Review of the provision of pensions in small superannuation funds

Discussion Paper

January 2005

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TERMS OF REFERENCE

REVIEW OF THE PROVISION OF PENSIONS IN SMALL SUPERANNUATION FUNDS

The Government has been advised, including by the Government Actuary, of a number of concerns with the provision of defined benefit pensions in small superannuation funds, namely:

- access to unintended tax and social security benefits, particularly from the use of 'RBL compression';
- their use for estate planning purposes in the superannuation system outside what was intended and not available to other superannuation fund members; and
- whether a small number of members can effectively pool risk and guarantee income payments over the term of the pension.

The Government has established a team to address these concerns and review the provision of pensions in small superannuation funds.

The review will examine options for small superannuation funds to provide pensions to their members, including consideration of:

- design features of prospective pensions that address the Government's concerns and that could attract complying status for taxation and social security purposes;
- management of investment, liquidity and mortality risks; and
- likely future demand for pensions with defined benefit characteristics.

The review will be conducted by a team within the Department of Treasury, including a representative from the Australian Government Actuary's Office, and will consult with industry and other stakeholders, superannuation regulators and the Department of Family and Community Services.

An initial round of consultation will aid Treasury in developing a discussion paper. The Treasury discussion paper will outline key issues and canvass options and is expected to be released by the end of the year [2004]. Following further consultation, Treasury will report to Government by April 2005.

OVERVIEW

1 BACKGROUND TO THE REVIEW

This part summarises the contextual background for the review. The 2004-05 Budget announced measures to address the use of defined benefit pensions by small superannuation funds for tax avoidance and non-retirement income purposes. The measures also sought to address prudential issues with small funds, namely the ability to manage the risks of providing a defined benefit pension. The objectives of these measures were broadly supported. However, the superannuation industry raised concerns with the means chosen. On 5 August 2004 the Government announced a review of pensions provided by small superannuation funds.

2 REVIEW PROCESSES

This part identifies the key tasks required by the terms of reference, sets out the scope of the review, and explains the purpose of this discussion paper as part of the broader review process. This part also specifies how to make a submission.

The key tasks are to review the provision of pensions by small superannuation funds, to address certain concerns with small superannuation funds providing defined benefit pensions, to examine options for the provision of pensions by small superannuation funds, to prepare this discussion paper, to consult with stakeholders, and to report to Government by April 2005.

The review is directed at defined benefit pensions and other pensions that are provided in small superannuation funds. A small superannuation fund is defined as having fewer than fifty members. The review will take into account the defined benefit pension integrity measures announced in the 2004-05 Budget.

The discussion paper outlines key issues with pensions in small funds and canvasses strategies to address the issues. The paper is intended to help individuals and organisations prepare further submissions to the review. Interested parties can make submissions up until 11 March 2005.

3 Retirement income policy objectives

This part provides a policy background for the review by presenting a statement of the Government's retirement income policy objectives.

Broadly, the objectives of the retirement income system are to encourage people to achieve a higher standard of living than would be possible from the age pension alone, while ensuring they have security and dignity in retirement. To achieve this the system should encourage people to save for their retirement, be predictable, facilitate choice, and be equitable. Australia's ageing population also highlights the need for retirement income policy to be fiscally sustainable in the longer term.

Substantial tax concessions for superannuation encourage people to save for their retirement. These are made on the basis that the savings provide genuine retirement income. They are not intended to provide estate planning or wealth accumulation benefits beyond those necessary for retirement income purposes. Assets built up in superannuation should be drawn down in retirement.

Similar objectives underpin the generous social security concessions provided to income streams when ownership of the asset backing the income stream is signed away in return for a regular, dependable income based on life or life expectancy.

4 Key issues with pensions provided by small superannuation funds

Key issues are examined from the perspectives of choice, complexity, taxation, social security and risk.

The restrictions on small funds providing lifetime and guaranteed term pensions effectively reduce the range of income stream choices available from small funds. Small superannuation funds still can provide allocated pensions and market linked pensions. However, initial submissions argue there will still be demand for defined benefit pensions from members wanting a given level of income for their lifetime or other term.

The system for retirement income stream products in Australia is complex, reflecting a mixture of legislative frameworks that are designed to meet different retirement income policy objectives.

The non-arm's length nature of small funds allows a member to design a pension to gain unintended tax and social security benefits. Two such arrangements, Reasonable Benefit Limit (RBL) compression and estate planning, are examined.

There are three key issues about the ability of small funds to guarantee a defined benefit pension: the lack of an employer guarantor, the absence of risk pooling, and the management of investment risks.

5 STRATEGIES FOR ADDRESSING ISSUES

The initial round of submissions suggested a number of proposals to overcome issues with small funds providing defined benefit pensions. To facilitate further comments, the discussion paper presents three main strategies that may allow greater retirement income choice for members of small funds and address, directly or indirectly, taxation, social security, risk and complexity issues.

The strategies are to develop new rules for the provision of defined benefit pensions, to modify existing pension products, and/or to introduce new pension products. The strategies could be implemented separately or in combination.

New rules to address RBL compression could include a purchase price valuation or updating pension valuation factor tables. Pension design standards and changed taxation arrangements to recover excessive benefits could address estate planning issues. Risk management options include transferring risk to the pensioner, introducing portfolio rules and attaching longevity insurance (in the form of a deferred annuity) to a pension.

Four modified product options are presented. Two options manage the longevity risks of the market linked pension by extending the term and attaching longevity insurance respectively. The third smooths payments from the market linked pension and the fourth manages the longevity risks of the allocated pension through updating the minimum payment factors.

To address tax avoidance and risk management issues the new product options are limited to account based products. Each option aims to provide a CPI-indexed pension to an advanced age, but with payment adjustments to eliminate the build up of excessive reserves. The new product options also use pension valuation factors to minimise complexity so they can be administered by fund members.

The budgetary cost of each option is still to be estimated. A possible outcome from the review could be that the restrictions on small funds providing defined benefit pensions would remain in place. Whether or not new products or product modifications or new rules for defined benefit pensions were introduced would be a matter for Government.

1 BACKGROUND TO THE REVIEW

In the 2004-05 Budget the Government announced a number of measures to improve the integrity of the superannuation system that impacted on self managed superannuation funds (SMSFs) and other small superannuation funds (Appendix A).

The measures included new regulations that took effect from 12 May 2004 for defined benefit pensions (Appendix B). Under these new rules defined benefit funds and funds providing defined benefit pensions must have at least 50 members. The Government introduced these new rules to address tax avoidance arrangements, and to strengthen the prudential standards, relating to these funds.

After the integrity measures were announced, the superannuation industry broadly supported the need to limit abuse of superannuation schemes for tax avoidance or other non-retirement income purposes. Nevertheless, the superannuation industry and representatives of small superannuation funds argued that the defined benefit pension integrity measures reduce the range of income stream choices available from small funds. They also argued that the measures are not well targeted, and that the Government's concerns can be addressed through other means.

The Government put in place the following transitional arrangements to address any unintended consequences arising out of the Budget measures:

- the introduction of the new complying market linked income stream from 20 September 2004;
- a transition period to allow those people, who on 11 May 2004 were members of a fund with fewer than 50 members and who retire, the ability to commence a complying lifetime or life expectancy pension until at least 30 June 2005; and
- the establishment of the review of the provision of pensions in small superannuation funds.

The key tasks of the review are set out in the terms of reference.

2 REVIEW PROCESSES

2.1 KEY TASKS OF THE REVIEW

The Minister for Revenue and Assistant Treasurer announced the review of the provision of pensions in small superannuation funds on 5 August 2004 (Appendix C). The terms of reference are at the start of the discussion paper.

In accordance with the terms of reference, Treasury is conducting the review, along with a representative from the Australian Government Actuary's Office.

The terms of reference stipulate six key tasks:

- **review** the provision of pensions in small superannuation funds;
- **address** the following concerns with the provision of defined benefit pensions in small superannuation funds:
  - access to unintended tax and social security benefits, particularly from the use of 'RBL compression';
  - their use for estate planning purposes in the superannuation system outside what was intended and not available to other superannuation fund members; and
  - whether a small number of members can effectively pool risk and guarantee income payments over the term of the pension;
- **examine** options for small superannuation funds to provide pensions to their members, including;
  - design features of prospective pensions that address the Government's concerns and that could attract complying status for taxation and social security purposes;
  - management of investment, liquidity and mortality risks; and
  - likely future demand for pensions with defined benefit characteristics;
- **develop and release** a discussion paper that outlines key issues and canvasses options;

- **consult** with industry and other stakeholders, superannuation regulators and the Department of Family and Community Services, both before and after release of the discussion paper; and

- **report** to Government by April 2005.

2.2 Scope of the review

The review is directed at defined benefit pensions and other pensions that small superannuation funds provide. A small superannuation fund for the purposes of this review has fewer than 50 members.

