns in relation to the actuarial validity of providing a defined benefit pension from a self managed fund centre around the inability of those funds to adequately manage mortality, investment (return) and liquidity risks. As Section 2.5 above clearly demonstrates, not all defined benefit pensions carry all of these risks and some, in fact, can be constructed to carry none of them.

3. PENSIONS FROM A POLICY PERSPECTIVE

3.1 As mentioned earlier, SR 84 and this Review were prompted by a range of Government concerns about the appropriateness of providing a defined benefit income stream from a small fund. While the remainder of this submission addresses those concerns, it is worth first examining whether or not these pensions have a genuine role in meeting the Government's retirement incomes policy objectives (since it is difficult to analyse the suitability or otherwise of the existing types of pension unless there is some agreement on why the Government offers tax concessions to superannuation pensions in the first place).

3.2 A very brief outline of my own interpretation of where superannuation pensions "fit" in this context is as follows:

- numerous tax incentives and compulsory levies exist to encourage Australians to save for their own retirement, particularly via the superannuation system;
- those incentives continue beyond retirement in that ongoing concessions are provided to retirees who choose to take their superannuation in the form of an income stream;
- even within that broad group who choose to take their superannuation in the form of an income stream, the greatest benefits are provided to those who are prepared to take very specific steps towards ensuring that their superannuation balance will genuinely be preserved to provide their retirement income (either wholly or in part);
- these more substantial concessions include the ability to attain a higher Reasonable Benefit Limit (ie, have benefits assessed against the pension RBL rather than the lump sum equivalent) and an asset test exemption for social security purposes;
- the pensions which historically provided access to these concessions were complying lifetime pensions and complying life expectancy pensions. Key elements of these two pensions are:
  - the inability to take commutations (hence, the inability to dissipate assets early in retirement);
  - the spreading of the initial capital over the pensioner's life or a period related to life expectancy;
  - their "guaranteed" nature (ie, pensions must continue whatever happens to investment markets);
- since 20 September 2004, however, these concessions have also applied to market linked pensions. Not only do these income streams make no attempt to provide an investment-proof guarantee, they have in fact been specifically designed to "run out" at a time when many recipients will still be alive (discussed further below). Interestingly, these new income streams would appear to have been introduced with little community debate as to whether or not they are consistent with the Government's broader retirement incomes objectives. While as a practitioner, I welcome

any measure that provides greater choice to retirees (my clients), I question whether these new income streams will actually have a negative impact on the community as a whole in the long term (discussed further below).

3.3 This suggests that the Government's objective has historically been to encourage taxpayers to draw down their superannuation over their post-retirement lifetime, but not too quickly. More recently, the Government would appear to have added a second qualification to this objective : "not too slowly either". In other words, several of the Government's concerns (addressed elsewhere in this submission) are designed to ensure that taxpayers are not able to slow down their superannuation pension drawings to such an extent that large capital sums remain on death, allowing the pensioner to benefit from the generous superannuation tax concessions for longer than anticipated. Perhaps even more significantly, the extension of the most substantial tax benefits (pension RBL access and a partial asset test exemption) to market linked pensions (which incorporate no attempt to provide a guaranteed income stream) implies that the ability to *definitely* provide for one's entire retirement is (surprisingly) no longer considered so critical.

3.4 If this is the case, I believe the Government should be actively *encouraging* defined benefit income streams, and lifetime pensions in particular. A lifetime pension remains the only income stream structure that is specifically designed to provide an orderly draw down of capital over the life of the pensioner and (if applicable) their spouse. Unlike other income streams:

- they provided a regular amount each year (either fixed or indexed), regardless of what happens to investment returns. Contrast this to the new market linked pensions where volatile investment returns will translate directly into volatile pension payments; and

- they are designed to last for life. Again, contrast this to a market linked pension which must cease at the end of its term. Simple statistics suggests that <u>most recipients of market linked pensions will still be alive when their pension ends</u> – even if they have chosen the longest term possible given their age (ie, a term based on the life expectancy of a recipient 5 years their junior)[2]. In my view, a pension design which results in most people outliving their capital places too much emphasis on the "not too slowly" component of the Government's objective.

3.5 Encouraging lifetime pensions does not necessarily mean encouraging their use in self managed superannuation funds. The Government could, instead, encourage taxpayers to purchase these contracts externally (say via an annuity provider). Realistically, however, this is unlikely to be successful:

[2] I make this comment for two reasons. Firstly, if mortality continues to improve, the actual life expectancy of today's retirees is likely to be several years longer than the life expectancy figures we have today (as these are based on historical experience). Secondly, it is important to remember that life expectancies are "average" calculations not "median" figures. The median age at death of a particular group of (say) 100 people aged 65 is the age at which 50 are dead and 50 are still living – and this is generally **<u>higher</u>** than the life expectancy of that same group of people. In my view, this would be a more appropriate figure on which to base the term of a market linked pension if the intention of the community as a whole is for the pension to stop too early for some and too late for others.

- Australians would appear to be dissatisfied with, and even distrustful of, institutional providers – the general growth in self managed funds supports this;

- in our market, we have relatively few annuity providers and rightly or wrongly, commercial annuities are perceived to be poor "value for money"; and

- those retirees who have chosen to use a self managed superannuation fund throughout their working lives are unlikely to experience a sudden change of heart at retirement unless there are very significant tax or other drivers to do so.

3.6 Faced with a choice between a market linked pension from their own fund or a commercial lifetime annuity, I expect that almost all retirees will choose a market linked pension. Given that these pensions are virtually *designed* to run out during the recipient's lifetime, encouraging pensioners to use them at the expense of lifetime pensions will ultimately result in a greater dependence on the age pension. Surely this is short term thinking?

