



TAX FORUM

4-5 October 2011

STATEMENT OF REFORM PRIORITIES

PARTICIPANT NAME AND POSITION

David Cox

Head of Government Relations

ORGANISATION

Challenger Limited

Challenger Limited is an Australian listed life office and funds manager specialising in retirement income streams. Challenger commissioned a number of major independent actuarial investigations and other studies which it contributed as part of its submissions to the Review of Australia's Future Tax System and the Review into the Governance, Efficiency, Structure and Operation of Australia's Superannuation System.

STATEMENT OF PRIORITIES

What are your priority reform directions for the tax and transfer system?

Reforming the taxation and regulatory arrangements which determine the characteristics of private superannuation pensions to allow provision under the Life Insurance Act for deferred lifetime annuities (DLAs) and other guaranteed lifetime pensions to manage the principle risks to retirement income; longevity risk, inflation risk, and market risk.

Over the last 25 years the Australian superannuation system has undergone a substantial shift away from defined benefit (DB) and toward defined contribution (DC) schemes. This shift has resulted in a transfer of risk from superannuation scheme providers to superannuation fund members.

The superannuation system is yet to reach maturity and the overwhelming majority of retirees confront their post-retirement years with inadequate retirement savings. As the superannuation system matures and more retirees have adequate levels of saving they will continue to have a need for products which ensure their retirement incomes are sustainable. This means there is both an urgent need now and a long-term need for post-retirement products which will allow retirees to make maximum use of their limited resources, these include;

- (a) superannuation savings;
- (b) assets accumulated outside the superannuation system; and
- (c) the significant mortality premium retirees can obtain by pooling some of their assets through an immediate or deferred lifetime annuity.

Policy to date has increased private saving through the Superannuation Guarantee (SG) and reduced the tax burden on retirees. While those policies have increased superannuation savings and after tax incomes they do not directly address the principle risks to retirement income. Retirees should have



TAX FORUM

4-5 October 2011

available to them choice amongst a range of products which, individually or in combination, are capable of sustaining sufficient income to meet their financial needs throughout their retirement.

DLAs are an important product type not currently provided for in legislation. They are bought at one date and provide a lifelong income stream commencing at a later date. As a non-commutable risk product they provide a substantial mortality premium allowing a retiree to buy a significant amount of longevity insurance for a comparatively small price. A mortality premium is an earned return reflecting the risk the policy holder may not receive any return of income or capital as a result of their premature death.

For example, for a non-commutable deferred lifetime annuity as pure longevity insurance, using pricing provided by Challenger to AFTS in 2009, a 65 year old male retiree could buy for a single \$10,000 premium an annual real income of \$8,000 which is equivalent to about half the real value of a full single rate Age Pension. This lifetime income stream would commence at the annuitant's age cohort life expectancy of 91 years. With mortality improvements, by 2030 the average life expectancy of a 91 year old male will be a further 9 years. This pricing was dependent on removing the product impediments described below.

Consistent with the recommendations of AFTS and a detailed examination of the tax and regulatory impediments to the provision of DLAs by KPMG and provided to government by Challenger, the following matters require policy reform:

1. Amend the SIS definition of a superannuation pension to include deferred lifetime annuities so they will be eligible for the Benefits Tax exemption for persons over 60 years.
2. Clarify the Earnings Tax treatment of non-commutable deferred lifetime annuities during the deferral period to explicitly recognise that they are risk products.
3. Clarify the accruals tax treatment of non-commutable deferred lifetime annuities to ensure that they can be bought either by an individual or by the trustee of a superannuation fund.
4. Amend the APRA prudential standard on minimum surrender values so that non-commutable deferred lifetime annuities are not treated as investment products during the deferral period.
5. Exempt non-commutable deferred lifetime annuities from social security and aged care assets tests during the deferral period, as proposed by AFTS.
6. Exempt non-commutable deferred lifetime annuities from the minimum drawdown rules during the deferral period, as discussed by AFTS.
7. Remove the restrictions, including the work test, on the purchase of non-commutable lifetime annuities, as recommended by AFTS.