The review will take into account the defined benefit pension integrity measures announced in the 2004-05 Budget. However, the review has not been asked to consider other superannuation integrity measures announced in the 2004-05 Budget (for example, the requirements that accumulation funds allocate all contributions to a member's account and fully vest benefits in a given member) or other measures affecting small superannuation funds.

2.3 Purpose of the discussion paper

An initial round of consultation, involving taking initial submissions from interested parties, has helped Treasury in developing this discussion paper. These initial submissions are posted on the review's website (see below) except where consent to make them publicly available has not been obtained.

Consistent with the terms of reference, the discussion paper outlines key issues with pensions in small funds and canvasses strategies to address the issues.

The paper is intended to help individuals and organisations prepare further submissions to the review, drawing attention to key issues on which the review is seeking comment.

After Treasury receives the next round of submissions, the review team may convene consultations with groups to further discuss key issues and options.

Treasury will take into account the outcomes of its consultations before reporting to Government by April 2005.

2.4 INVITATION FOR PUBLIC COMMENT

All interested parties are invited to make submissions and comment on this paper. Treasury will accept written submissions up until 11 March 2005.

In formulating your submission please note the issues, options and questions that this discussion paper raises. The matters raised are not exhaustive and you may comment on other matters you consider relevant to the terms of reference.

Forward submissions to:

The Manager
Retirement Income and General Rules Unit
Superannuation, Retirement and Savings Division
The Treasury
Langton Crescent
PARKES ACT 2600

Alternatively, email submissions to:

dbpensionreview@treasury.gov.au.

The review intends to make submissions publicly available except where the provider wishes them to be confidential. If you do not want your submission or any parts of your submission to be made publicly available, please indicate that clearly.

Additional information and further contact details are available at:

http://dbpensionreview.treasury.gov.au

3 Retirement income policy objectives

A key commitment of the Government is the development of a sustainable retirement income system, that is, a system that meets its objectives in a manner that the community can afford over time. The Government's retirement income objectives were set out by the Treasurer and the then Minister for Social Security in the policy statement *Savings: Choice and Incentive*.

Retirement income policy objectives

The Government is committed to a retirement income policy that provides encouragement for individuals to provide a higher standard of living than would be possible from the Age Pension alone, but also ensures all Australians have security and dignity in retirement. This will be achieved by:

- encouraging people who are able to save for their retirement to do so, particularly through superannuation;
- ensuring the provision of an adequate public safety net in the form of an Age Pension for Australians who are unable to support themselves in their retirement years;
- ensuring the system is predictable, but facilitates choice and is equitable; and
- ensuring the system is fiscally sustainable and delivers an increase in national saving.

The Government believes these objectives can be met by the current three pillared retirement income system comprising:

- voluntary superannuation and other private savings;
- compulsory superannuation savings through the Superannuation Guarantee contributions; and
- a means tested Age Pension and associated social security arrangements.[1]

1 *Savings: Choice and Incentive*, Statement by the Hon Peter Costello, MP, Treasurer and Senator the Hon Jocelyn Newman, Minister for Social Security, 13 May 1997, p. 10.

The statement also highlights that a sustainable retirement income system is needed to address the implications of the ageing population.

Implications of the ageing population

Australia, like most other economically advanced countries, is facing a steady ageing of its population … This … demographic change highlights the increasing need to develop a retirement income policy that is fiscally sustainable. It implies the need for Australians to make adequate provision for their own retirement. The primary way in which people can provide for an income in retirement is by saving through their working lives.[2]

The statement also indicates how the Government intends that superannuation savings be used.

The purpose of superannuation savings

The Government believes that superannuation savings should be directed to their intended purpose: namely to provide for retirement income. Towards this end, superannuation receives substantial tax concessions.[3]

In *A more flexible and adaptable retirement income system* the Government expressed this alternatively by stating that the substantial tax concessions provided to superannuation to encourage people to save for their retirement 'assume people will draw down on their superannuation benefits later in their lives'.[4] Accordingly, the Government regards the use of superannuation specifically for estate planning rather than retirement income purposes as 'inconsistent with the purpose of providing tax concessions to superannuation'.[5]

The retirement income system is not designed for individuals to build up excessive wealth or manage their pre-retirement affairs in a low tax environment.

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2 *Savings: Choice and Incentive*, p. 9.
3 *Savings: Choice and Incentive*, p. 17.
4 *A more flexible and adaptable retirement income system*, February 2004, p. 8.
5 *A more flexible and adaptable retirement income system*, p. 8.

Limits imposed on the retirement income system to meet these objectives include:

- a sole purpose test, and investment and borrowing restrictions for superannuation funds;
- special duties for superannuation trustees including investment strategy covenants;
- age based deduction and reasonable benefit limits on taxation concessions; and
- a means test for the age pension.

The social security means test, comprising the income and assets tests, helps keep the age pension affordable and sustainable by requiring people with significant resources to draw on them before calling on the community for assistance through the age pension. Social security concessions are provided to income streams when ownership of the asset backing the income stream is signed away in return for a regular, dependable income based on life or life expectancy. They encourage people to maximise their income in retirement while restricting the scope for relatively wealthy people to qualify for the age pension through income minimisation or estate planning strategies.

4 KEY ISSUES WITH PENSIONS PROVIDED BY SMALL SUPERANNUATION FUNDS

4.1 INTRODUCTION

The vast majority of small funds are self-managed superannuation funds (SMSFs). SMSFs are small funds with fewer than five members. They are run by the members, that is, each member must be a trustee. SMSFs have been the fastest growing sector in the superannuation industry in recent years, reflecting the desire of many people to have more control and flexibility in using their superannuation fund assets.

SMSFs must be established for the sole purpose of providing benefits to people on their retirement, or to their dependants in the case of a member's death. These funds are also subject to the same rules that govern other superannuation funds, such as those regarding the preservation of benefits. SMSFs are regulated by the Australian Taxation Office. Funds with five or more members are regulated by the Australian Prudential Regulation Authority.

Nevertheless, there are several issues with SMSFs and other small funds related to their ability to pay defined benefit pensions.

- Tax avoidance opportunities have arisen largely because of the absence of an arm's length separation between the roles of the trustee, fund manager and member. In these circumstances, paying a defined lifetime or fixed term pension from a small superannuation fund allows the member to design the pension to manipulate the application of certain superannuation rules. As a result, small funds may have access to tax and social security benefits that were not intended by the Government's policy objectives.

- There are also prudential issues with small funds providing defined benefit pensions — namely the ability of a small fund, in the absence of pooling or an employer guarantor, to adequately manage the market and mortality risks of a defined benefit pension.

The Government sought to address these issues through the integrity measures it announced in the 2004-05 Budget.

The key issues with pensions provided by small superannuation funds are examined below from the perspectives of choice, complexity, taxation and social security objectives, and risk.

4.2 Choice

Many small superannuation funds are established so that members can have more control over their retirement investments and avoid the ongoing fees and charges of external management. Members are attracted to these funds as they provide choice over the eventual structure of their withdrawal benefits, including the perceived ability to access an income stream that can be aligned with a retiree's financial needs and personal circumstances.

The restrictions on small funds providing lifetime and guaranteed term pensions introduced in the 2004-05 Budget reduce the range of income stream choices available from small funds.

Initial submissions note that members of small funds purchasing an equivalent annuity through a life company incur extra costs (through external fees, asset realisation costs and capital gains tax) and give up control of their retirement savings and estate benefits (beyond the pension guarantee period). Retirees also perceive lifetime annuities as poor value for money.

Small superannuation funds still can provide allocated pensions and market linked pensions to their members. These are account based pensions, with choice of pension investments and consequential risk remaining with the individual account holder. The market linked pension is also a complying pension, which qualifies for a higher reasonable benefit limit and a 50 per cent asset test exemption under social security rules.

These products provide a range of retirement income options that meet most retirees' needs. However, initial submissions argue that there will still be demand for defined pensions from individuals wanting a given income level for their lifetime or other term, and that small funds should be able to offer these pensions to their members.

4.3 Complexity

The system for retirement income stream products in Australia is intrinsically complex, reflecting a legislative framework that encourages self provision in retirement through a mixture of taxation and social security incentives. There are also prudential requirements and measures designed to meet other retirement income policy objectives. An example of the complexity arising from these different regulatory dimensions is that actuarial certification provisions for defined benefit pensions provided by small funds apply different assumptions for prudential and taxation purposes. There are also interactions between the tax and social security systems in the treatment of income stream products.

Providing these products may involve a significant compliance or administrative burden for retirees, the superannuation industry and regulators. Many retirees may have to access professional advice to make informed decisions about the best retirement strategy and the ongoing management of income stream products. Retirees may also focus on the tax and social security advantages of competing products rather than their underlying suitability.

4.4 INAPPROPRIATE ACCESS TO TAX CONCESSIONS

A key element of the Government's retirement income policy is the provision of significant taxation concessions to encourage savings for retirement. These concessions are provided on the basis that these savings will be drawn down as income in retirement. The value of the concessions is estimated at $13.3 billion for the 2004-05 year.