3.7 Providing, then, that the Government's concerns with the provision of these pensions via self managed funds can be appropriately dealt with (and this is the subject of the remainder of this submission), I expect that allowing self managed funds to provide defined benefit pensions (in particular lifetime pensions) will actually have a positive impact on reducing long term use of the social security system.

4. ACTUARIAL VALIDITY

4.1 The issue

4.1.1 In a self managed fund environment, the process leading to the establishment of a defined benefit pension is typically as follows:

- members build up benefits on an "accumulation" basis until retirement;
- at a particular point in time (often retirement), the account balance is converted to a defined benefit pension;
- at the point of conversion, calculations are done to determine what level of annual payment can be supported by the capital available, given the particular terms and conditions agreed for the pension; and
- from that point forwards, the member's account balance is specifically earmarked for the provision of the defined benefit pension and no further contributions are added to that account.

4.1.2 The potentially undesirable outcomes are therefore:

- the initial capital set aside will ultimately prove insufficient to discharge the agreed pension obligation (including all its terms and conditions) and the trustee will fail to honour the pension in full. I have referred to this as "**pension failure**"; or
- the reverse – in order to minimise the chance of pension failure, the trustee will provide an artificially low annual income from a given capital sum. I have referred to this as a "**lack of commerciality**".

4.1.3 **Government Concerns**. The Government has suggested that one of these two outcomes are far more likely in a self managed fund environment than under an alternative arrangement because such funds are unable to adequately manage their risks. The natural extension of this viewpoint is that self managed fund members will benefit disproportionately from the public purse, either by:

- experiencing pension failure and then accessing the age pension; or
- by minimising their pension income, accessing the age pension during their lifetime and/or passing on wealth to future generations in a manner that is more tax effective than intended.

4.2 Putting "pension failure" into perspective

4.2.1 Before addressing these concerns in detail, I believe it is important to put the issue of pension failure (in particular) into perspective. While I believe it would be inappropriate for actuaries to routinely condone the establishment of pensions where failure was inevitable or at least commonplace, I do feel it is important to consider the impact of the occasional failure on the community.

4.2.2 Individual vs Group failure. Failure of a pension arrangement within a self managed fund is clearly undesirable for the members of that fund. However, while it may result in those individuals claiming an age pension, the impact on the community as a whole is negligible. The impact on the community is only

significant if a large number of self managed fund pensions fail. In contrast, if an annuity provider fails, thousands of individuals will be affected – resulting in a much greater impact on the community. To some extent, the proliferation of self managed funds providing income streams of any kind (including defined benefit pensions) allows the *community* to benefit from "pooling" of risks.

4.2.3 Failure results in a reduction in payments, not a cessation. The failure of a self managed fund will rarely result in the immediate termination of all pension payments. Instead, the pension would ordinarily be restructured so that a lower amount is paid on different terms and conditions.

"Failure" therefore does not result in an immediate impact on the community. In fact, I believe that the best approach for minimising age pension access for self managed fund pensioners is to make "restructuring" their pensions as simple as possible. This is discussed further in Section 8.

A related point is that even if restructuring does not occur, payments may well continue for several years despite the fact that the pension has technically failed by (say) reaching a point where the available assets no longer exceed the best estimate of the liabilities. Providing the community does not give the pension recipient an incentive to immediately dissipate their assets at the point of failure (for example, by imposing draconian restrictions or immediate loss of age pension entitlements), the most likely outcome is that the pension recipient will simply let their income stream run its course. Again, this benefits the community by delaying the point at which the pensioner is fully reliant on public funding.

4.2.4 Failure can actually occur in all income streams**.** From the community's perspective, "failure" really occurs whenever an individual taxpayer accumulates retirement savings to a point where they should logically sustain that person for his/her retirement but they fail to do so (because, for example, the retiree lives longer than expected, spends more than expected, achieves lower investment returns than expected etc).

In the case of an account based income stream (allocated and market linked pensions), failure manifests itself by a retiree outliving the term of their pension (for market linked income streams) or by the retiree's account balance, and therefore pension drawings, reducing to trivial amounts (an allocated pension). While the pension has not defaulted on its terms and conditions (and has therefore not "failed" as per the Government's interpretation), the retiree is nonetheless making an unintended call on social security benefits.

In other words, the impact is exactly the same as failure of a defined benefit pension, it is simply camouflaged by the design of the pension.

4.3 Is pension failure really any more likely in a self managed fund?

4.3.1 As outlined in Section 4.2, it is important to keep the issue of pension failure in perspective. That said, the Government would rightly be concerned if defined benefit pensions routinely "failed" and hence in this Section I have considered whether failure of defined benefit pensions is necessarily particularly likely in a self managed fund environment.

The three risks identified by the Government (as outlined in the terms of reference for the Treasury Review) are:

- mortality – ie, pensioners living longer than expected when the capital sum was converted to an income stream;
- investment – ie, returns falling below the level assumed in the conversion calculations; and
- liquidity – ie, at a particular point in time, the fund has insufficient cash to meet its agreed pension payments.

In claiming that self managed funds are unable to adequately manage these risks, the Government and others have emphasised two important features which distinguish self managed superannuation funds from most other superannuation or insurance providers offering defined benefit pensions:

- **number of members** – self managed funds, by definition, have fewer than 5 members whereas other income stream providers often have a large "pool" of lives;
- **lack of external finance** – corporate and public sector superannuation funds are sponsored by an employer (or government) that is ultimately responsible for financing the pension obligations. A self managed fund, however, typically has no recourse to external finance in the event of poor experience.

