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10 March 2005

Dear Sir/Madam

Review of the provision of pensions in small superannuation funds
Response to Treasury discussion paper (January 2005)

Thank you for the opportunity to respond to the Treasury discussion paper dated January 2005 regarding the provision of pensions in small superannuation funds.

This submission responds to the key issues outlined in that paper (hereafter referred to as the "discussion paper").

Introduction

1. As stated in our previous submission, we consider that the ban on small funds providing defined benefit pensions was a very broadbrush and poorly targeted approach to dealing with the concerns which the government was seeking to address. Defined benefit pensions play a valuable role in the retirement plans of many retirees and we believe that access to defined benefit pensions within small funds should be allowed to continue.

Choice and Complexity (Your ref: 4.2 & 4.3)

2. As noted in our initial submission, in order to encourage retirees to draw their superannuation in the form of an income stream in retirement, sufficient choices must be provided so that retirees can structure their income stream to suit their needs. Allocated Pensions and Term Allocated Pensions (TAPs) may suit some, but they will not meet the needs of all as explained in our previous submission. In particular, they are unlikely to maintain real levels of income in the final years for many pensioners who are expected to

outlive average mortality and TAPs in particular are unlikely to provide a stable income when investment returns fluctuate. Pensions with defined benefit characteristics specifically address these fundamental problems, and as such defined benefit life-time pensions (and fixed term / fixed payment pensions) continue to fill a valuable role in the retirement plans of many retirees.

3. The discussion paper states that the provision of such income streams may involve a significant compliance or administrative burden for retirees. An example given is the different regulatory requirements applying to defined benefit pensions for prudential and taxation purposes. We note that these requirements have been imposed over time by various Governments. We would be willing to work with the Government to develop appropriate ways of simplifying these (and other) requirements if the Government believes that this now adds an unnecessary level of compliance or administrative burden.

Reasonable Benefit Limit compression (Your ref: 4.4.1 & 5.2.1)

4. The discussion paper sets out several options to address the concern termed "RBL compression". These are consistent with those set out in our original submission and would, in our opinion, resolve the Government's concerns relating to RBL compression. These solutions could be implemented relatively easily.

5. However, it is incorrect to imply (page 14) that a "one-size fits all" approach in larger funds does not give rise to RBL compression. Although the benefit design in larger funds may be relatively uniform, the recipients themselves are not. The standard valuation factors group people into five year age bands, do not distinguish between genders and take no account of the age of any reversionary beneficiaries. Consequently, the use of standard factors, together with the outdated nature of these factors, gives rise to undervaluation in larger funds as well.

Estate planning (Your ref: 4.4.2 & 5.2.2)

6. The discussion paper suggests that estate planning is used by people to shelter large amounts of assets within their superannuation fund for future generations. This may be true for some. However, for the majority of people, estate planning is of concern only to the extent that they desire any residual assets to be left for their dependants, rather than an external institution (such as a life company), on death. The aim is generally not to

intentionally leave large sums on death, but to ensure that any residual assets on death are left for their dependants. We question why this would be considered abuse?

7. We address a number of issues with respect to estate planning as raised in the discussion paper.

Cameos presented in Appendix D

8. Following the Senate hearings in mid 2004, we pointed out to the office of the Australian Government Actuary and the Treasury Department the inaccurate and misleading nature of the cameos presented to those hearings. It is disappointing that the same cameos are again presented in Appendix D of the discussion paper as factual, despite the fact that critical errors were previously brought to your attention.

9. In particular:

   (i) the cameos ignore the superannuation investment tax that applies to earnings on the reserve component of the defined benefit pension within the superannuation fund. This significantly understates the total tax payable in respect of the defined benefit pensions presented relative to the account based pensions.

   (ii) the cameos state that residual assets within a fund can be paid tax-free to a dependant on death. In the case of a complying pension for RBL purposes, it has by definition no residual capital value. Consequently, our understanding is that any residual payment (outside of any guarantee period) must be reported as a new benefit for RBL purposes. It would only be tax-free to a dependant to the extent of the unused portion of the deceased's pension RBL. In the case of the $5,000,000 example, this would mean that all of the residual would be treated as "excessive" on payment to a beneficiary. This not only significantly increases the tax payable in the examples shown, but also acts as a significant disincentive to building up large residual amounts within the superannuation fund.

   These points were also made in our previous submission.

10. If the cameos had been constructed more accurately, the tax differences between the defined benefit pension and the account based pensions shown would not be large. In fact, in some cases such as the $600,000 cameo in Appendix D, the overall tax received from the

defined benefit pension (both the tax paid by the individual and the superannuation fund) would be higher than the tax paid from the account based pension. Consequently, had the cameos been constructed correctly, it would have been clear that these differences would not have justified a ban on defined benefit pensions.