For equity and budgetary reasons, certain limits apply to individuals accessing these concessions. For instance, the system includes age-based taxation deduction limits for contributions and an overall cap on the level of benefits that can receive tax concessions. In addition, the superannuation cashing rules and income stream standards are intended to ensure an individual's superannuation savings provide genuine retirement income rather than estate planning or wealth accumulation benefits.

Many of these limits and standards can, in practice, be avoided by designing and providing a pension through a small, non-arm's length fund.

4.4.1 Reasonable Benefit Limit compression

The Reasonable Benefit Limit (RBL) arrangements provide an overall lifetime limit on an individual's superannuation benefits that can receive tax concessions. Complying pensions (lifetime, life expectancy and market linked pensions) receive a higher reasonable benefit limit as they are non-commutable, do not have a residual capital value and make annual payments for a term which is usually at least as long as the recipient's life expectancy at the commencement of the pension.

RBL compression refers to the practice of designing a lifetime pension in order to reduce the pension's value that is reported for RBL purposes. The strategy is used to avoid excess benefits tax (including on death benefit payments) and secure a full rebate (15 per cent) on taxable pension income.

Pension valuation formula

Pensions payable for life are valued according to the formula in section 140ZO of the *Income Tax Assessment Act 1936* (ITAA 1936).

[Annual value x Pension Valuation Factor] – Undeducted Purchase Price + Residual Capital Value [6]

Manipulating the formula

The goal of RBL compression is to minimise the capital value of the pension (according to the above formula) as far as possible. Several key elements in the formula can be readily manipulated through providing a lifetime pension through a small fund.

- A low initial annual payment — and a favourable pension valuation factor — can be determined through setting the terms of the pension (such as whether there is reversion), the level of risk and the indexation rate.
- After tax contributions (undeducted contributions) can be made to the fund, providing scope for the value of the pension to be reduced further or eliminated entirely. This can result in the reported value of the pension being zero for RBL purposes, even though the pension is partly funded by accumulated contributions that have benefited from tax concessions.

Pensions in larger funds

The formula and the pension valuation factor tables in Schedule 1B of the Superannuation Industry (Supervision) Regulations 1994 (SISR), were designed to apply to lifetime pensions provided by traditional public sector and corporate defined benefit funds. The formula and the 'one size fits all' approach of the tables reflect the uniform characteristics of these pensions rather than the gender or personal circumstances of their recipients. Nevertheless, the lack of precision and outdated assumptions of these tables makes most valuations of lifetime pensions provided by these funds lower than equivalent purchased annuities.

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6 In this formula, the annual value means the sum of the pension payments to be made in the course of the first year of the pension. The pension valuation factors are set out in Schedule 1B of the Superannuation Industry (Supervision) Regulations 1994. Regulation 53H of the Income Tax Regulations 1936 provides that the factor mentioned in the definition of the 'pension valuation factor' in section 140C of the ITAA 1936 is in accordance with Schedule 1B of SISR. The undeducted purchase price is the amount outlaid (after tax) by the individual to purchase the pension, for which no tax deduction has been granted. The residual capital value for a complying lifetime pension must be zero but can be up to the purchase price for a non-complying pension.

4.4.2 Estate planning

The tax concessions provided to superannuation can result in superannuation being used for inappropriate estate planning purposes. In particular, small superannuation funds can be used to maintain investments in a low tax or tax free environment, to pass to future generations, rather than being paid out as retirement income. The ability to pay a defined benefit pension, on non-arm's length terms, may form a key element of these arrangements.

Estate planning arrangements

Estate planning can include specific strategies to preserve key family investments in a small superannuation fund for subsequent generations. These strategies may involve use of non-complying pensions, that can be commuted or have a residual capital value. For example, a term pension, with 100 per cent residual capital value, can set aside a given investment to pass to a nominated family member following a pensioner's death.

Estate planning benefits also arise through the need for small funds paying lifetime pensions to maintain investment and mortality reserves. According to the Australian Government Actuary, reserving policies for reversionary lifetime pensions, on average, are likely to result in about 25 to 30 per cent of the residual capital (in real terms) remaining in a small fund after 25 years (Appendix D). This is about three to four times more than the expected remaining account balance for a market linked or allocated pension product.

An important difference to note regarding these outcomes is a compulsory minimum drawdown with market linked and allocated pension products. With a lifetime pension there is no minimum compulsory drawdown, thus providing better estate planning opportunities.

Estate planning incentives

Some initial submissions argue estate planning incentives are moderate since reserves eventually are cashed from the superannuation system as beneficiary pensions or lump sum death benefit payments.

These arrangements still provide significant tax advantages over and above those received by beneficiaries of arm's length pension arrangements or from savings held outside the superannuation system. Reserves reallocated to 'second or third generation' fund members may benefit from remaining in a low tax environment for 30 or more years. Furthermore, while these amounts are reported for surcharge purposes, they are not subject to contributions tax or deduction limits. Lump sum death benefit payments also receive very favourable tax treatment with tax free payments to financial dependents up to the deceased's pension Reasonable Benefit Limit.

The tax treatment of superannuation funds paying defined benefit pensions may limit the incentive to build up excessive reserves. The tax exemption for income earned by a small superannuation fund paying a lifetime pension is limited to a 'best estimate value' of the pension. Any income generated from surplus assets above this level is taxed at the fund taxation rate of 15 per cent.

However, 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. The use of franking credits and capital gains tax concessions could reduce the rate of tax on these earnings. There is also some scope for actuarial discretion in estimating surplus assets.

4.5 Inappropriate access to social security concessions

A further element of the Government's retirement income policy is the use of substantial social security means test concessions to encourage people to maximise their retirement income. Generous concessions are provided under the income and assets tests to those individuals who choose to draw down their savings for retirement in a steady, predictable manner in the form of an income stream. At the same time, the Government is concerned to minimise the scope for relatively wealthy people to use income streams to access the age pension inappropriately.

Access by relatively wealthy people to the age pension is largely addressed by the reduction in the exemption from the assets test from 100 per cent to 50 per cent for complying income streams purchased from 20 September 2004. However, small funds that provide these pensions can still manipulate their reserves to increase access to age pension payments. There are also concerns regarding the capacity of small funds to guarantee the complying pensions that facilitate increased access to the age pension, potentially increasing pressure on age pension outlays.

4.6 Risk

A defined benefit pension is an entitlement to an income stream where the characteristics are established on creation and payment is guaranteed for the term of the pension.

4.6.1 Key issues

There are three key issues about the ability of small funds to guarantee such pension entitlements. First is the lack of an employer sponsor or other guarantor (such as shareholder capital). Second is the absence of risk pooling, and third is the management of investment risks.

Lack of an employer sponsor or other guarantor means no one is obligated to contribute extra money if the fund experiences poor investment returns that jeopardise member entitlements.

A major issue, particularly with lifetime pensions in small funds, is the absence of risk pooling — especially mortality risk. A pension for an individual may be paid for a day, or far beyond their life expectancy. Consequently, the fund is bound to have too much or not enough money. In a larger pooled arrangement deaths occur with greater certainty, consistent with the broader population allowing the spreading of risk. Thus future benefit liabilities are easier to estimate.

More members also provide for more diverse investment choice, to ameliorate the risks of poor returns and investments not being able to be liquidated to meet pension payments. In small funds, investments may be concentrated in a single investment class (such as property or business assets) or even a single investment.

4.6.2 Risk management techniques

Current legislation allows a small fund to manage its risks to some extent through techniques such as reserving, asset and liability matching, and regular actuarial review and control. The legislation also allows a small fund to adjust the pension payment through commuting and repurchasing the pension. However, these provisions are not ideal. For example, reserving may be tantamount to estate planning, and downward adjustment of the pension payment raises the question of whether the pension was viable to begin with.

5 STRATEGIES FOR ADDRESSING ISSUES

5.1 INTRODUCTION

The initial round of submissions suggested a number of proposals to overcome issues with small funds providing defined benefit pensions. To facilitate further comments, the discussion paper presents three possible strategies that could provide greater retirement income choice for members of small funds. To varying degrees each strategy could allow small funds to provide a broader range of pensions to their members, and could address, either directly or indirectly, the taxation, social security, risk and complexity issues raised.

The strategies canvassed are to:

- develop new rules for the provision of defined benefit pensions;
- modify existing pension products; and/or
- introduce new pension products.

The strategies could be implemented separately or in combination, but only to the extent that they are consistent with the Government's retirement income objectives.

The strategies encompass and build on many of the suggestions contained in initial submissions to the review. These submissions are posted on the review's website.

The following income stream characteristics would maximise public compliance and minimise compliance and administration costs for individuals, industry and government:

- simple, certain, and transparent products that retirees can understand;
- transparent and internally consistent rules governing products; and
- consistent treatment of income stream products so that similar products are taxed in a similar way.

