Institute of Actuaries of Australia

11 March 2005

The Manager
Retirement Income and General Rules Unit
Superannuation, Retirement and Savings Division
The Treasury
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Dear Sir

Review of the Provision of Pensions in Small Superannuation Funds
Response to Treasury Discussion Paper (January 2005)

The Institute of Actuaries of Australia welcomes the opportunity to make a further submission in relation to the above review. We believe that the training and experience of most actuaries gives the profession great insight into the management of retirement incomes and we have many members practising across all aspects of the superannuation and retirement incomes sector. We appreciate the opportunity to contribute to this area of Government policy.

Our submission is attached, and seeks to comment specifically on the discussion paper released by Treasury.

The Institute would welcome the opportunity to discuss the issues raised in the Treasury review paper. Please contact the Chief Executive, Catherine Baldwin on catherine.baldwin@actuaries.asn.au or phone (02) 9239 6106.

Yours sincerely,

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Terms of reference

1. The terms of reference set down by the Government for the current pension review were to address the Government's concerns relating to the provision of defined benefit pensions and to review the provision of pensions in small superannuation funds, including examining options for small superannuation funds to provide pensions to their members.

2. This submission responds to the key issues outlined in the Treasury discussion paper dated January 2005 titled "Review of the provision of pensions in small superannuation funds" (hereafter referred to as the "discussion paper").

Choice and Complexity (Your ref: 4.2 & 4.3)

3. As noted in our initial submission, in order to encourage retirees to draw their superannuation in the form of an income stream in retirement, it is preferable that they be provided with sufficient choices to structure their income stream to suit their needs. Allocated Pensions and Term Allocated Pensions (TAPs) may suit many people, but are not likely to meet the needs of all. In particular, they are unlikely to maintain real levels of income in the final years for many pensioners who are expected to outlive average mortality (some recent papers indicate more than 50% of pensioners) and TAPs in particular are unlikely to provide a stable income when investment returns fluctuate. Pensions with defined benefit characteristics can specifically address these fundamental problems and provide certain features not provided by allocated pensions and TAPs. We remain of the view that defined benefit style life-time pensions (and fixed term / fixed payment pensions) fill a valuable role in the retirement plans of many retirees.

4. While our preference is for simplicity over complexity, providing choices to people in retirement necessarily involves individuals making decisions between different types of products and/or income streams. We believe that there needs to be an adequate level of choice and flexibility to allow people to structure their retirement incomes to suit their needs and objectives, including providing a stable income and maintaining their real level of income in later years, without unnecessary complexity.

5. The discussion paper notes that the different regulatory requirements applying to defined benefit pensions for prudential and taxation purposes gives rise to additional complexity. These requirements have been imposed over time by various Governments. If the Government believes that they give rise to unnecessary complexity, the Institute would be happy to work with the Government to develop appropriate ways of simplifying these (and other) requirements.

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

6. The discussion paper sets out several options to address the concern termed "RBL compression". We are pleased to note that these options are consistent with those set out in our original submission.

7. The discussion paper appears to imply that RBL compression is not an issue in larger funds due to the application of a standard set of pension valuation factor tables (Superannuation Industry (Supervision) [SIS] Regulations Schedule 1B) and the uniform characteristics of pensions in larger funds. We would note that, while benefit design may be relatively uniform, the recipients themselves are not. For example, individuals are grouped into five year age bands, and no account is taken of the differing ages of beneficiaries or gender distinction. This, together with the outdated nature of these factors, can give rise to undervaluation in larger funds as well.

Estate planning (Your ref: 4.4.2 & 5.2.2)

8. The discussion paper suggests that estate planning is used by people to shelter large amounts of assets within their superannuation fund for future generations, and this may be true for some. However, for many, estate planning would only be of concern to the extent that they desire any residual assets to be left for their dependants, rather than an external institution (such as a life company), on death.

9. The discussion paper notes several concerns in relation to estate planning. We discuss these in turn below.

Preserving key family investments for subsequent generations.

10. Concern is raised that commutable ("non-complying") pensions can be used to preserve key family investments within a small fund for future generations through the use of strategies such as a term pension with a 100% residual capital value (RCV).