Tax on reserves

11. Although the cameos in Appendix D ignore the tax on reserves, this issue is acknowledged on page 16 of the paper. However, the discussion paper then asserts that *"any fund tax imposed through holding surplus assets will be minimal as it will only apply to a small proportion of the fund's earnings"*. This seems a strange statement to make – the tax will only be minimal if the surplus assets are minimal, in which case, why the concerns over estate planning? Tax is payable on both income and realised capital gains – and assets will inevitably have to be sold as the pension runs its course. It is incorrect to imply that the use of franking credits means that a person pays less tax. An account based pension with a full tax exemption would receive a full refund of franking credits, and pay no tax at all. The use of franking credits to offset tax in a defined benefit pension still represents a payment of tax (ie greater revenue to the government).

Preserving key family investments for subsequent generations.

12. The discussion paper raises concerns over the use of residual capital value (RCV) pensions to preserve key family investments within a small fund. We refer you back to our original submission where we suggested limiting the ability to structure an RCV beyond the compulsory cashing age (e.g. age 65 or 70) and possible restrictions on the beneficiaries that can be included as reversionaries (such as placing a bound on the age at which children can receive a reversionary payment). It is disappointing that the discussion paper simply restates the concerns, without taking on board the suggestions made to address such concerns.

13. We question whether, in this respect, the discussion paper actually meets the terms of reference set by the government, which included "addressing the concerns", not just restating them.

Estate planning benefits from investment and mortality reserves

14. The discussion paper states that *"Estate planning benefits also arise through the need for small funds paying lifetime pensions to maintain investment and mortality reserves."* On the one hand, the Government argues that small funds need to hold reserves to provide some certainty with respect to future pension payments. On the other hand, the Government then considers the existence of such reserves as estate planning and a potential abuse of the system. Which is it?

15. The need for reserving arises from the uncertainty in relation to future investment returns and uncertainty about how long an individual will live. Reserving is not unique to small funds – large funds, as well as institutions, also carry and manage various reserves. One of the differences with a small superannuation fund is that the reserves ultimately stay with the member's beneficiaries on death, rather than going to an institution.

16. Reserves are not a one-sided game, and it is incorrect to draw the conclusion that the existence of reserves must be for estate planning purposes. Residual assets on death will only arise if investments returns are as good as, or better than expected, and/or a person dies before or around their life expectancy. However, if future experience is less favourable than expected, there may be little (or no reserves) on the eventual death of a pensioner. Even government legislation is built around this principal (eg the high probability statement).

17. If experience is as good as, or better than expected, then residual monies may arise on death. In this case, the incentive for estate planning opportunities is limited by the following:

    - The payment of residual monies from a nil residual capital value pension results in a new death benefit ETP being reported for RBL purposes (since, by definition, it is not part of the original pension) and assessed against any unused portion of the deceased's RBL. Consequently, in most cases, part or all of any benefit payable on death would most likely be classed as an excessive amount (see above for further discussion).

    - In the case of a commutable (non-complying) pension, which could be structured to allow the payment of residual monies on death, the SIS Regulations restrict the amount of a lump sum that can be commuted from the pension (refer SIS Regulation 1.06(6)(g) and SIS Regulation 1.08). Any payment above the maximum amount permitted by the SIS Regulations would then need to be reported as a new ETP, and would be assessed against the unused portion of the deceased's RBL. This appears to have been overlooked by the discussion paper.

- Rather than pay out residual monies as a lump sum on cessation of a pension, it is possible that monies could be transferred to the accounts of other members in the fund. In this instance, the provisions of the superannuation surcharge legislation would usually apply (eg contributed amounts and allocation of reserve provisions). When these monies are ultimately taken as a benefit by the recipient, the funds allocated from reserves would be assessed against the recipient's RBL and subject to tax as part of their own pension. If the Government believes that these measures are not sufficient on their own to address their revenue concerns, then we refer you back to our previous submission which put forward several suggestions on how to limit the build-up of excessive reserves within a fund and hence, reduce the likelihood of large residual amounts remaining on death (pages 14-16).

18. We also note again that any reserves do not attract a tax exemption on income each year within the superannuation fund.

19. The discussion paper suggests one option of dealing with residual monies in a small superannuation fund could be to tax it as special income of the fund. We are not in favour of this suggestion. This appears to be very severe, given the current taxes that apply to superannuation and the points noted above. Also, given the paper seems to advocate that any pension options available for small funds should also be available for large funds, any tax consequences should also be applied equally to all funds as well.