Moreover, any incentives or disincentives should be deliberately designed, be clearly identifiable and operate consistently across products. This avoids opportunities for abuse, consistent with the overall objectives of the retirement income system.

As far as possible these characteristics form the basis for developing the strategies.

The budgetary cost of each option is still to be estimated. A possible outcome from the review could be that the restrictions on small funds providing defined benefit pensions would remain in place. Whether or not new products or product modifications or new rules for defined benefit pensions were introduced would be a matter for Government.

5.2 Develop new rules for the provision of defined benefit pensions

Under this strategy, new pension standards and taxation rules would address the Reasonable Benefit Limit (RBL) compression, estate planning and risk management issues associated with funds providing defined benefit pensions. To ensure equity and competitive neutrality these new rules may apply to all pension and annuity products. If the Government fully implements this strategy small funds may be able to provide defined benefit pensions. However, the new rules would need to be simple and transparent and operate in a manner that minimises compliance costs.

5.2.1 Options to address RBL compression

Initial submissions have put forward two main approaches to address RBL compression.

The first approach is that a pension entitlement based on a given account balance or asset value (net of undeducted contributions) be taken as the purchase price of the pension. This would apply regardless of whether the pension was purchased from a third party or by book entry within a small fund. The valuation method could be administered under Section 140ZO of the *Income Tax Assessment Act 1936* (ITAA 1936), with the pension valuation factors remaining as default factors for funds not covered by these arrangements. This approach would involve amendment to Section 140ZO of the ITAA 1936.

The second approach is updating the pension valuation factor tables in Schedule 1B of the Superannuation Industry (Supervision) Regulations 1994 (SISR) using current economic and mortality data. This approach could involve developing more detailed tables, possibly modelled on those used in Schedule 4 of the Family Law (Superannuation) Regulations 2001 that better reflect individual pension characteristics. These factors could be updated regularly. For example, they could be updated to coincide with the five-yearly release of the Australian Life Tables.

This latter approach would value all lifetime pensions on a more accurate and consistent basis, including pensions paid by public sector and corporate funds, for reasonable benefit limit purposes. However, it would still provide scope for some RBL

compression in small funds through adjustment of the pension's annual value and undeducted purchase price.

The above two approaches could also be implemented together; that is, using a purchase price approach where there is a clear purchase price and updating the pension valuation factors for public sector and corporate defined benefit funds where there is no identifiable purchase price.

The formula in section 140ZO of the ITAA could be amended to prevent valuations being manipulated through the use of large undeducted contributions. The Institute of Actuaries of Australia's submission proposes a formula whereby the addition of undeducted contributions has no effect on the RBL value of the pension. This formula values the pension by multiplying the annual pension by the pension valuation factor and adding the residual capital value, and then reducing this amount proportionately corresponding to the share of the undeducted contributions in the purchase price (or by the absolute value of the undeducted contributions if that will give a higher resultant capital value).

5.2.2 Options to address estate planning

Pension design standards and additional taxes to recover excessive benefits could address estate planning.

Pension design standards could:

- ensure pensions provide a reasonable level of retirement income through prescribing:
  - initial payment factors or probability levels;
  - indexation caps; or
  - actuarial guidelines that ensure the purchase price of the pension is wholly converted into income;
- require excess reserves to be paid out as additional pension payments with a one-off adjustment to annual payments or an additional indexation rate applying to a pension where the reserves exceed a certain level;
- restrict the amount of residual that could be paid from a pension on commutation:
  - residual capital value pensions could be restricted to pensions paid up to the compulsory cashing age of 65; or

  - minimum draw down rules could apply to these pensions based on income that would be received from a lifetime annuity;

- limit reversion to a member's spouse or other financial dependants; and

- require any remaining reserves on the death of the final pension beneficiary to be cashed from the superannuation system. These could be paid as pension income to the estate of the final beneficiary.

Specific taxation measures also could address estate planning involving defined benefit pensions in small funds. For example, residual capital remaining in a small superannuation fund after the death of a pensioner or reversionary pensioner (outside the pension guarantee period) could be taxed as special income of the fund under section 273 of the *Income Tax Assessment Act 1936*.

Alternatively, income from pension reserves that do not qualify for a taxation exemption (the excess above the actuary's 'best estimate' value) could be taxed as special income. Otherwise reserves could be taxed as they emerge in the way life office profits are taxed.

However, such options would add more complexity. These measures would need careful drafting so they do not have unintended consequences and are not easily circumvented through restructuring pension arrangements.

5.2.3 Managing risk

Initial submissions highlight that members in small funds ultimately bear the risk of a defined benefit pension. An alternative would be to formally transfer this risk from the superannuation fund to the pension recipient. If this occurred, defined benefit pensions provided by small funds could be renamed to distinguish them from guaranteed income stream products.

However, if these pensions were to continue to receive complying status for tax and social security purposes, the taxpayer would require certainty that these pensions would remain payable for the recipient's life expectancy or lifetime.

Portfolio rules for small funds paying defined pensions would provide greater certainty. Current actuarial certification requirements could be enhanced or the investment rules in the *Superannuation Industry (Supervision) Act 1993* (SISA) and SISR could be tightened. The latter approach would allow these rules to be applied to all small funds that paid income streams.

Longevity insurance (in the form of a deferred annuity) could also be attached to a pension to help manage the mortality risk. The cashing rules and pension standards in

the SISR would need to be amended so people could access the insurance through pension products or from rollover amounts on, or after, age 65.

Key questions on the strategy to develop new rules for defined benefit pensions

- Defined benefit pensions in non-arm's length funds can be structured to provide a residual capital value. What role do residual capital pensions and annuities have in providing retirement income?
- What would be the likely demand for defined benefit pensions in small funds if the above measures to develop new rules were implemented?

5.3 Modify existing pension products

Four modified product options are presented. The first two options involve managing the longevity risks of the market linked pension by extending the term and attaching longevity insurance respectively. The third involves smoothing payments of the market linked pension to provide more predictability within the context of the existing term options. The fourth option involves managing the longevity risks of the allocated pension through updating the minimum payment factors.

5.3.1 Extending the maximum term of the market linked pension

Presently, market linked pension terms range from the life expectancy of the retiree to their life expectancy calculated as if they were five years younger. Alternatively, where the pension reverts to a spouse, the pension can be based on the longest life expectancy of both spouses (or life expectancy if the spouses were five years younger). Market linked pensions can be commuted and recommenced to take advantage of increased life expectancy on reaching a given birthday, thereby increasing the effective term of the pension.

The maximum pension term could be extended to cater for retirees seeking an income stream well beyond their life expectancy. This would provide retirees with a greater degree of certainty that they will not outlive the pension. The average pension income would be lower to allow for the longer term.

5.3.2 Attaching longevity insurance to a market linked pension

A deferred lifetime annuity could be attached to a market linked pension to insure against the possibility of a retiree living beyond the pension term. The deferred

annuity would commence following the final pension payment. Annuity premiums could be paid annually from the pension account balance or through a one-off payment from the account balance at the commencement of the pension.

The design features of the deferred annuity would be based on the standards in sub regulation 1.05(2) of the SISR. Therefore the annuity could not be commuted to a lump sum or have a residual capital value. However, annuity payments would be deferred and could be reduced, or cancelled, if premiums had not been paid for the full term of the pension.

5.3.3 A mechanism to allow the smoothing of pension payments

As a market linked pension is an account based pension, retirees can tailor their investment portfolio to meet their retirement income needs. Retirees wanting a stable income stream, for their life expectancy, could opt for a market linked pension that invested in fixed interest securities. A more diversified portfolio may deliver a higher retirement income but greater income variation over time.

The payment formula for a market linked pension divides the pension account balance on 1 July each year by a fixed drawdown factor. While these factors should increase pension payments in nominal terms over time (subject to investment returns), they do not provide any leeway to vary payments in a given year.

A possible mechanism to smooth income payments could be to allow an annual payment within the range of the payments calculated under the existing payment formula for the current year and the previous year. This would smooth income payments between years without providing significant tax deferral advantages. The capital would be exhausted at the end of the term.

5.3.4 Updating the basis for the allocated pension

An allocated pension provides considerable flexibility in the annual drawdown of retirement income, within the range of the minimum and maximum payment factors. It can also be commuted to a lump sum at any time. The pension is not a complying income stream for tax and social security purposes.

The minimum payment factors for this pension are designed so the pension payment in any one year is similar to that from a reversionary, CPI-linked lifetime pension purchased with the account balance at the start of the year. The maximum pension factors are based on a reasonable income stream being paid to age 80. These factors have not been updated since the product commenced in 1992.

Updating of the minimum payment factors to reflect current economic and mortality assumptions would allow lower annual payments in initial years. This would lead to higher levels of income being paid in later years than at present because of larger account balances in these years.