11. We believe that such strategies can be restricted by incorporating some of the suggestions proposed in our initial submission. In particular, limiting the ability to structure an RCV beyond the compulsory cashing age (e.g. age 65 or 70) and possible restrictions on the beneficiaries that can be included as reversioners (such as placing a bound on the age at which children can receive a reversionary payment).

Estate planning benefits from investment and mortality reserves

12. The discussion paper states that *"Estate planning benefits also arise through the need for small funds paying lifetime pensions to maintain investment and mortality reserves."* The need for reserving arises from the uncertainty in relation to future

investment returns and uncertainty about how long an individual will live. If investments returns are as good as, or better than expected, and/or a person dies before or around their life expectancy, then it is likely that there will be residual assets in the fund. However, if future experience is less favourable than expected, there may be little (or no reserves) on the eventual death of a pensioner. Reserving is not unique to small funds – large funds, as well as institutions, also carry and manage various reserves. The difference with a small superannuation fund is that the reserves ultimately stay with the member's beneficiaries on death, rather than going to an institution.

13. In the situation where residual monies are left on the cessation of a pension, we believe that the incentive for estate planning opportunities is limited by the following:

    13.1 In the case of a nil residual capital value pension (eg traditional complying pensions), it is our understanding that any residual monies paid out on death outside of any guarantee period will need to be reported as a new benefit for RBL purposes, since by definition, the original pension (benefit) had a nil residual capital value. The payment would then need to be assessed as a death benefit ETP. If the deceased had previously exhausted their pension RBL, this final payment would be treated as fully excessive for tax purposes. In our opinion, the discussion paper and the cameos presented in Appendix D incorrectly state that this balance is available as a tax free payment to dependants – this would only be the case for the unused portion of the deceased's pension RBL (if any). Given that many people who enter into these arrangements are doing so to access their pension RBL, the likelihood of a large tax free benefit on death appears small.

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

    13.3 It is possible that, rather than pay out residual monies as a lump sum on cessation of a pension, monies could be transferred to the accounts of other members in the fund. In this instance, the provisions of the superannuation surcharge legislation would usually apply (eg contributed amounts and allocation of reserve provisions). When these monies are ultimately taken as a benefit by the recipient, the funds allocated from reserves would be assessed against the recipient's RBL and subject to tax as part of their own pension. If the Government believes that these measures are not sufficient on their own to address their revenue concerns, then we refer you back to our previous

submission which put forward several suggestions on how to limit the build-up of excessive reserves within a fund and hence, reduce the likelihood of large residual amounts remaining on death (pages 14-16).

14. We also note that, unlike current pension assets, reserves do not attract a tax exemption on income each year within the superannuation fund. Consequently, income on reserves is subject to the standard superannuation investment tax each year. While this has been acknowledged in the body of the discussion paper, we note that this tax appears to have been omitted from the calculation of the cameos presented in Appendix D.

15. The discussion paper suggests one option of dealing with residual monies in a small superannuation fund could be to tax it as special income of the fund. This appears to be a very onerous proposition, given the current taxes that apply to superannuation and the points noted above. Furthermore, in the interests of equity (and simplicity), it could be suggested that if such a measure were introduced, it should be applied to all funds, not just a certain class of superannuation funds (a rather extreme approach). We are not in favour of this suggestion.

16. We acknowledged in our previous submission that it was possible under the current rules, for a person to draw an unreasonably low pension relative to the assets. Our previous submission (reference point 2.3.1) canvassed possible options for addressing this, if this is a concern of Government.

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

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

18. The discussion paper also states that there are concerns over the potential pressure on future age pension outlays given the inability of small funds to guarantee pension payments. We comment on the "guarantee" issue below. However, we would note that TAPs effectively receive the same social security treatment as defined benefit pensions and carry no guarantees. In fact, a TAP will (with 100% certainty) be exhausted by the end of its nominated term (which is based on life expectancy), potentially forcing many people back onto the social security system much earlier than a defined benefit lifetime pension. The use of "average" life expectancy to set the maximum payment period (even if a retiree chooses the life expectancy based on a person five years younger) means that a large number of pensioners are expected to outlive their pensions, requiring support by other means in their final years. Future improvements in longevity further exacerbate this problem.

