FSC FINANCIAL SERVICES COUNCIL

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The Treasury
PARKES ACT 2600
AUSTRALIA

By email: Superannuation@treasury.gov.au

To Treasury

Treasury Laws Amendment (Innovative Superannuation Income Streams) Regulations 2017

The Financial Services Council (FSC) welcomes the opportunity to make this submission in relation to the draft regulations to implement the Government announced reforms to open the retirement income product market.

The FSC has over 100 members representing Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advisory networks and licensed trustee companies. The industry participants represented by the FSC are responsible for investing more than $2.7 trillion on behalf of 13 million Australians. The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange, and is the fourth largest pool of managed funds in the world.

The FSC promotes best practice for the financial services industry by setting mandatory Standards for its members and providing Guidance Notes to assist in operational efficiency.

The FSC supports the Government's reforms. In this context Attachment A provides details on a number of technical issues that, if amended, will assist the Government achieve its policy objective.

Yours sincerely

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Attachment A

Minimum payment rules

The draft regulations provide different treatment for simple hybrid products (a deferred or immediate lifetime annuity, Group Self Annuity (GSA) and an account based pension inside a superannuation fund) compared to an individual who buys an ABP and a GSA or annuity separately and directly.

The inequality affects minimum drawdown requirements. The FSC is concerned that an account based pension and DLA in a superannuation fund will initially have higher drawdown requirements than if the two products were bought separately. When the DLA reaches the trigger date for payment, the necessary draw on the account based pension to meet the minimum drawdown requirements would then be reduced compared to a situation where equivalent products were bought separately.

For retirees with low starting balances the higher initial minimum drawdown requirements for the composite product may result in a need to shorten the deferral period for the DLA with a material impact on payment rates. For retirees with higher starting balances the resulting lower minimum drawdown requirements from the account based component when the DLA commences payment may have estate planning benefits.

The FSC supports providing neutrality between deferred annuities and GSAs held directly by individuals and through a superannuation fund.

Life tables

Determining the rules for innovative longevity income streams presents an opportunity to make more contemporary the definition of life expectancy for tax purposes. With the ongoing Department of Social Services Review of Means Test Treatment of Retirement Income Streams there is also the opportunity to simultaneously make identical changes for social security purposes.

The FSC has been advocating for adopting the Australian Government Actuary's (AGA) age cohort life expectancies with 25-year improvements provided, for reasons of simplicity, they are used for both tax and social security purposes.

The objective of this proposal is to provide more realistic guidance to retirees, advisers and superannuation funds on longevity. The life tables currently used for this purpose reflect the current longevity experience of the population. Through time these have persistently understated the life expectancy of the retiree population. For this reason, while the AGA age cohort life expectancies with 25-year improvements rely on assumptions, they better reflect retirees' longevity.

The effect of this change of life expectancy tables in extending the period for which a death benefit is payable is not material in terms of pricing or income efficiency.

Accruals taxation should not apply to deferred income streams prior to benefit payments

The FSC is concerned that one of the impediments to the provision of deferred lifetime annuities and deferred GSAs is that they would be subject to accruals tax during the deferral period if bought by a superannuation fund. This may continue to be the case under the TOFA provisions in Division 230.

A deferred annuity or GSA and supporting assets will be held in the complying superannuation class of a life insurance company or fund prior to a condition of release being satisfied. Income from those assets will be subject to tax at 15%. If the superannuation fund is also subject to accruals tax on the product under TOFA, this will result in double taxation in respect of the individual's superannuation interest.

The issue does not arise once a condition of release is satisfied, as the product would qualify for an earnings tax exemption.

The FSC understands that this can be resolved through inserting into the ITAA97 a deeming provision to treat a deferred superannuation income stream that is a product held by a complying superannuation fund as if it has been issued for the benefit of a natural person.

The reason for this preference is that by treating the deferred product as a separate interest relating to individual fund members would be consistent with another proposal in this submission, to look through a deferred product held by a superannuation fund and exclude it when calculating the minimum payments required from assets supporting an account based pension. This will provide neutrality between deferred products held directly by individuals and through a superannuation fund. It should also avoid introducing an extra layer of complexity when considering portability of deferred products under the proposed CIPR regime.

Valuation of deferred superannuation income streams

(a) Proposed valuation should take into account earnings tax prior to a condition of release

The proposed new regulation 307-205.02C seeks to value a superannuation interest that supports a deferred superannuation income stream by reference to the "above threshold rate" under the Social Security Act 1991. For a deferred product issued by a life insurance company, income from supporting assets will be subject to tax at 15% whilst held within the complying superannuation class.

We propose a simple amendment to apply only 85% of the above threshold rate to these calculations to recognise the economic effect of the earnings tax.

(b) The above threshold rate is not appropriate for a fixed rate deferred product

The use of a variable notional earnings rate that is likely to fluctuate, to value a fixed rate deferred product is not appropriate because the consumer will receive a fixed rate of return, irrespective of the returns on other types of assets against which the above threshold rate is set.

What is required is a separate provision for a deferred superannuation income stream that will pay a fixed rate of return, to fix the notional earnings rate in subregulation 307-205.02C(2) at the above threshold rate on the day of issue of the deferred product by the issuer.