Key questions on the strategy to modify existing products

- Would there be a demand for the above modified products?
- Would the industry be willing to offer such products? For example, is it feasible to develop longevity insurance products that could be provided to small superannuation funds?

5.4 Introduce new pension products

Some initial submissions have proposed new pension designs. The Institute of Actuaries of Australia proposed a lifetime allocated pension and two alternative lifetime pension products. PricewaterhouseCoopers Securities Ltd, Rice Walker Actuaries Pty Ltd and Actuarial Solutions Pty Ltd also proposed new products.

Two new product options are presented in this paper to evoke further discussion. To address tax avoidance and risk management issues, the options canvassed are limited to account based products. Each option aims to provide a CPI-indexed pension until, at least, an advanced age, but with payment adjustments to eliminate the build up of excessive reserves.

The new product options would use pension valuation factors to minimise complexity so fund members can administer them. They would also remove the potential for unintended access to tax concessions that could occur when pension payment and reserve levels are set by a private actuary. The Australian Government Actuary would prepare the pension valuation factors and updates would coincide with the publication of the Australian Life Tables.

The proposed options are:

- a lifetime annuity approach to determining the initial income; and
- an annuity certain (term certain) approach to determining the initial income.

Under each option income payments would be reviewed annually and reset if they fell outside an acceptable corridor. The new pensions would be complying income streams for reasonable benefit limit and social security purposes. As such they could only be commuted into other complying income streams and would involve a steady, predictable drawdown of income. Income payments from the pensions would be

assessed for taxation and social security purposes on a consistent basis with similar products.

Further details of the options are set out below.

5.4.1 Lifetime annuity approach to determining the initial income — annual rebalancing within a corridor

This option aims to provide a CPI-indexed pension until, at least, an advanced age. The pension would be subject to annual review to assess whether the fund level remained within an acceptable corridor. Income payments could increase or decrease following this review. The corridor would enable the pension to provide a relatively stable income and assist in smoothing out any investment volatility.

Central pension valuation factors would be used to set the initial pension payment and, if required, to rebalance payment levels following a review. Two other sets of pension valuation factors (high and low pension valuation factors) would be used for the annual review to assess whether the fund level was excessive or too low, relative to the pension being paid. The central factors would be based on a lifetime annuity, using a conservative earnings rate and adjusted mortality assumptions to allow for improved mortality and some degree of selection.

The lifetime annuity approach would generally allow a steady income stream to be paid until the youngest beneficiary reached, about, age 85. However, beyond this point income payments would taper off until the pension account was exhausted. This shortcoming could be eliminated through requiring that the pension be commuted to purchase a lifetime annuity at an advanced age, perhaps when the youngest beneficiary was say 85. This would also reduce the potential for significant balances to remain in the pension account following the youngest beneficiary's death.

Features of the product design

Initial payment setting

- The initial pension would be determined by dividing the purchase price by a prescribed pension valuation factor.
  - At age 65 the factor would be similar to those used by small funds for CPI-linked pensions. The factor would depend on: age and gender, if non-reversionary; ages of couples and their genders, if reversionary.
- The product would operate on a financial year basis, with a pro rata payment for the first year.

- Each year the pension would be increased with the CPI. A pro rata increase would apply if the first year is a part year.

Rebalancing method

- There would be an annual review to determine whether the fund level was too high or too low for the pension being paid.

- At the end of each year the current annual pension indexed to CPI would be multiplied by a prescribed 'high PVF' and a 'low PVF'. Provided that the account balance fell between these two numbers (that is, within the corridor), then no rebalancing would be required.

- If the account balance were greater than the upper limit of the corridor or lower than the lower limit of the corridor, then the account balance would be divided by the relevant central factor to determine the pension payable going forward.

- In each case, (central, high and low PVFs) the factors would be based on the situation at the time. For instance, if the pension was originally reversionary and one of the couple has died, then the factors would be based on the survivor's age and gender.

5.4.2 Annuity certain (term certain) approach to determining the initial income — annual rebalancing within a corridor

This option would aim to provide a CPI-indexed pension until the youngest beneficiary reaches age 95. The pension would operate in a similar manner to the life time annuity approach except that the factors would be based on a term certain annuity, with a moderate earnings rate, to age 95 for the youngest beneficiary.

The pension would have relatively similar initial income payments compared to the lifetime annuity approach and would allow a relatively stable income stream to be continued for the pension's term. Income payments would, in practice, approximate payments under a market linked income stream with an extended term.

Features of the product design

Initial payment setting

- The initial pension would be determined by dividing the purchase price by a prescribed pension valuation factor. The factor would depend on age only if non-reversionary, or younger age of couple if reversionary.

- The product would operate on a financial year basis, with a pro rata payment for the first year.

- Each year the pension would be increased with the CPI. A pro rata increase would apply if the first year is a part year.

Rebalancing method

The same annual rebalancing method described in 5.4.1 would be used.

5.4.3 Graphical representation of the lifetime and term certain annuity approaches

Chart 1 shows the pension draw downs for the lifetime annuity approach (for a single male) and the annuity term certain approach. Chart 2 shows the closing balances for the two approaches. It should be recognised that these charts give a highly simplified example of the differences in the approaches for a male aged 65 at commencement. For purposes of comparison, the pension draw downs and closing balances for a male under the current market linked income stream have been plotted on Charts 1 and 2 respectively (based on the maximum term of twenty two years).

The charts are based on the following assumptions: purchase price $200,000; age at commencement 65; CPI increase 3 per cent; and investment return 6 per cent.

Chart 1 shows that income levels under both the lifetime annuity and annuity term certain approaches would be broadly similar up to about age 85. Under the term certain approach, income levels would continue at roughly the same level in real terms until the end of the term. Under the lifetime annuity approach, income levels start to taper off in real terms and, as a result, income would be paid over a longer period.

Chart 2 shows that the annuity term certain approach has higher balances over most of its term, reflecting slightly lower income draw downs until age 80. However, the account balance runs down quickly from age 80 until age 95 in order to fund constant real incomes. The balance for the lifetime annuity approach falls at a steadier rate reflecting lower real incomes over a longer term.

These charts clearly show the lower incomes associated with the lifetime annuity approach in later years. They emphasise that the lifetime pension payable from an account balance would not address longevity risk unless it were to be commutated to a purchase a lifetime annuity at some stage, preferably before reaching age 90.

The charts also show the current market linked income stream provides a greater level of income over life expectancy compared to either the lifetime annuity or term certain approaches. However, the market linked income stream by itself would not address the circumstances where an individual lives significantly beyond life expectancy.

Chart 1: Annual pensions drawn from the market linked income stream and possible lifetime annuity and term certain annuity approaches

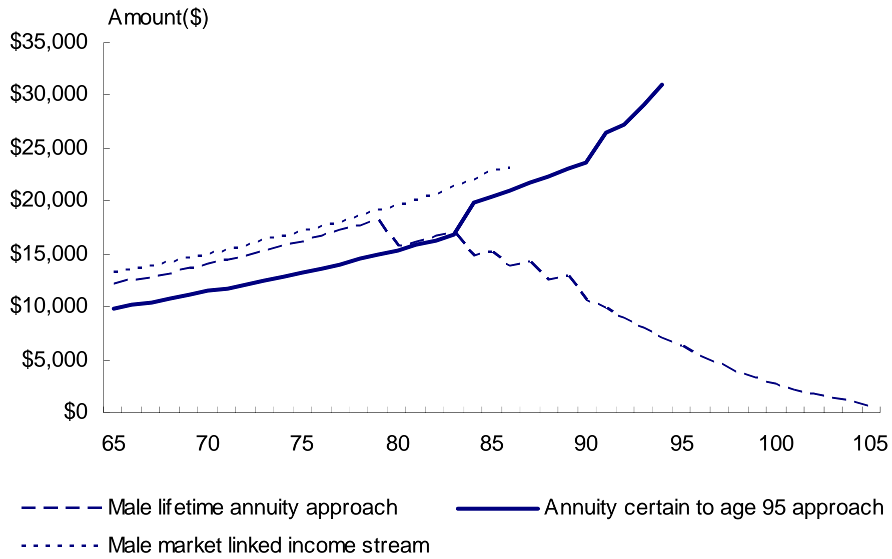
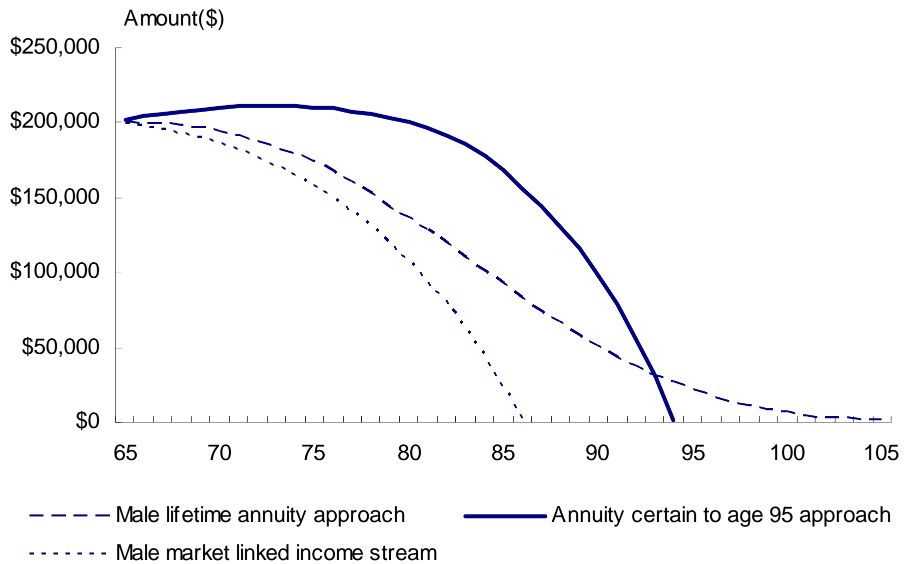


Chart 2: Closing balances from the market linked income stream and possible lifetime annuity and term certain annuity approaches



Key questions on the strategy to introduce new products

- Should new products be introduced or should modifications be made to existing account based products?
- Would the industry be willing to offer such products? For example, would annuity providers be willing to offer lifetime annuities at an advanced age, and if so, from what age?