In my view, the Government's concerns are unfounded.

4.3.2 Different pensions carry different risks

Section 2 indicated that the term "defined benefit pension" covers a very broad range of income streams. It is important to bear in mind that not all of the risks identified by the Government affect all pensions. In particular:

- *mortality risk* is only applicable for lifetime pensions – it is simply not relevant for a significant number of pensions historically provided by self managed funds (complying life expectancy, fixed term);
- *investment risk* is relevant for most defined benefit pensions but it will have a limited impact for pensions with a fixed term (ie, fixed term or complying life expectancy) where the assets have been specifically matched to the liabilities;
- *liquidity risk* is primarily an issue for non-commutable pensions (ie, ordinarily only complying lifetime or complying life expectancy). Any pension which can be commuted at will provides a "last resort" option of paying the commuted value to the member as an in specie lump sum. While this may not represent a particularly attractive option for the member, it nonetheless provides added protection against pension failure on the grounds of insufficient liquidity.

Clearly then, even if self managed funds are ultimately considered to be unable to adequately manage one or more of these risks (and I do not believe this is the case), **there is no case for a blanket ban on all defined benefit pensions from self managed funds**.

4.3.3 Management of mortality risks

Much has been made of the fact that small funds cannot benefit from "pooling" – ie, spreading mortality risk across a large body of lives. I certainly do not dispute that fact. However, in my view this does not preclude small funds from adequate management of mortality risk.

This is because **pooling is simply <u>one</u> way of managing <u>one</u> aspect of mortality risk** – the risk that the experience of a single life will differ from his or her peers. Pooling does **not** assist in the management of the other key element of mortality risk – general improvements in life expectancies.

In the corporate superannuation environment, the "systemic" risk presented by increasing longevity is managed by calling upon the employer for additional funding.

In the annuity market, however, it is managed by returning some of the risk to the insured (ie, the annuitant) by including a (non guaranteed) bonus element in the contract. In other words, a "core" level of pension is guaranteed with increases above this level being subject to the experience of the insurer.

While self managed funds cannot approach the provision of defined benefit income streams in precisely the same way as large corporate funds, I would argue that they are still ideally placed to manage mortality risks by:

- <u>Adopting the life insurer's approach of variable bonuses</u>. Self managed funds can use a similar approach to annuity providers in passing the risk of general mortality improvements back to the pensioner. In a self managed superannuation fund, this is achieved by incorporating some flexibility into the pension terms and conditions (such as flexible indexation, reversionary arrangements etc); and
- <u>Ignoring conventional mortality statistics (which rely on pooling in order to be effective predictors of longevity) and valuing lifetime pensions as term certain income streams</u>. A lifetime pension can be valued as a term certain annuity to (say) age 100 plus a provision for the purchase price of a lifetime annuity at that age (taking into account the relatively small chance of the pensioner living that long). This removes the need for mortality experience pooling and certainly minimises the chance of pension failure due to mortality risk. While it should theoretically result in a lack of commerciality, my experience is that it does not (see Section 4.5 below).

These are just two approaches available (and commonly used) in the self managed fund arena to cope with the particular challenges presented by the actuarial management of a small fund.

It is also worthy of note that there would appear to be no statistical basis for the choice of 50 lives as an appropriate figure for funds providing defined benefit pensions:

- SR 84 only stipulates that the fund must have 50 members (not defined benefit pension members) to provide defined benefit pensions. In practice, then, a 50-member fund could have only 1 defined benefit pensioner – providing exactly the same opportunities for pooling of mortality risk as a self managed fund with 1 defined benefit member;
- Hansard transcripts suggest that the figure of 50 was chosen simply because it was already a "familiar number" in SIS (see pages 25 and 26 of the 9 August 2004 hearing) rather than because it is inherently appropriate;

- A submission prepared by Mr Allen Truslove of Cumpston Sarjeant Truslove Pty Ltd[3] indicated that 50 was a grossly insufficient number of lives to provide adequate pooling.

4.3.4 Management of Investment Risk

The number of fund members has no impact on the ability of a superannuation fund to minimise its investment risk.

Typically, the principal tool employed to manage investment risk is diversification. A fund's ability to achieve an adequate level of diversification is (at worst) limited by the size of its assets. The number of members giving rise to those assets is completely irrelevant.

The proliferation of investment products today means that even quite small funds are able to achieve a high degree of diversification. Arguably, self managed funds are able to achieve levels of diversification which are, for all practical purposes, similar to a large corporate superannuation fund (or annuity provider) that adopts a single investment strategy for its pension assets.

No amount of diversification will assist in managing investment risks presented by (say) a general, long term decline in returns. Conceptually, this is akin to the systemic mortality risk presented by a general increase in life expectancies. It can therefore be dealt with in the same way, ie by either:

- seeking additional funding (the corporate fund approach); or
- incorporating some flexibility in the pension terms (the annuity provider's approach).

Again, the self managed fund is free to adopt the annuity provider approach if necessary.

Finally, it is worthy of note that in a self managed fund environment, the trustee and pension recipients have a common goal – the ongoing maintenance of the income stream. They are not subject to commercial pressures which might encourage investment risks that are not consistent with this (to permit more aggressive pricing, greater returns to shareholders, reduction in an employer's funding commitments etc).

4.3.5 Management of Liquidity Risk

Insufficient liquidity is a risk that faces any pension – it is not specific to defined benefit pensions. The contractual obligation of an allocated or market linked pension to make its designated payment in a particular year is every bit as important as the obligations implicit in a defined benefit pension contract.