Unreasonable deferral of benefit payments – subregulation 1.06A(3)(c) SISR

The proposed new Regulation 1.06A contains a governing condition that the amount of benefit payments are determined using a method that ensures those payments are not unreasonably deferred after they start, having regard to the four factors listed in subregulation 1.06A(3)(c).

The FSC supports the intent of this integrity measure but notes there is no definition of "unreasonably deferred" in SISA, SISR, ITAA36, ITAA97, nor the regulations for either of the income tax Acts, and only limited guidance on how this principle will be applied to an innovative new income stream.

To give confidence to both product issuers and customers it would be valuable to give some practical examples of benefit payment schedules which result in varying payments but which should not give rise to concerns that those benefits are being unreasonably deferred.

Mutually exclusive products

The draft regulations have been drawn to create under SIS Regulation 1.06(1) a new class of products which meet the capital access schedule but have more flexibility in relation to the deferral and variability of payments than the closely specified products defined in SIS Regulation 1.05(1). They must respectively meet the provisions of SIS Regulations 1.05(11A) and 106(9A). However one of the requirements for the new category of products is that they do not meet the requirements of the existing category of products, which means the product types must be mutually exclusive.

The FSC understands that purpose of this rule is to ensure that this category is confined to pooled longevity products, permitting both deferral and more variability in payments than existing product types. However we do not see that there is a logical policy reason to include a blanket requirement that for a product to qualify under 106(1) it must not qualify under 105(1).

Depending on market conditions some products will at times not fit 105(1) and therefore qualify under 106(1) but at other times fit 105(1). This creates unnecessary complexity both for product providers and taxation authorities.

A current example is immediate lifetime annuities that are CPI indexed. These are explicitly intended to be a permitted product type under 105(1). However, in the current low interest rate environment a properly priced CPI indexed immediate lifetime annuity will fail to meet the minimum drawdown requirements in the first year for those at normal retirement ages. The problem is worse for women who because of their expected longevity receive a lower rate.

In this case younger consumers purchasing a CPI indexed lifetime annuity would qualify under 106(1) but older consumers buying an identical product with a higher rate would qualify under 105(1) and therefore be excluded under 106(1). The situation could then be reversed for frail aged consumers with much higher drawdown requirements who might only qualify under

106(1). The ages at which these crossovers between product types will change every time the yield curve changes and prices have to be adjusted.

This would require consideration of the treatment of each individual retiree to determine into which product type their annuity would fall, rather than considering the issue on the basis of a specific product.

This is a current issue under 105(1) and is currently dealt with by making adjustments to payment rates and indexation arrangements so that retirees can obtain what would otherwise be a simple CPI indexed immediate lifetime annuity. AS CPI indexed immediate lifetime annuities are one of the potential basic building blocks for CIPRs, along with similar products such as GSAs, this needs to be fixed.

Life expectancy concepts – "remaining life expectancy" minus one

The formula for "remaining life expectancy", after taking into account the "life expectancy period", age at commutation and primary beneficiary's age as the "retirement phase start date", takes the resulting figure and subtracts one. This is an integrity measure designed to remove the opportunity for retirees to rollover products at strategic dates into the same or similar products to maintain access to 100% of their capital.

The minus one formula has three drawbacks:

1. It would be complicated to explain to retirees and intuitively unappealing;
2. It result in the removal a year of the capital access schedule after only 14 days and without any payment to the retiree actually having been made; and
3. It results in the removal of the last year of the capital access schedule on the first day of the last year.

An alternative integrity measure that achieves the same objective is reducing access to capital on a monthly schedule, which would:

1. Coincide with industry practice of monthly payments and so reduce system costs;
2. Provide a closer fit with the straight line concept of the capital access schedule;
3. Be easier to explain to retirees; and
4. Be fairer.

Primary beneficiary concept in reversionary pension context

The draft regulations define the "life expectancy period" by reference to "the number of years in the complete expectation of the life of the primary beneficiary of the benefit".

A majority of people enter retirement as a couple. There are sound reasons for couples to buy annuities or GSAs or other potential products with a reversionary benefit to provide longevity protection for both partners. There may be differences in their ages and it is standard industry practice to price their combined longevity. No mischief can arise from this.

The precedents under existing legislation are that the Commissioner should consider life expectancy having regard to the number of years in the total period during which the product

will be, or may reasonably be expected to be payable. An example in the EM to the Income Tax Assessment Amendment Act (No.3) 1984, provides examples that include reversionary benefits.

The definition of life expectancy for reversionary benefits under these regulations should be redrafted to be consistent with this legislation.

Death of primary beneficiary during the deferral period

Regulation 1.06A(3)(a) requires that in the case of a deferred product with a reversionary benefit not be paid if the primary beneficiary has died during the deferral period. This provision and its policy rationale are not explained in the EM, possibly because it is inexplicable. It effectively precludes offering a deferred product with a reversionary benefit.

There is a substantial superannuation asset gender gap and for practical purposes many women, and some men too, must rely either on reversionary benefits or bequests from spouses for retirement income. This regulation will deny them access to the most efficient form of longevity protection. It is incompatible with the concept of joint CIPRs or more generally with reducing the superannuation gender gap by considering retirement incomes on a household basis as the Age Pension does.