Inappropriate access to Social Security concessions (Your ref: 4.5)

20. The discussion paper notes that the ability of relatively wealthy people to access the age pension has been largely addressed by the reduction in the exemption from the assets test from 100% to 50% for purchased pensions commencing from 20 September 2004 (even though the 100% exemption still applies to new non-purchased pensions such as those paid from corporate or public sector superannuation funds!).

21. The discussion paper also states that there are concerns over the potential pressure on future age pension outlays given the inability of small funds to guarantee pension payments. We comment on the "guarantee" issue below. However, such comments appear to show a

misunderstanding of this issue. TAPs effectively receive the same social security treatment as defined benefit pensions and yet carry no guarantees. If these concerns arise with respect to defined benefit pensions, by logical extension, they must also arise with regard to TAPs, and yet there is no move to ban TAPs?

22. In fact, a TAP will (with 100% certainty) be exhausted by the end of its nominated term (which is based on life expectancy), potentially forcing many people back onto the social security system much earlier than a defined benefit lifetime pension. The use of "average" life expectancy to set the maximum payment period (even if a retiree chooses the life expectancy based on a person five years younger) means that a large number of pensioners are expected to outlive their pensions, requiring support by other means in their final years. Future improvements in longevity further exacerbate this problem. Defined benefit pensions address these issues by setting the initial pension level appropriately and the use of reserving to allow for payment into old age.

Risk (Your ref: 4.6)

23. The discussion paper states that a key concern is the ability of small funds to guarantee pension entitlements. It is disappointing that the discussion paper seems to have simply brushed aside our views (and those of others) on the issue of risk management. Rather than restate our views again, we refer you back to our initial submission, and that of the Institute of Actuaries of Australia with which we concur.

24. However, there appears to be an inappropriate fixation on the absence of the pooling of mortality risk in the discussion paper, as it is described an *"a major issue"*. While pooling addresses one aspect of mortality risk (the risk that different members of a pool will die at different times but within a large pool, overall experience is expected to be "average"), it does not address the very significant risk of increasing longevity - that is, everyone in the pool living longer. Increasing longevity is an issue that many governments and providers of annuity products are grappling with – with no easy answers. Arguably, this is an issue which can be more readily allowed for in small funds, where there are no shareholders to protect or profit margins to manage. The debate so far has focussed on pooling alone at the exclusion of this other very significant risk.

25. To summarise the views in our previous submission, we believe defined benefit pensions allow a retiree to manage risks such as volatility in investment earnings and longevity risk

better than account based pensions. Small funds can employ various reserving techniques to assist in providing a stable level of income that can be maintained into old age. Small funds are also subject to ongoing actuarial review. We refer you back to our original submission for suggestions on how to further improve the management of these risks.

26. Furthermore, for many small funds, the use of defined benefit pensions should result in higher levels of income over the longer term (compared to traditional life office annuities) due to the ability to invest in higher returning assets (other than long term government bonds) and the absence of shareholder returns and profit margins which are inherent in institutional products. Any residual assets would also usually be passed on to the next generation of retirees, rather than shareholders. Consequently, the use of defined benefit pensions should reduce the long term burden on the social security system, rather than increase it.

Management of Risk (Your ref: 5.2.3)

27. The discussion paper makes several suggestions to assist in managing the risks in small funds. Unfortunately, it appears to ignore the key suggestion we made in our previous submission (pages 18-19).

28. We briefly comment on the suggestions outlined in the discussion paper.

- *Enhanced actuarial requirements* - we would be happy to work with the government to enhance current actuarial requirements if this is considered desirable. We would require further detail of the areas that the government has in mind.

- *Tightening of investment rules* - we are not in favour of the suggestion. The SIS legislation already has a range of investment rules with which all superannuation funds must comply. The government's objectives of simplicity and flexibility may be compromised by more prescriptive standards. Furthermore, one of the attractions of small superannuation funds is the ability for individuals to have more control over the investment of their retirement savings money, provided they meet the sole purpose test and other relevant requirements. The introduction of more restrictive investment rules which apply only to small funds paying particular kinds of income stream appears unnecessary regulatory intervention.

- *Requirement to purchase longevity insurance* - we are not in favour of forcing all small funds paying defined income streams to purchase a deferred annuity simply to help manage mortality risk. The mere suggestion of this requirement means that the discussion paper has missed the point that many people do not wish to purchase an institutional product. For some people, longevity insurance may well be appropriate. However, for others, this will not be the case. The option to do so is currently available to individuals, but a large number of people have not taken up that option for a variety of reasons. People who use small superannuation funds do so because they prefer these arrangements to the other products available in the market. The need for institutional providers to charge high risk premiums to protect the institution against investment and mortality risk, as well as to provide profit margins, often results in pricing which is often perceived to be unfavourable to the average retiree.