The Final Report of AFTS supported both DLAs and the removal of restrictions on the purchase of lifetime annuities:

- *"The Review has also identified the role that deferred annuities can play in an ageing society. These products commence from a specified age and are a type of insurance against running out of income in retirement."* (page 543)
- *"an allocated pension cannot ensure security of retirement on its own"* (page 118)
- *"Products are not available in the market to cover the broad range of preferences of retirees in achieving security of income. This is a structural weakness in the Australian retirement income system. The main product on the market that does achieve this security of income is a guaranteed income for life...Given the diverse preferences of retirees, a single product is*



TAX FORUM

4-5 October 2011

unlikely to satisfy all people who wish to manage their longevity risk. This suggests a need for product innovation within the Australian market.” (page 118)

- *“The increasing life expectancies of Australians will require a greater choice of retirement income products that can cater for the different needs of individuals in retirement. There are not enough products that guarantee an income for the whole of a person’s retirement.” (page 120)*
- *“Deferred annuities (overseas), which provide an income from a certain age, are also becoming more prevalent. These annuities allow a person to lock in part of their retirement savings to generate an income when they are entering the latter stages of their retirement. This provides a person with more certainty in how they manage the rest of their assets before the commencement of the deferred annuity.” (page 123)*
- *“many people prefer to have the security of knowing they will always have an income above the Age Pension” (page 118).*
- *“given the unique nature of deferred annuities, there is a case that they should only be means tested when they start to pay an income, unless a person can access the capital before this time.” (page 126)*
- *“the rule requiring a minimum payment to be made from a pension every year does not cater for deferred annuities.” (page 119)*
- *“The government should also consider removing other legislation constraints that may inhibit the development of longevity products. However, this should not be at the cost of necessary prudential or consumer protection. Given the nature of these products, they should only be provided by prudentially regulated entities. Products that provide a guaranteed income should follow consistent prudential requirements to reduce the risk that a provider is unable to meet their obligations as they fall due.” (page 124)*
- *“There should be no restrictions on people wanting to purchase longevity insurance from a prudentially regulated entity. This would be an important element in making it easier for people to purchase these products.” (page 116)*
- *“People should be able to purchase these products with superannuation as well as non-superannuation money.” (page 126)*
- *“The restriction on people aged 75 and over making contributions should be removed. However, a work test should still apply for people aged 65 and over. There should be no restrictions on people wanting to purchase longevity insurance products from a prudentially regulated entity. (AFTS Recommendation 20)*
- *“In many cases, people may choose not to purchase longevity insurance at their retirement age. As they grow older they may be in a better position to judge their potential longevity. However, after a person retires they may be unable to make further contributions into a superannuation fund due to the work test rules. These restrictions should not apply to contributions made to a prudentially regulated superannuation fund or life insurance company for the purposes of purchasing a longevity product.” (page 126)*

For the retiree, lifetime annuities have the advantages of APRA prudential regulation of life office guarantees on their income stream. The availability of these products would allow retirees to transfer longevity, inflation and market risk to an entity better able to manage them. Pooling of longevity risk allows retirees to manage it more cheaply than if they were to attempt to self-insure. Indeed most retirees simply lack the resources to do so.



TAX FORUM

4-5 October 2011

For government, non-commutable lifetime annuities protect against a number of forms of abuse of superannuation's tax preferred status. In particular, the risk nature of a DLA removes any motivation to buy a larger annuity than is necessary for an individual's retirement income needs.

Given the prevalence of market linked income streams in today's post-retirement market a critical issue is the sustainability of an allocated pension. An investigation of this question by the independent actuarial consulting firm Towers Perrin was provided by Challenger to AFTS. Towers Perrin used stochastic modelling to demonstrate that retirees can have a reasonable expectation, but not a guarantee, of an allocated pension lasting their lifetime but only if they are prepared to live quite modestly. If a retiree chooses to live comfortably they can expect their allocated pension to fail within a few years if they have a starting balance of less than \$150,000. Even an allocated pension with a starting balance of \$500,000 can be expected to fail short of age cohort life expectancy for a 65 year old if the retiree chooses to live comfortably.

The drawdowns used by Towers Perrin were the Westpac/ASFA benchmarks of modest but adequate and comfortable for an individual, then of \$19,399 and \$37,452 which includes any Age Pension entitlement. Most people with \$500,000 in superannuation assets probably expect both to obtain more from an allocated pension and for it to last longer.

Retirees need to be able to choose a product or combination of products that will optimise the amount and security of their retirement income. That set of choices needs to contain products which have characteristics capable of dealing with the principal risks in retirement:

- (a) Longevity risk – outliving average life expectancy and retirement savings
- (b) Market risk – depletion of superannuation assets or income by adverse market events; and
- (c) Inflation risk – inflation erodes the purchasing power of an income stream which will be accelerated by periods of above average inflation.

An important subset of market risk can be referred to as retirement risk. That is the impact of adverse market events close to the time of retirement, either before, at or after it, which can seriously impair post-retirement outcomes. DLAs able to be bought prior to retirement when market conditions are favourable could be used to mitigate the risk associated with the timing of retirement.

Because non-commutable DLAs with a long deferral periods provide access to both mortality and liquidity premiums which exceed any reasonable expected equity premium DLAs should not require any subsidy or compulsion to find a place in the market as longevity insurance.