Overall cost to revenue

19. The Government has identified two key risks to revenue in the discussion paper: tax concessions on pensions / superannuation and the cost of social security outlays. The discussion paper attempts to address these issues separately – however, these issues are not independent. For example, the greater the tax paid by a retiree, the less money available to the retiree in retirement and the more likely they will fall back onto the social security system. Conversely, the less tax paid by a retiree, the more likely an individual will be able to fund their retirement for a longer period of time and hence, the lower the likely long-term cost on the social security system.

20. Rather than trying to address each of these issues independently, it may be more productive to approach the design of retirement income products based on the total cost to government, rather than targeting each cost separately without recognising their interaction. A "total cost" approach may also allow a more flexible framework in the design of such products.

Risk (Your ref: 4.6)

21. The discussion paper states that a key concern is the ability of small funds to guarantee pension entitlements. Our views on the management of risks in small superannuation funds are set out in detail in our previous submission. A brief summary of the key points follows.

    21.1 We believe that it is generally well understood by pensioners in small superannuation funds that there is no guarantor to support payment of the pension should there be poor investment experience and/or the pensioner lives longer than expected.

    21.2 Investment and mortality risks also apply with account based pensions such as allocated and term allocated pensions (TAPs). To the self-funded retiree using their own superannuation fund to pay a pension, the practical risks are remarkably similar. If the pensioner loses 50% of their assets, then regardless of whether they are receiving a TAP or defined benefit pension, they will need to reduce their income drawing.

    21.3 In terms of longevity risk, a TAP does not even attempt to maintain payments for the remainder of a person's life – at the end of a nominated term, the pension will cease. While a TAP can be regularly commuted and repurchased every few years to extend the remaining term, this seems a less than ideal way of achieving the desired result of maintaining payments over a person's life. It will also result in too much capital being withdrawn in the early years, forcing a lower and lower income to be drawn in later years. Where an institution is involved, it may further deplete the pensioner's resources if entry/exit fees are applied repeatedly as a consequence. Unless the government permits people to

use a product which allows income to last for life, it is likely that an even greater proportion of people will eventually fall back on to the social security system.

21.4 In many cases, from the pensioner's perspective, defined benefit pensions assist them to better manage their risks. Small funds can employ various reserving techniques to manage these risks, and are also subject to ongoing actuarial review. We refer you back to our original submission for suggestions on how to further improve the management of these risks. In addition, where members have the resources to do so, the Government may wish to consider allowing members the option to "top-up" their pension accounts with additional contributions in much the same way as an employer-sponsor would in their defined benefit plan. This would need to be subject to appropriate reporting mechanisms for RBL purposes to minimise the potential for any abuse, but could be another way of further assisting individuals to manage these risks.

21.5 Members receiving a pension from a small superannuation fund make a conscious decision to bear any risks that arise, rather than pay an institution to bear these risks for them. Given the majority of Australians bear all the risks in the accumulation phase of their superannuation and will continue to do so in retirement if they choose a TAP or allocated pension, it is difficult to see why this is considered so undesirable with the small fund version of a defined benefit pension.

21.6 The absence of the pooling of mortality risk is described in the discussion paper as *"a major issue"*. Pooling addresses one aspect of mortality risk - the risk that an individual may die much earlier or later than average but within a large pool, overall experience is expected to be "average". It is a valid point that small funds do not benefit from pooling, although it is worth noting that the benefits of pooling for larger institutions are diminished by the availability of long guaranteed terms (now up to 20 years). In addition, pooling has limited effectiveness in dealing with the very significant risk of increasing longevity - that is, the average member of the pool living longer because of improving mortality. International research into the provision of retirement income confirms that this is a significant challenge facing current governments. Mortality improvements affecting retirees have been substantial and sustained over the last 25 years, with no assurance that they are likely to slow. Institutional annuity providers must, quite legitimately, make allowance for increasing longevity in their initial pricing and need to be careful not to underestimate mortality improvements since they have no ability to reduce annuity payments. Small funds, on the other hand, have some flexibility to adjust ongoing pension payments to make allowance for improving mortality expectations as they emerge.