In my view, self managed funds are actually in a better position to manage their own liquidity than external providers, precisely because the trustees and the members are one and the same (and therefore have a common goal):

- recipients of a pension from a self managed fund will invariably accept payments "in specie" in lieu of cash if necessary, particularly if they do not actually require their entire pension payment to meet their living expenses, they are simply taking it because they are required to do so;
- wherever possible, self managed funds incorporate the option to fully commute the pension, even in circumstances where selection risk would

[3] Page 4, submission dated 22 July 2004 prepared by Mr Allen Truslove of Cumpston Sarjeant Truslove Pty Ltd for the Senate Economics Legislation Committee.

prevent an arms length provider from doing so (a commutable lifetime pension being the best example). In the extreme, therefore, the trustee is able to cease the pension and pay out the lump sum value "in specie". Not only is this theoretically possible, it is highly likely to be acceptable to both parties (the trustee and members);

- members of self managed funds will happily defer the receipt of their pension to coincide with dividend, interest and rent payments;
- self managed funds are quite often "family" vehicles with both parents and (adult) children belonging to the same vehicle. The younger generation's contributions provide added cash flow for pension payments. In contrast, a closed corporate pension fund has no automatic cash flow provided by members who are still in service; and
- the significant "product design" flexibility available with defined benefit funds gives self managed fund trustees the opportunity to structure their income streams to (in part) suit the investments of their particular fund.

In fact, in my view the new market linked pensions perhaps present the greatest liquidity threat of all income streams for two reasons:

- they are specifically designed to draw down capital over a fixed number of years. In most cases, the annual drawings will exceed (say) a typical inflation linked lifetime pension reverting to the pensioner's spouse **or** an allocated pension (where the minimum is paid each year); and
- the payment schedule (ie, a specified proportion of the member's balance each year) provides absolutely no mechanism to "smooth" payments over time in line with the fund's cash flow (allowing for an orderly sale of assets over time). Consider the case, for example, of a fund invested in a "balanced" (and well diversified) portfolio. Short term growth in (say) the Australian share market resulting in a "peak" at 30 June will have a direct impact on the payment required for the following year. That share market growth, however, will not necessarily be immediately translated into higher dividends, interest, rent, trust distributions etc. Funds providing these pensions will inevitably face significant liquidity challenges simply because the annual pension payment will fluctuate considerably from year to year.

4.4 Evidence of failure

4.4.1 In my view, self managed funds can adequately manage the risks they face. This "theory" is also supported by my experience as a practitioner in this field.

4.4.2 In my experience as an actuary and consultant specialising exclusively in self managed superannuation funds, I have seen very few cases (I estimate around 1-2%) where the pension has "failed". By "failure", I mean reaching a point where the fund is not expected (on a "best estimate" basis) to have enough funds to meet its pension obligations.

4.4.3 More funds (perhaps a further 2-3%) have chosen to "restructure" (generally, this means they stop the existing pension and either move to an annuity provider or start a new, lower, pension from the self managed fund) before reaching that point. Typically, they have chosen to do so because they have failed the so-called "70% test"[4]. Failing this test does not constitute a

[4] The "70% test" is also referred to as the "high degree of probability" test. Funds providing defined benefit pensions are required to obtain a statement from an actuary each year as to whether or not the actuary believes there is a high degree of probability that the Fund has sufficient assets to meet its pension obligations.

legislative breach, it simply means that the pension loses its status as an "asset test exempt" pension for social security purposes. In my view, this is a poorly designed test and hence the restructures say more about the test itself than the inability of small funds to manage their risks.

4.5 Lack of commerciality

4.5.1 Section 4.3 outlines the various avenues self managed funds have available to them for the purposes of managing risk. This does not mean that every self managed fund will do so, nor does it mean that failures will never occur. However, we believe that these sections do demonstrate that a self managed fund is not fundamentally unable to manage risk (as suggested by Government).

4.5.2 Section 4.4 also indicates that my own experience is that self managed funds have proven adept at doing so – the incidence of failure has been low. This suggests that the undesirable outcome that is most likely in a self managed fund is that of a lack of commerciality – ie, the income streams paid from a given capital sum are much lower than the equivalent amount available from a commercial provider.

4.5.3 Again, this is not consistent with my own experience. I regularly check my own calculations against the annuity rates quoted by the (few) providers. For a given capital sum, I generally find that the income level I am prepared to certify is ***higher*** than the annuity offered commercially.

4.6 Conclusion

In my view, using a self managed fund to provide a defined benefit pension is not fundamentally unsound. Such funds have ample opportunity to manage the risks they face and have historically done so without resulting in a great lack of commerciality. Even if this was **not** the case, I would argue that failure is a possibility with any defined benefit pension provider (large or small) and what is important from a policy perspective is that the overall impact on the community if and when failure occurs is minimised to an acceptable level.

5. TAX BENEFITS – RBL COMPRESSION

5.1 What is RBL compression?

5.1.1 I understand that the term RBL compression is used to describe the fact that when certain defined benefit pensions are valued for RBL purposes, the resulting value is lower than the assets set aside to provide the pension. In other words, part of the member's account balance can effectively be quarantined from the RBL system. This enables taxpayers with balances in excess of their RBL (lump sum or pension) to fall within that RBL and receive greater tax concessions than anticipated by Government.

5.1.2 In the self managed fund environment, this arises because:

- in the case of lifetime pensions (either complying or non-complying) the RBL value of those pensions is determined using a formula rather than being linked to the member's account balance;
- in the case of all other defined benefit pensions (ie, those paid for a fixed term), the RBL value is generally calculated (according to Tax Determination 2000/29) as follows : Account balance[5] less solvency reserves.