APPENDIX A

C038/04

11 May 2004

IMPROVING THE INTEGRITY OF THE SUPERANNUATION SYSTEM

The Government will make changes to the superannuation laws to target tax avoidance arrangements used primarily by small and non-arms length superannuation funds, the Minister for Revenue and Assistant Treasurer, Senator Helen Coonan, announced today.

These changes will address schemes involving the forfeiture of superannuation benefits, contributions to reserve accounts, and the use of defined benefit funds and defined benefit pensions.

These arrangements seek to maximise the concessionality of superannuation far beyond what was ever intended by Parliament by avoiding deduction and reasonable benefit limits as well as the payment of the superannuation surcharge.

They also provide opportunities for estate planning, allow significant assets to be shielded from creditors in bankruptcy, and even enable the wealthy to gain access to social security benefits.

To address these activities, the law is being changed to require accumulation funds to allocate superannuation contributions, and fully vest these amounts, to the member's account.

The Government has also acted to strengthen the prudential standards that apply to funds that offer defined benefit arrangements including pensions to ensure that these funds have the capacity to provide these benefits. These funds will be required to have at least 50 defined benefit members.

Small funds will continue to have the flexibility to offer to their members account-based pensions such as allocated pensions and the new market-linked income stream.

Small funds will also be able to provide defined benefit pensions where these are purchased through a life company.

The changes will not impact on existing defined benefit funds or existing funds paying a defined benefit pension.

These measures will take effect from tonight, and ensure that taxation concessions given to superannuation are used to provide genuine retirement incomes.

APPENDIX B

Superannuation Industry (Supervision) Amendment Regulations 2004 (No. 2) 2004 No. 84

EXPLANATORY STATEMENT

STATUTORY RULES 2004 No. 84

Issued by authority of the Minister for Revenue
and Assistant Treasurer

Subject — *Superannuation Industry (Supervision) Act 1993*

Superannuation Industry (Supervision) Amendment Regulations 2004 (No. 2)

Subsection 353(1) of the *Superannuation Industry (Supervision) Act 1993* (the Act) provides, in part, that the Governor-General may make regulations prescribing matters required or permitted by the Act to be prescribed, or necessary or convenient to be prescribed for carrying out or giving effect to the Act.

Generous taxation concessions are provided to superannuation to encourage the provision of retirement income. For equity and revenue purposes these concessions are subject to certain limits determined at the contribution and benefit payment stage. Additional taxation is also imposed on excessive lumps sums and on death benefits paid to a person who is not a dependant of the deceased. Other operating standards require that superannuation savings are withdrawn from the superannuation system on retirement or death of an individual in the form of a lump sum or bona fide income stream. These standards aim to ensure that the taxation concessions given to superannuation are used to provide genuine retirement income.

The purpose of the Regulations is to address a range of taxation avoidance strategies primarily involving small superannuation funds. These strategies are designed to avoid reasonable benefit and deduction limits, and the superannuation surcharge. They are also used to obtain taxation concessions for wealth accumulation and estate planning arrangements rather than retirement income purposes.

In addition some of these strategies are used to avoid social security means tests and to shield assets from creditors in bankruptcy.

The Regulations also ensure that that funds providing defined benefits and pensions have the capacity to provide the benefits.

The Regulations target strategies involving the forfeiture of superannuation benefits, the use of reserve accounts, and defined benefit and pension arrangements.

The Regulations require:

- benefits in accumulation funds to be fully vested in a given member;
- contributions to accumulated funds to be allocated to a member of a fund;
- defined benefit funds to have at least 50 members; and
- funds providing defined benefit pensions to have at least 50 members.

The Regulations do not apply to certain arrangements that were established prior to the commencement of the regulations and to certain specified public sector defined benefit funds.

Details of the Regulations are set out in the Attachment.

The Regulations commence on the date of their notification in the *Gazette*.

ATTACHMENT

Superannuation Industry (Supervision) Amendment Regulations 2004 (No. 2)

Regulation 1 — Name of the Regulations

This clause provides that the Regulations are the Superannuation Industry (Supervision) Amendment Regulations 2004 (No. 2).

Regulation 2 — Commencement

This clause provides that the Regulations commence on the date of their notification in the *Gazette*.

Regulation 3 — Amendment of the Superannuation Industry (Supervision) Regulations 1994

This clause provides that the Superannuation Industry (Supervision) Regulations 1994 (the Principal Regulations) are amended as set out in Schedule 1.

Schedule 1 — Amendments

Items 1 to 3

These items are intended to prevent the use of forfeiture arrangements for tax avoidance purposes by accumulation superannuation funds. These arrangements typically involve the forfeiture of a given member's excess superannuation benefits to the trustee of a fund who then pays the benefits to another member of the fund (usually a spouse or other associate of the member).

Item 1 amends subregulation 5.04(2) so that all benefits in an accumulation fund are minimum benefits.

Existing regulation 5.08 requires minimum benefits to be identified and maintained in a superannuation fund until they are cashed, rolled over or transferred for a given member's benefit. Minimum benefits also cannot be used to pay temporary incapacity benefits. These benefits therefore cannot be forfeited for the benefit of another member of the fund.

Item 2 amends regulation 5.08 to ensure that reference to subsections 31(1) and 32(1) is consistent with current drafting practice. This item also makes a technical amendment to accommodate further subregulations (see item 3, below).

Item 3 inserts two new subregulations to regulation 5.08 to provide exceptions to the rules regarding the treatment of minimum benefits.

Subregulation 5.08(2) provides an exception to these rules in order to grandfather existing employee retention schemes, where voluntary employer funded benefits only fully vest in an employee after a certain period of employment. The exception only applies to arrangements evidenced by a written agreement between the fund member and their employer that was entered into prior to the commencement of these Regulations.

Subregulation 5.08(3) provides a further exception to these rules to enable an amount of a member's minimum benefits to be cashed for the purposes of the member's temporary incapacity, where the amount is not attributable to the member's member-financed or mandated employer-financed benefits. The subregulation enables temporary incapacity benefits to continue to be paid from an accumulation fund from voluntary employer funded or insured benefits.

Items 4 to 8

These items create a new Division 7.1 encompassing into the existing regulations 7.01 to 7.05 and make consequential referencing amendments to those regulations where required.

Item 9

This item inserts new Division 7.2 after existing regulation 7.05. Division 7.2 contains new regulations 7.06, 7.07 and 7.08, requiring contributions to be allocated to members of accumulation funds.

Division 7.2 is intended to prevent the practice of allocating contributions directly to reserve accounts or deferring the allocation of a contribution to a member account to avoid the superannuation surcharge. The division will also ensure that all accumulation funds have efficient and timely administration procedures in place for dealing with contribution money.

Regulation 7.06 provides that Division 7.2 only applies to accumulation funds.

Regulation 7.07 provides that a requirement set out in the division is an operating standard for regulated superannuation funds. Under section 34 of the *Superannuation Industry (Supervision) Act 1993* (the Act) the trustee of a superannuation entity must ensure that an operating standard is complied with at all times.

Regulation 7.08 requires a trustee of an accumulation fund that receives a contribution in a given month to allocate that contribution to a member of the fund within 28 days after the end of the month or if it is not reasonably practicable to do so, within such longer period as is reasonable in the circumstances.

It should be noted that regulation 7.09 will not preclude the transfer of administration costs that are charged against a contribution to an administration reserve account provided the contribution is first allocated to a member of the fund.

Item 10

This item inserts new Divisions 9.2A and 9.2B into Part 9 of the Principal Regulations, which contains prudential requirements for the 'Financial Management of Funds'.