How are your proposals financed over the short and longer term?

As a result of the tax and regulatory impediments there are no DLAs on the Australian market today. Challenger commissioned Deloitte Access Economics to provide some estimates of the potential fiscal costs and benefits resulting from reform of the tax and regulatory arrangements around DLAs under different demand and tax scenarios.



TAX FORUM

4-5 October 2011

Introduction of DLAs into the Australian superannuation system would involve a short term cost to government finances. By buying a DLA a retiree is deferring retirement income which will result in a reduction in retirement income during the deferral period. If the retiree is eligible for a part Age Pension this would result in a small increase in pension outlays. Provided retirees are complying with the minimum draw down rules they have the option to defer private income and take a larger Age Pension whether they are buying a DLA or not.

That said, if DLAs are treated as a risk or pension product that is not subject to Earnings Tax during the deferral period there is no cost to revenue relative to the real life alternative, which is a pension phase income stream that is not subject to Earnings Tax. This means there is no net loss of tax revenue during the deferral period.

When the DLA starts to pay there are significant outlays savings. These result from retirees having significantly higher incomes late in life. These savings come from two sources, reductions in outlays on the Age Pension and reductions in Aged Care subsidies as a result of the operation of the means test.

Deloitte Access Economics also modelled a hypothetical market in which DLAs were a small part of the retirement incomes market and had been subject to earnings tax during the deferral period - this is the hypothetical baseline scenario. Removing the earnings tax from the hypothetical annuity market leads to both income and substitution effects. The income effect arises because the reduced tax means the individual has more income, and will tend to buy more of everything, whereas the substitution effect picks up the impact of the changed after-tax relative price of DLAs – and hence results in an increased market share of DLA's.

In the hypothetical baseline case the income effect produces costs to government finances of 0.009% of GDP and savings of 0.006% of GDP. If the substitution effect results in retirees buying on average an additional \$10,000 each of deferred annuities then the resulting government savings would be around 0.15% of GDP. That is, the savings to the Government increase twenty-fold for a ten-fold increase in the number of DLAs. This differential arises due to timing: in effect, more DLAs shifts 'income sooner' to 'income later', and the latter has an impact through the operation of income and assets tests applying to Age Pensions and to Aged Care subsidies.

As a result the long run impact on government finances would be positive, with savings to government (through cost reductions in age pensions and aged care) exceeding lost revenue to the government by a ratio of at least 5 to 3.

In any event these revenue losses are hypothetical. There is little revenue collected from the alternatives to DLAs - in essence, there is a 'levelling of the playing field' across competing products where one was previously harder hit by tax than its competitors. That, not surprisingly, has little impact on revenue as there wasn't much there in the first place.

The benefits to government of removing the impediments to DLAs are more pronounced when compared to the 'real life' scenario. Relative to the 'real life' scenario, the government's overall budget position is projected to improve by 0.03% of GDP by 2020 and 0.18% of GDP by 2050.



TAX FORUM

4-5 October 2011

The Deloitte Access Economics modelling shows two other important effects of introducing DLAs into the Australian retirement market which are desirable outcomes of the proposed reforms:

1. The result of the policy change would be a redistribution of income (1) from early in retirement to later in retirement and (2) towards those who live longer. Not surprisingly, that better accounts for longevity risk. Indeed, the realignment of retirement incomes towards the later years of retirement should be a key priority for government, both because it serves to reduce age pension expenditures, and because it increases the welfare of future retirees by countering the key market failures in the provision of longevity risk insurance in the Australian retirement income system.
2. The benefits of DLAs are skewed toward retirees in the lower income deciles who are largely below the key thresholds in the age pension means test and who would not therefore experience any reduction in their Age Pension entitlements. Accordingly, their income from their DLA represents an absolute enhancement to their welfare. This will reduce future pressures for increases in the rate of the Age Pension.

The Deloitte Access Economics modelling highlights an important opportunity for Australia's retirement income system – that it is possible to (1) increase retirement incomes, (2) reduce reliance on the Age Pension, and (3) improve the targeting of government assistance by improving the way retirement savings are used to fund retirement incomes.

Removing the regulatory impediments to post-retirement products that allow the principal retirement risks to be transferred to private providers will reduce the Australian Government's already considerable exposure to longevity, inflation and market risk through the means test for the Age Pension and Aged Care. Reducing the quantum of those contingent liabilities on government will reduce future pressure on Australia's sovereign rating.

LIST OF ATTACHMENTS

Deloitte Access Economics, Fiscal implications of possible tax treatments for deferred lifetime annuities, Challenger Limited, 20 September 2011.