5.1.3 In my analysis, I have ignored the fact that some taxpayers will certainly experience differences between their total assets and the RBL value of their income stream simply because their balance includes components that are always excluded from RBL contention (undeducted contributions, post-94 invalidity components etc). I note, however, that it would appear some (uninformed) debate has ignored differences that will arise for these reasons alone and assumed that a difference arising for these reasons immediately points to a "rort" of some description.

5.2 **How does it arise?** RBL compression arises from one or more of the following:

- the RBL formula **undervalues** some income streams. In other words, the pension being received is actually worth more than the value placed on it for RBL purposes. Note that undervaluation is only relevant for a pension that is valued (for RBL purposes) using a formula. In the self managed fund environment, this is really only relevant for lifetime pensions;
- our legislation imposes **solvency standards**, encouraging funds to hold assets over and above the actuary's "best estimate" of the pension liabilities. In this context, I have referred to solvency reserves as any amount over the actuary's best estimate of the pension liabilities – including additional funds set aside to ensure a positive opinion can be expressed under the "70% test". Whilst we acknowledge that SIS does not **require** this opinion to be positive (leaving all funds – including self managed funds – with the option of simply ignoring it) we believe that the existence of this test (and its implications for social security benefits) actively encourages funds to set aside sufficient funds to at last receive a positive opinion at the outset (ie, the critical time for RBL purposes); and

[5] excluding undeducted contributions and various other components.

- trustees may deliberately set aside **additional provisions** (more than is really required to finance their pension liabilities). This may be because the pensioner / trustee is particularly conservative (and want to ensure that there really are sufficient funds to pay the pension) or it may be because the pensioner wishes to preserve some of his or her capital for future generations.

5.3 Is it a real problem and is it specific to self managed funds?

5.3.1 In my view, RBL compression **is** an issue that should be debated and resolved. However I do not believe it is specific to self managed funds and I am concerned that the focus on self managed funds has caused some valid solutions to the problem to be ignored.

5.3.2 The **undervaluation** issue will arise for any income stream valued using a formula (ie, predominantly lifetime pensions for self managed funds but including all other defined benefit pensions for corporate and public sector funds). *Every taxpayer receiving one of these pensions (regardless of the fund from which it is being paid) has had their entitlements undervalued, sometimes to a significant degree*. In my experience, this will often be the most significant source of RBL compression and it will undoubtedly result in greater tax concessions (via higher pension rebates) than intended.

5.3.3 The "70%" **solvency standards** are a recent legislative imposition that has resulted in greater RBL compression. Once again, they apply equally to any defined benefit pension fund – including corporate and (funded) public sector schemes and is not specific to self managed funds. In my view, however, it is *entirely appropriate* that legislated solvency reserves are excluded from an individual's RBL assessment. This is because the RBL assessment process seeks to measure the amount being ***taken out*** of the superannuation environment by a particular individual rather than control the amount being ***put in***. In a defined benefit pension context, this implies that the only factors that should affect a taxpayer's RBL assessment are those affecting the value of the particular benefit to which the member is entitled. Solvency reserves (in this context) have no impact on the size of that benefit, they simply make it more likely that it will be paid as promised. While a self managed fund is unique in that these solvency reserves (if not used) will remain in the fund for the use of other fund (family) members at the end of the pension, this is an estate planning issue rather than an RBL compression consideration. I have therefore considered it further in Section 6.

5.3.4 The fact that some trustees choose to make **additional provisions** over and above the implied legal requirements is an issue that (for all practical purposes) is peculiar to self managed funds. Once again, however, those additional provisions will not necessarily have any impact on the benefit actually provided to the pensioner and hence are not an RBL compression issue – they are an estate planning consideration.

5.3.5 For the remainder of this section, therefore, we have examined solutions to the **undervaluation** problem for two reasons:

- this is often the greatest source of RBL compression; and
- it is genuinely an RBL issue rather than an estate planning matter.

5.4 Alternative solutions to resolve RBL compression

5.4.1 Update and improve the Pension Valuation Factors (PVFs).

Particular issues that should be addressed in any improvement of the PVFs are:

- use of current investment return, mortality (in the case of lifetime pensions) and inflation assumptions.

  Perhaps even more importantly, we should recognise that in practice, these assumptions would be updated from time to time and perhaps regularly review the PVFs (resulting in new factors being published, say, with the new life tables every 5 years).

  Alternatively, the factors could be updated less frequently but expressed in such a way as to automatically adjust for the fact that while (say) individual long term return and inflation assumptions will vary, the gap between them will generally remain broadly unchanged.

  For example, the greatest opportunity for RBL compression due to undervaluation currently arises when a pension's indexation is fixed rather than linked to CPI. This is because a CPI indexed pension is valued using RBL factors originally calculated on a 10% (investment return) / 7% (inflation / pension indexation) basis. This 3% gap is probably not too dissimilar to a gap that might be used today. A pension indexed at a fixed rate of 3% pa, however, is valued on a 10% / 3% basis, even though in practice the benefit may be almost identical to an inflation linked pension.