Division 9.2A Size of Defined Benefit Funds

New Division 9.2A is intended to ensure that all new defined benefit funds, or defined benefit funds that admit new defined benefit members, are of a sufficient size to pool member benefits to satisfactorily manage mortality and investment risks. The division will also prevent small defined benefit funds from being established, or from accepting new members, for tax avoidance or minimisation purposes.

Regulation 9.04A provides that the division applies to defined benefit funds established after the commencement of these Regulations and to existing funds that convert to defined benefit funds after the commencement of these Regulations (new defined benefit funds). The division also applies to existing defined benefit funds that accept new defined members, or allow existing members to convert to defined benefit members, after the commencement of these Regulations. The division does not apply to certain specified public sector superannuation schemes.

Regulation 9.04B provides that for the purposes of the division, a sub-fund will be treated as a defined benefit fund if the sub-fund has separately identifiable assets and beneficiaries, and the interests of each beneficiary of the sub-fund is determined by reference only to the conditions governing that sub-fund. This provision is intended to prevent the circumvention of regulation 9.04D through the use of master and hybrid fund arrangements.

Regulation 9.04C provides that a requirement set out in the division is an operating standard for regulated superannuation funds.

Regulation 9.04D stipulates minimum membership requirements for new defined benefit funds or defined benefit funds accepting new members after the commencement of these Regulations. A new defined benefit fund must have at least 50 defined benefit members. Similarly, an existing defined benefit fund can only admit a new defined benefit member, or convert an existing member to a defined benefit member, if it will have at least 50 defined benefit members after accepting or converting the defined benefit member.

As a requirement of the division is an operating standard for the purposes of the Act, the Australian Prudential Regulation Authority or the Commissioner of Taxation (the Regulator) may under section 328 of the Act exempt a particular person or class of persons from compliance with the given requirement. It is envisaged that exemptions will only be granted from regulation 9.04D in limited circumstances such as where a fund is to be established as a successor fund, or made available to new members following the acquisition or merger of a business. In these circumstances the Regulator would need to be satisfied that there were adequate arrangements in place to fund member benefit entitlements and that the members and the trustee of the fund were at arms-length.

Division 9.2B Provision of Defined Benefit Pensions

New division 9.2B is intended to restrict the provision of defined benefit pensions to funds that are of a sufficient size to satisfactorily manage the investment and mortality risks of providing those pensions. The division also prevents the payment of non-arms length defined pensions, by small funds, in order to avoid reasonable benefit limits and social security means tests and to access taxation concessions for estate planning rather than retirement income purposes.

The division will only apply to new pension arrangements put in place following the commencement of these Regulations.

Regulation 9.04E inserts a definition of a defined benefit pension. A defined benefit pension is any pension under section 10 of the Act, other than a pension wholly determined by a policy of life insurance purchased or obtained by the trustee, or an account based allocated pension. In these circumstances the investment and mortality risks of the pension are not assumed by the superannuation fund but rather by the life

insurance company or the pensioner. It is intended that the definition will be amended to exclude market linked income streams when regulations permitting the payment of these income streams are made.

Regulation 9.04F applies the division to new superannuation funds established after the commencement of these regulations, where the governing rules of the fund provide for the payment of a defined benefit pension, and to existing superannuation funds, where the governing rules are amended after the commencement of this division to provide for the payment of a defined benefit pension. The division will not apply to certain specified public sector superannuation schemes.

The new division will not prevent a defined benefit pension from being paid by an existing superannuation fund where the governing rules of that fund set out the terms and conditions of the pension prior to the commencement of these regulations. If, however, the governing rules of an existing superannuation fund are amended to specify a term or condition of the pension, prior to the commencement of that pension, then the new division would apply.

Regulation 9.04G provides that for the purposes of the division, a sub-fund will be treated as a defined benefit fund if the sub-fund has separately identifiable assets and beneficiaries, and the interests of each beneficiary of the sub-fund is determined by reference only to the conditions governing that sub-fund. This provision is intended to prevent the circumvention of regulation 9.04I through the use of master and hybrid fund arrangements.

Regulation 9.04H provides that a requirement set out in the division is an operating standard for regulated superannuation funds.

Regulation 9.04I provides that, despite anything in the governing rules of a fund, that a regulated superannuation fund that has less than 50 members must not provide a defined benefit pension.

As a requirement of the division is an operating standard for the purposes of the Act, the Regulator may under section 328 of the Act exempt a particular person or class of persons from compliance with the given requirement. It is envisaged that exemptions will only be granted from regulation 9.04I in limited circumstances such as where a fund providing a defined benefit pension is to be established as a successor fund, or where membership of a fund falls below the 50 threshold through natural attrition. In these circumstances the Regulator would need to be satisfied that there were adequate arrangements in place to fund all future pension benefits and that the trustee and members of the fund were at arms-length.

APPENDIX C

No.001

05 August 2004

TERMS OF REFERENCE FOR REVIEW INTO DIY SUPER

The terms of reference for a review into the provision of defined benefit pensions by DIY and other small superannuation funds were announced today by Minister for Revenue and Assistant Treasurer, Mal Brough.

The review, part of a package of measures announced by the Government on 23 June 2004, will examine options for small funds to provide pensions to their members. Consideration will be given to the design features of prospective pensions that could attract complying status for taxation and social security purposes.

'I encourage all interested parties to make a submission to the review, to ensure that all viewpoints can be properly considered,' Mr Brough said.

Initial submissions are welcome until Friday 1 October 2004. Treasury will then produce a discussion paper outlining key issues and options. It's expected the discussion paper will be released by the end of the year and, following a further round of consultation, Treasury will report to Government by April 2005.

(Terms of Reference attached.)

Contact: Carlie Hogan
(02) 6277 7360

REVIEW OF THE PROVISION OF PENSIONS IN SMALL SUPERANNUATION FUNDS

The Government has been advised, including by the Government Actuary, of a number of concerns with the provision of defined benefit pensions in small superannuation funds, namely:

- access to unintended tax and social security benefits, particularly from the use of 'RBL compression';
- their use for estate planning purposes in the superannuation system outside what was intended and not available to other superannuation fund members; and
- whether a small number of members can effectively pool risk and guarantee income payments over the term of the pension.

The Government has established a team to address these concerns and review the provision of pensions in small superannuation funds.

The review will examine options for small superannuation funds to provide pensions to their members, including consideration of:

- Design features of prospective pensions that address the Government's concerns and that could attract complying status for taxation and social security purposes.
- Management of investment, liquidity and mortality risks.
- Likely future demand for pensions with defined benefit characteristics.

The review will be conducted by a team within the Department of Treasury, including a representative from the Australian Government Actuary's Office, and will consult with industry and other stakeholders, superannuation regulators and the Department of Family and Community Services.

An initial round of consultation will aid Treasury in developing a discussion paper. The Treasury discussion paper will outline key issues and canvas options and is expected to be released by the end of the year. Following further consultation, Treasury will report to Government by April 2005.

Interested parties are invited to make initial submissions on the above issues up until 1 October 2004. Submissions can be sent to superannuation@treasury.gov.au or mailed to:

General Manager
Superannuation, Retirement and Savings Division
The Treasury
Langton Crescent
PARKES ACT 2600

APPENDIX D

CAMEO ANALYSIS COMPARING TAXATION AND AGE PENSION OUTCOMES FROM ALLOCATED, MARKET LINKED AND LIFETIME PENSIONS PAID FROM A SMALL SUPERANNUATION FUND

Cameo 1 — $600,000 purchase price

Romeo is planning to retire on 1 July 2005 when he will be aged 65. He is married to Juliet who is five years younger than him. Romeo will have a benefit of $600,000. Table 1 illustrates the outcomes that Romeo would receive from the purchase of either an allocated pension, a market linked income stream or a lifetime pension paid from a small superannuation fund. The assumptions used for the illustrations are attached. The allocated pension is paid using the minimum drawdown factors. The market-linked pension is based on the life expectancy of a 55 year old female (five years younger than Juliet), giving a term of 30 years. The lifetime pension is indexed at 3 per cent per annum and is 100 per cent reversionary.

Table 1 shows that the income taken from the lifetime pension can be considerably less than the minimum required to be taken under each of the allocated and market linked products. That is, $24,000 in the first year compared with $38,200 and $32,600 for the allocated pension and market linked product respectively. It is not until some 20 years later that the payment received from the lifetime pension is close to that required to be paid under the allocated pension. Because of the low pension payment, over time this results in a significant build-up in the fund, such that at age 85 the account balance remaining in the lifetime pension is $803,400 compared to $317,400 and $453,400 for the allocated and market linked products. In other words, the account balance has grown for the lifetime pension in nominal terms, compared with the reduction in the account balance in the other products.