Appropriateness of residual capital values

29. The discussion paper raises the issue of residual capital values. Residual capital values (RCVs) can only be structured with pensions that comply with SIS Regulation 1.06(6). These pensions count towards the lump sum RBL, not the higher pension RBL. Rather than debating the pros and cons of RCVs in retirement products, we would suggest that RCV's simply be treated in a similar manner as non-current pension assets in terms of cashing restrictions and taxation concessions, since they are lump sum by nature.

Demand for modified defined benefit pensions

30. The discussion paper seeks the views of industry on the likely future demand for defined benefit pensions in small funds. Given that allocated pensions and TAPs do not cater for everyone's needs, we believe that defined benefit pensions will continue to fill a valuable role in the retirement plans of retirees, provided that any proposed modifications to such pensions are not overly restrictive or onerous.

Modifying existing pension products (Your ref: 5.3)

31. The discussion paper presents several modified product options. We do not believe that these modified products will replace the role of defined benefit pensions, but for completeness, we briefly comment on each of the modifications proposed.

- *Extending the maximum pension term for TAPs* – we believe that there is merit in modifying the rules of the existing TAP (market-linked pension) to extend the maximum pension term to provide retirees a greater degree of certainty that they will not outlive the pension.

- *Requirement to purchase a deferred life-time annuity* - we do not support the suggestion of requiring small funds paying pensions to purchase a deferred life-time annuity, as explained above.

- *Smoothing the annual TAP payments* - we would support the introduction of a mechanism which provides for some smoothing of the annual payments each year for TAPs to give the retiree some certainty on their year-to-year payments, provided the mechanism is relatively simple and flexible enough to have the desired effect in practice. The simplest way to achieve this would be to allow minimum and maximum drawdown factors for TAPs with a range sufficiently wide enough to achieve a reasonable level of smoothing in practice.

- *Updating the allocated pension drawdown factors* - we would support this suggestion.

Alternative pension designs (Your ref: 5.4)

32. The paper puts forward several alternative pension designs. It is unfortunate that only account based pension designs are considered, despite the merits of defined benefit pensions as explained in our previous submission (and submissions put forward by others).

33. The one-size fits all approach which inevitably comes from prescribing standard factor tables with account based pensions is unlikely to be flexible enough to suit the circumstances of all retirees. For example, a standard set of factors will not allow for the differing investment/risk profiles of each retiree. A retiree who invests primarily in cash or capital guaranteed products may need to draw a lower income than one who invests in higher returning growth

assets. Or a retiree in poor health may be able to draw a higher income than one in better health. A standard set of factors does not allow for such differences.

34. Different pensioners will seek different things from their income stream. However, we believe that the most common set of needs may be summarised as follows:

- Ability to draw down capital in an orderly fashion so that the income stream is genuinely designed to be paid at material levels throughout the lifetime of the primary pensioner and (if applicable) the reversionary pensioner;

- Reasonable level of certainty in income levels from year-to-year;

- No required involvement of an external insurer / larger institution;

- Ability to access pension RBL / social security asset test exemptions; and

- No investment restrictions (other than the practical limits such as sufficient liquidity to be able to pay the pension payment each year).

35. The two approaches put forward in the discussion paper fail in meeting one or more of the above objectives:

35.1 The lifetime annuity approach (Your ref 5.4.1):

- Only aims to maintain real level of income until age 85, which will be inadequate for many;

- Jumps in income are likely to occur by forcing individuals to use the central PVF as soon as the minimum/maximum drawing limit is reached;

- The approach applies a standard factor table for all and applies them at a single point in time – it does not recognise the specific circumstances of each individual.

35.2 The annuity certain approach (Your ref 5.4.2)

- While aiming to maintain income into old age, it still has the problems of the second and third points For example, the use of a standard set of factors, together with the assumption of a *"moderate earnings rate"* (as stated in the discussion paper) may not be appropriate for more conservative investors, or if the risk profile of an investor changes as their time horizon becomes shorter.

36. Unlike account based pensions, defined benefit pensions allow a retiree to meet all of the objectives set out above, and will, if allowed to continue, form an important role in the retirement plans of retirees.

If you would like to discuss the above further, please do not hesitate to contact me.

Yours sincerely,

Cohen Watson
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