- Extension of the number of variables considered in the construction of the PVF tables to avoid the current problem of ignoring key components which have a material impact on the "real" value of a pension. For example, in the case of lifetime pensions:

  - the age of the reversionary pensioner - the current system places the same RBL value on a 100% reversionary pension to a 65 year old male regardless of whether his reversionary beneficiary is (say) 25, 65 or 105;

  - the exact level of the reversionary benefit - the current system places the same RBL value on a 76% reversionary pension as a 100% reversionary pension;

  - the exact age of the primary pensioner - the current system groups pensioner's in 5-year age bands – using exactly the same factor for a taxpayer who has just turned 65 as for one who is 1 day short of 70;

  - particular terms and conditions of the pension - for example, the factors ignore the presence (or lack thereof) of any guarantee period. This has become even more acute since 20 September 2004 when the allowable guarantee period for (say) a lifetime pension has increased to 20 years.

In my view, simply updating these factors would resolve the undervaluation component of RBL compression to a significant degree. I accept that this would also affect pensions provided by funds other than self managed funds but I contend that this is entirely appropriate.

Finally, it would appear that considerable work on deriving appropriate factors for converting income streams to lump sums has already been carried out for the purposes of the Family Law Act 1975. Is there any reason why the same (or at least conceptually similar) tables of factors could not be used for RBL purposes?

5.4.2 Use a purchase price approach

An alternative would be to value all defined benefit pensions arising from a clearly identifiable account balance based on the size of that account balance (ie, the method currently used for purchased (non lifetime) pensions – see Section 5.1.2 above). This has some intuitive appeal in that it is simple.

However, I believe it should be rejected for the various reasons outlined in the Institute of Actuaries' submission to the ATO (dated August / September 2003) regarding TD 2000/29:

- In my view, solvency reserves should continue to be excluded from the RBL assessment process (as outlined above). Unless legislative guidance is introduced as to how these solvency reserves should be calculated, there is a risk of great uncertainty and that different taxpayers with identical pension entitlements will have varying RBL results, simply because their respective actuaries do not adopt identical assumptions. If additional calculations are required in order to value the solvency reserves in order to exclude them, I contend that the purchase price method no longer has the intuitive appeal of being simple;

- Inconsistency between superannuation funds – a purchase price valuation process will introduce a significant disparity between lifetime pensions provided by different superannuation funds (for example, a corporate fund and a self managed fund providing identical income streams);

In the IAA's submission to the ATO in relation to TD 2000/29, it was recommended that a formula approach be used for all defined benefit pensions – purchased and non-purchased alike. This suggests that the best approach for resolving RBL compression is to address this formula and its inputs.

6. TAX BENEFITS – SOCIAL SECURITY

6.1 What are the Social Security opportunities?

6.1.1 Certain pensions (including two of the defined benefit pensions defined in Section 2 – the complying lifetime pension and the complying life expectancy pension) confer particular social security advantages on the pension recipient. Specifically, these pensions provide a full or partial exemption from the social security assets test – a full exemption is provided for pensions which commence prior to 20 September 2004 and a 50% exemption is provided for pensions commencing after that date.

6.1.2 I understand that the Government's concern is that this exemption extends social security eligibility (particularly the age pension) to a far "wealthier" group than originally intended.

6.2 Is it a real problem and is it specific to self managed funds?

6.2.1 I do not purport to have particular insight into the specific group within the community that "should" or "should not" receive social security benefits.

6.2.2 I do note, however, that the treatment of pensions from self managed funds is identical to externally purchased annuities for the purposes of this concession. Hence, the fact that an individual chooses to provide their income stream through a self managed fund rather than by purchasing an annuity provides no additional social security benefit to them.

6.2.3 If the Government considers that the current concessions allow inappropriate access to social security benefits, it would be difficult to argue that this was specific to self managed funds. In fact, I would argue that the Government has already taken extremely significant action on this concession by reducing the asset test exemption from 100% to 50%.

6.2.4 Self managed fund members are actually at a significant **disadvantage** relative to those members of the community who still enjoy a 100% asset test exemption – members of public sector & corporate defined benefit pension schemes.

6.2.5 Furthermore, the Department of Family and Community Services has already taken steps towards ensuring that taxpayers do not achieve access to social security benefits by drawing an artificially low pension from a given capital sum. This has been achieved by having the Australian Government Actuary's Office assess each social security application which incorporates a defined benefit pension from a self managed fund. The purpose of the assessment is to determine whether the amount set aside to provide the pension (the member's account balance) is significantly higher than a notional "purchase price" calculated by the AGA for that income stream. To the extent that the account balance exceeds this notional purchase price, the difference is treated as a "deprived asset" (ie, as if the funds have been given away by the pensioner immediately before retirement). This will act to reduce the age pension entitlement in the early years. I believe that these deprivation assessments are not made when the pension is provided from an arms length superannuation fund or an annuity provider – presumably on the basis that the transaction will, by definition, be "commercial" when carried out between two arms length parties.

7. TAX BENEFITS – ESTATE PLANNING

7.1 What are the estate planning opportunities?

7.1.1 Defined benefit pensions all have pre-determined end dates – ie, on death for a pension paid for life or at the expiry of the term for a pension paid for a fixed term. Providing the pension has not failed prior to that point, there will almost certainly be money left over at the end due to:

- the "solvency reserves" (as defined in Section 5.2). If these are not required (because the Fund's experience is as good as, or better than, expected), they will simply accumulate in the Fund throughout the course of the pension;

- better than expected experience (for example, higher than anticipated investment returns, lower than expected indexation, shorter than expected life etc).

7.1.2 The amount leftover at the end will be higher if the pensioner has set aside more than required at the outset – either because the trustee / pensioner wanted to be particularly conservative or because they intentionally overfunded their pension.

7.1.3 When a defined benefit pension is provided from a corporate fund or via an annuity, the leftover funds effectively become the property of that fund or provider. In a self managed fund environment, however, they remain the property of the trustee of the Fund and can be distributed to remaining fund members, the estate of the deceased etc.