In each case, the balance remaining in the fund at death is generally available for payment to dependants tax free or to the estate (how the estate distributes the death benefits will determine the tax outcomes). Clearly, the larger the amount remaining in the fund at older ages the greater the likelihood that a significant amount will remain on death. If beneficiaries are also members of the fund, there is the possibility that monies will be transferred to their accounts and remain in the accumulation phase attracting concessional tax treatment for a further 30 years or more. This shows the scope available for estate planning that can be obtained from the lifetime pension.

Table 1: Cameo 1 — $600,000 purchase price

Age	Income Stream Payment ($)			Account Balance ($)			Age Pension ($)			Tax – if NO undeducted contributions($)		
	Allocated	Market Linked	Lifetime	Allocated	Market Linked	Lifetime	Allocated	Market Linked	Lifetime	Allocated	Market Linked	Lifetime
65	38,217	32,626	24,000	600,000	600,000	600,000	0	7,405	7,405	360	1,094	0
70	42,822	37,014	27,823	578,091	609,994	659,774	0	15,379	20,368	0	2,575	1,743
75	46,373	42,036	32,254	524,015	597,333	716,964	8,472	23,672	29,019	0	3,767	2,895
80	47,810	47,789	37,391	435,071	550,525	767,062	27,790	28,842	34,435	2,926	3,306	2,347
85	44,713	54,500	43,347	317,466	453,441	803,462	44,722	35,248	41,143	3,348	2,705	1,637
90	34,815	62,601	50,251	191,482	282,955	816,648	55,880	43,067	49,441	0	1,963	724
95	20,551	0	58,254	31,546	0	713,873	67,986	67,986	59,696	0	0	0

Further, Table 1 shows that Government outlays in relation to the Age Pension are generally higher for the lifetime pension than for the other two products in this period. This is because there is no assets test exemption for the allocated pension while only 50 per cent of the assets supporting the other pensions are counted for determining access to the Age Pension. Lower tax payments are also made under the lifetime pension compared with the market linked pension, despite both qualifying for the same treatment for the assets test.

No tax is payable in any of the three cases if the $600,000 purchase price is made up wholly of undeducted contributions.

Cameo 2 — $5,000,000 purchase price

Carlos is planning to retire on 1 July 2005 when he will be aged 65. He is married to Camille who is five years younger than him. Carlos will have a benefit of $5,000,000. Table 2 illustrates the outcomes that Carlos would receive from the purchase of either an allocated pension, a market linked income stream or a lifetime pension paid from a small superannuation fund. The assumptions used for the illustrations are attached. The allocated pension is paid using the minimum drawdown factors. The market-linked pension is based on the life expectancy of a 55 year old female (five years younger than Camille), giving a term of 30 years. The lifetime pension is indexed at 3 per cent per annum and is 100 per cent reversionary.

In assessing the cost of the lifetime pension for RBL purposes, it is assumed that there is no excessive component (that is the benefit has been compressed to below the pension RBL). This is achieved through $2,500,000 of the purchase price arising from undeducted contributions and RBL compression of the remaining component of the purchase price to reduce the amounted counted for RBL purposes to be less than the pension limit of around $1,200,000.

Table 2 shows that the income taken from the lifetime pension can be considerably less than the minimum required to be taken under each of the allocated and market linked product. That is, $200,000 in the first year compared with $318,400 and $271,800 for the allocated pension and market linked product respectively. It is not until some 20 years later that the payment received from the lifetime pension is close to that required to be paid under the allocated pension. Because of the low pension payment, over time this results in a significant build-up in the fund, such that at age 85 the account balance remaining in the lifetime pension is $6,695,000 compared to $2,645,000 and $3,778,000 for the allocated and market linked products. In other words, the account balance has grown for the lifetime pension in nominal terms, compared with the reduction in the account balance in the other products.

Table 2: Cameo 2 — $5 million purchase price, including $2.5 million undeducted contributions

Age	Income Stream Payment ($)			Account Balance ($)			Age Pension ($)			Tax – if $2.5m undeducted contributions($)		
	Allocated	Market Linked	Lifetime	Allocated	Market Linked	Lifetime	Allocated	Market Linked	Lifetime	Allocated	Market Linked	Lifetime
65	318,471	271,887	200,000	5,000,000	5,000,000	5,000,000	0	0	0	64,248	62,018	19,220
70	356,846	308,452	231,855	4,817,426	5,083,281	5,498,118	0	0	0	78,158	73,707	26,672
75	386,441	350,301	268,783	4,366,788	4,977,773	5,974,696	0	0	0	87,451	86,853	35,126
80	398,417	398,238	311,593	3,625,592	4,587,706	6,392,186	0	0	0	88,031	101,632	44,702
85	372,612	454,168	361,222	2,645,548	3,778,674	6,695,516	0	0	0	70,715	118,638	55,530
90	290,124	521,672	418,756	1,595,680	2,357,959	6,805,402	0	0	0	30,532	139,107	67,749
95	171,258	0	485,452	753,533	0	6,609,265	58,636	67,986	0	0	0	81,511

In each case, the balance remaining in the fund at death is available for payment to dependants tax free or to the estate (how the estate distributes the death benefits will determine the tax outcomes). Clearly, the larger the amount remaining in the fund at older ages the greater the likelihood that a significant amount will remain on death. If beneficiaries are also members of the fund, there is the possibility that monies will be transferred to their accounts and remain in the accumulation phase attracting concessional tax treatment for a further 30 years or more. This shows the scope available for estate planning that can be obtained from the lifetime pension.

In this scenario age pension outlays do not arise with any pension product until age 92 (allocated pension), and age 95 (market linked pension).

Tax paid under the lifetime pension is only one-third to a half of that payable under a market linked pension, despite both qualifying for the same treatment for the assets test. Tax payments are also considerably less than under an allocated pension until after age 85. Approximately 35 per cent more tax would be payable under the lifetime pension if the RBL test were aligned with the test for market linked pensions. However the market linked pension would still deliver about 70 per cent more tax than the revamped lifetime pension. (This is because of the requirement to maintain reserves and the more favourable treatment of the undeducted purchase price for the lifetime pension.)

Assumptions

For the purposes of providing illustrations, it is necessary to make assumptions about the future. Given the complexity of some of the issues involved, some simplifying assumptions have been made. Nevertheless, the resulting illustrations are considered, in aggregate, to provide a reasonably realistic exposition of the principles involved. It should, however, be noted that the assumptions used do not necessarily represent the Australian Government Actuary's (AGA's) or Treasury's best estimates of future outcomes on individual matters.

Assumptions set by Treasury

- Common assumptions
  - Financial
    - : Investment return 7 per cent per annum
    - : Wage growth 4 per cent per annum
    - : CPI 3 per cent per annum
  - Data
    - : Married couple with male primary pensioner aged 65 and female reversionary spouse aged 60

- Tax and age pension
  - Benefits from 100 per cent Post 83 (taxed element) benefits
  - Homeowners
  - No other income or assets except for $100,000 in a term deposit paying 5 per cent

- Product specific assumptions
  - Allocated pension
    - Income using minimum drawdown factors
  - Growth pension
    - Use maximum reversionary term (30 years)
  - Lifetime pension
    - Pension is 100 per cent reversionary
    - Guaranteed indexation at the rate of 3 per cent per annum
    - High probability of payment based on mortality to reflect self funded retirees

Additional Assumptions set by AGA

- Common assumptions
  - Expenses
    - Expenses are assumed to be 1 per cent of fixed assets. That is, a net (after expenses) investment return of 6 per cent per annum has been used.
  - Tax and age pension
    - All tax bands and age pensions are assumed to increase in line with wages (4 per cent per annum)
    - Outcomes are shown where both of the couple are alive for the whole projection period.
    - All income from the income stream is paid to the primary beneficiary.
    - The age pension income is split equally between the couple.
    - All other income (from other assets) is paid to the reversionary beneficiary.
    - The couple is assessed under age pension means tests and each spouse is eligible for the Senior Australians Tax Offset.
    - No transitional RBL involved.

- Pension details
  - : The income streams are 'purchased' on 1 July 2005 and payments are made annually in arrears. That is, the first pension payment occurs on 30 June 2006. The male is assumed to be age 66 next birthday at the time of purchase.
- Undeducted member contributions
  - : Additional illustrations which include undeducted member contributions have been provided.

• Product Specific Assumptions

- Lifetime pension. It has been assumed that there is no guaranteed minimum term of payment.
- Asset Test. Lifetime pensions or market linked pensions which commence on or after 20 September 2004 are subject to a 50 per cent asset test exemption for age pension purposes.

• Lifetime Pension — Initial Amount

- For illustration purposes, figures have been prepared using an annuity value factor of 25. The first year's pension is derived by dividing the purchase price by the annuity value factor. This annuity value factor is similar to what AGA would expect to see for a male aged 65 with a 60 year old spouse, based on recent cases that AGA has received for Centrelink assessment purposes. To be consistent with the Treasury request to assume a high probability of payment, the annuity value factor used is towards the more conservative end of the range that AGA would expect to see for a male aged 65 with a 60 year old spouse.