7.1.4 The concern, therefore, is that taxpayers can deliberately structure their affairs to leave funds leftover at the end of their pensions for the benefit of other family members.

7.2 Is it a real problem and is it specific to self managed funds?

7.2.1 In my view, this issue is specific to self managed funds in that these funds are the only vehicle in which it is possible for the pensioner's family to retain control of the capital remaining at the end of a pension.

7.2.2 However, I believe that the build up of "leftover funds" is primarily a function of the legislative framework in which these pensions are provided rather than a sinister attempt to abuse the system:

- as mentioned in Section 5, defined benefit pension funds are encouraged to set aside more than the actuary's "best estimate" of the amount required to finance the pension. In fact, individuals seeking a social security assets test exemption <u>must</u> do so in order to keep their exemption. The natural outcome of this is that there will generally be funds left over at the end unless experience is much worse than expected;

- the SIS Regulations offer limited opportunities to adjust annual pension payments to reflect the ongoing performance of the fund relative to the initial actuarial assumptions. For example, some pensions cannot be reduced (prompting actuaries and trustees to take

a relatively conservative stance in establishing the pension and granting indexation increases) and some pensions can only be indexed at a fixed rate (despite, say, investment returns which would permit higher increases) etc.

Against this background, some reserves will almost always remain at the end of the pension (despite the best intentions of the pensioner, trustee and actuary).

Note, however, that the same could easily apply in a corporate fund or with an annuity provider but because these vehicles make no attempt to break down the total assets between individual pension recipients it would be less obvious.

From the community's perspective, is it necessarily any less acceptable for those reserves to pass to the family of the original pensioner than to other members of a corporate superannuation fund or the shareholders / policyholders of an insurance company?

7.2.3 My own experience as a practitioner in this field suggests that very few (if any) taxpayers will deliberately set aside more than required to finance their pension. While many may initially be excited by the idea of substantially minimising their tax obligations (or at least deferring them for many years), most (if not all) lose interest when they realise that:

- the left over funds will ultimately need to be allocated to someone (or someone's estate). The allocation will generally be subject to the superannuation surcharge, preserved and assessed against the ultimate recipient's RBL – resulting in a tax liability, albeit for a different taxpayer;

- assets underpinning any provisions over and above the actuary's "best estimate" of the pension liabilities do not receive the special tax exemption on investment income that normally applies to pension fund assets. A fund which is deliberately overprovisioned will therefore pay far more tax on its own income than would ordinarily be the case;

- once the decision is made to put "too much" aside for a pension, it cannot be changed without further tax consequences;

- there is arguably a breach of the "sole purpose test" (as defined in Section 62 of the SIS Act) if excess funds are being set aside with the intention of passing them on to future fund members.

As a result, I am not aware of any case in which a retiree has deliberately set aside more than the recommended amount to finance their pension. This technique may well be popular at technical conferences (where any tax reduction strategy attracts an attentive audience) but rarely implemented in practice. If my experience is consistent with that of other practitioners, it is difficult to justify a ban on defined benefit pensions from self managed funds on the grounds of estate planning opportunities.

7.2.4 In my experience, taxpayers who site "estate planning opportunities" as one of their motivations for maintaining a defined benefit pension in a self managed fund are focussing on the ability to retain control of capital on the

occurrence of a catastrophic event such as premature death. It is a defensive strategy rather than an aggressive one.

7.3 Alternative solutions to resolve estate planning issues

7.3.1 While I believe it unlikely that many taxpayers will deliberately overfund their pensions, it is certainly a possibility and could potentially cause revenue loss. I have therefore canvassed two ways of addressing this particular concern.

7.3.2 Taxation of emerging reserves

One way of making it less attractive to set aside "too much" for a defined benefit pension is to tax the reserves as they emerge (in a similar way to the way in which life office profits are taxed as they emerge).

In my view, however, if this is applied to self managed funds it should also be introduced to large schemes on the grounds of equity. Just because the reserves will end up benefiting a different group of individuals in a corporate fund does not make them any more or less appropriate.

7.3.3 Establishment of maximum funding levels

Alternatively, the Government could establish maximum funding levels to apply at the outset of a pension. (It is difficult to see how these limits could be imposed in subsequent years – what would the required action be in the event that the limit was exceeded?). The consequences of exceeding the maximum funding levels could be:

- an additional RBL assessment (equal to any amount by which the account balance exceeds the maximum funding limit); or
- additional tax; or
- loss of certain tax concessions in relation to the pension (for example, pension RBL access etc); or
- even greater taxation on the investment income of the reserves than currently applies; or
- some combination.

In a roundabout fashion, the Department of Family & Community Services has imposed defacto maximum funding limits for social security applicants in its use of the deprivation assessments discussed in Section 6. The weakness of that system, however, is that it ignores important features of individual funds in making its assessment (such as actual expense levels, actual investment structure etc). If maximum funding levels were to be adopted, it would be important to ensure that these recognised genuine differences between funds and the benefits being provided.

7.3.4 In conjunction with one or more of these measures, I believe there are strong grounds for providing greater flexibility in reserve management. In other words, assisting trustees to effectively control the build up of reserves when this occurs as a result of (for example) better than expected experience. This is discussed in more detail in Section 8.

8. IDEAL DESIGN FEATURES

8.1 Introduction

8.1.1 In Section 3, I expressed the view that defined benefit pensions (and lifetime pensions in particular) had a valuable role to play in achieving the apparent policy objective of encouraging Australians to effectively utilise their superannuation retirement savings to provide a long term income stream.

8.1.2 In subsequent Sections, I have indicated that I see no reason why these pensions cannot be provided from self managed superannuation funds.

8.1.3 However, I believe that there are some additional design features which would significantly enhance the pensions currently available under the SIS Regulations and this Section identifies the key ones.

8.1.4 I believe that two of the most important features which should be enhanced in our legislative framework are **flexibility and consistency**. Flexibility is critical in ensuring that as many retirees as possible take some kind of income stream while consistency ensures that we do not have two pieces of legislation counteracting each other unnecessarily.

8.2 Flexibility in Design

8.2.1 The current range of superannuation pensions provides significant design flexibility. Self managed fund members are able to essentially design a pension that suits their particular needs, albeit the greater the alignment of that income stream with the Government's policy objectives, the greater the tax / social security concessions. If the ban on defined benefit pensions from self managed funds continues, I suggest that consideration is given to expanding the range of account based pensions to include (say):

- pensions which incorporate some of the sound features of a market linked pension (for example, the ability to deliberately structure the draw down of capital to reflect a spouse's life expectancy – this opportunity is not available under an allocated pension) without the same level of inflexibility (ie, the inability to commute, the inability to choose from a range of payments etc);

- pensions which are designed to draw down capital evenly over an individual's <u>lifetime</u> rather than their <u>life expectancy</u>, albeit with no attempt to guarantee that this will occur.

8.2.2 Pensions providing this additional flexibility would not necessarily entitle the recipient to pension RBL access or a partial social security asset test exemption. They would nonetheless assist taxpayers needing neither of those concessions to structure their income streams to suit their needs.

8.3 Flexibility in choice of provider

8.3.1 I expect that it will simply not be cost effective for institutional providers to offer every pension option that might potentially suit a retiree. This is evident already in the annuity market – numerous pension designs which are permitted under SIS are simply not available commercially because they :

- present too great a risk for the provider (for example, a lifetime pension that can be commuted at any time. If an insurer offered this product, it would inevitably find that the “healthy” lives left their pension in place while the “unhealthy” lives commuted their pension prior to death); or

- are not sufficiently in demand.

8.3.2 In my view, it is therefore essential that self managed funds are not prohibited from providing these pensions to ensure that retirees are able to take advantage of the diverse range of pension structures available – even those which are not commercially viable for external providers.

8.4 **Flexibility and consistency in ongoing management**.

8.4.1 Currently, a social security recipient is faced with several conflicts within our legislative system:

- SIS implies that newly established pensions should be able to meet the 70% test and the Social Security Act 1991 requires that this test is met at all times in order to receive a full or partial asset test exemption. **However**, the fact that this will require additional solvency reserves is ignored in the deprivation assessment carried out by the AGA; and

- With the best will in the world, trustees will, from time to time, fail to meet the 70% test for a particular pension. (In fact, logically, a fund which intended to always meet the 70% test would need to set aside an even greater quantum of assets than the amount implied by this test simply to provide some buffer against adverse experience.) At that point, recipients will need to either (a) accept the fact that they have lost their asset test exemption and simply continue the pension unchanged or (b) “restructure” the pension (ie, essentially stop the existing pension and commence a new, lower, version with a view to regaining the asset test exemption. Social Security legislation recognises that this will occur and provides for a limited number of “restructures” before permanent loss of tax concessions. The ATO’s interpretation of SR 84 (as set out in Draft Determination SD 2004/01), however, is that SIS (as amended by SR 84) would prevent the restructure from occurring within a self managed fund (because the restructured pension would represent a new income stream).

8.4.2 In my view, then, it is essential that:

- some attempt is made to achieve consistency between the requirements of the Social Security Act 1991, SIS and the assessments of new pensions made by the AGA – particularly in relation to funding levels.

- “restructuring” defined benefit pensions which fail is relatively simple and does not encourage retirees to be unduly conservative in establishing their pensions;

- either the ATO Draft Determination SD 2004/01 or the legislation it purports to interpret is amended to ensure that restructures of pensions which pre-dated 30 June 2005 are not treated as new income streams. This is essential to ensure that those who start defined benefit pensions

before 30 June 2005 are not forced to move to an annuity provider (or take a market linked pension) should they ever need to restructure.

8.5 Flexibility in reserve management

8.5.1 One of the issues identified in Section 7 was that it is entirely possible for funds to be "left over" at the end of a pension (even if no solvency reserves have been set aside to meet the 70% test), simply because the Fund's experience is better than the actuary expected. For example, the Fund's investments may perform better than expected, the pensioner may live for a shorter time than expected, inflation (and therefore pension indexation) may be lower than expected etc.

8.5.2 One avenue to help trustees avoid building up large reserves as a result of favourable experience is to provide some flexibility in the key components of the pension so that it can (to some extent) emerge over time as the Fund's experience unfolds.

8.5.3 This could take many forms:

- a "core" pension which is guaranteed and cannot be reduced, combined with a bonus element (not guaranteed) which is declared periodically based on fund performance; or
- the "target pension" concept outlined by deLancey Worthington in his submission dated September 2004.

8.5.4 Both are designed to achieve broadly the same objective – ie, give trustees some means of dealing with reserves as they arise rather than at the expiry of the pension. Currently, some flexibility exists, for example:

- pensions may incorporate trustee discretion in relation to the indexation provided to pensions (although this has significant adverse implications for their social security deprivation assessments);
- some flexibility in the reversionary benefit is possible.

However, the two designs above would provide a far better reserve management tool without (in my opinion) any great threat to tax revenue.