21.7 Provided the initial pension level has been determined appropriately, many small funds should be able to pay higher levels of income over the longer term (compared to traditional life office annuities) due to the willingness of many retirees to retain investment risk in pursuit of the potential rewards of investing in higher growth assets. Life offices, on the other hand, tend to invest more conservatively to avoid a mismatch between their assets and their liability to pay a fixed annuity under the terms of the annuity contract. A higher level of income from one's pension should reduce the long term burden on the social security system, rather than increase it.

22. As stated previously, we do not believe that the fact that pensions from a small superannuation fund can't be guaranteed justifies a ban on small funds providing such pensions. However, it may be appropriate to consider a different name for the small fund version of defined benefit pensions to enable prudential and other controls to be targeted specifically at these pensions having regard to their characteristics.

Management of Risk (Your ref: 5.2.3)

23. The discussion paper makes several suggestions to assist in managing the risks in small funds.

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

25. *Tightening of investment rules* - we are not in favour of the suggestion to tighten the investment rules currently within the SIS legislation, without further details of precisely what the Government has in mind. The SIS legislation already has a range of investment rules with which all superannuation funds must comply. The government's objectives of simplicity and flexibility may be compromised by more prescriptive standards. Furthermore, one of the attractions of small superannuation funds is the ability for individuals to have more control over the investment of their retirement savings money, provided they meet the sole purpose test and other relevant requirements. The introduction of more restrictive investment rules which apply only to small funds paying particular kinds of income stream appears unnecessary regulatory intervention, taking into account our views above on the management of risks.

26. *Requirement to purchase longevity insurance* - we are not in favour of forcing all small funds paying defined income streams to purchase a deferred annuity simply to help manage mortality risk. As a general rule, people purchase insurance (of any kind) when they cannot afford to, or are unwilling to, take the risk that is being covered by that insurance. For some people, longevity insurance may well be appropriate. However, for others, this will not be the case. The discussion paper also seems to have missed the point that many people do not wish to purchase an

institutional product. The option to do so is currently available to individuals, but a large number of people have not taken up that option for a variety of reasons. People who use small superannuation funds do so because they prefer these arrangements to the other products available in the market. The need for institutional providers to charge high risk premiums to protect the institution against investment and mortality risk, as well as to provide profit margins, results in pricing which is often perceived to be unfavourable to the average retiree. In light of the uncertainty surrounding improving longevity, we also question whether the insurance industry would be willing to offer sufficient choices for such a product in a cost effective manner to retirees.

Appropriateness of residual capital values

27. The discussion paper raises the issue of residual capital values. Residual capital values (RCVs) can only be structured with pensions that comply with SIS Regulation 1.06(6). These pensions count towards the lump sum RBL, not the higher pension RBL.

28. Although we will leave the role of RCV's in retirement products to other respondents, a residual capital value is essentially lump sum in nature. Consequently, we believe that there is prudential merit in treating residual capital values in a similar manner to non-current pension assets in terms of cashing restrictions (as mentioned previously) and taxation concessions.

Demand for modified defined benefit pensions

29. The discussion paper seeks the views of industry on the likely future demand for defined benefit pensions in small funds. Although predicting future demand for anything is difficult, given that allocated pensions and TAPs do not cater for everyone's needs, we believe that pensions with some of the characteristics currently only available in defined benefit pensions will still fill a valuable role in the retirement plans of retirees, provided that any proposed modifications to such pensions are not unrealistically restrictive or onerous.

Modifying existing pension products (Your ref: 5.3)

30. The discussion paper presents several modified product options. We briefly discuss each of these in turn below.

31. *Extending the maximum pension term for TAPs* - we believe that there is merit in modifying the rules of the existing TAP (market-linked pension) to extend the maximum pension term to provide retirees a greater degree of certainty that they will not outlive the pension. For example, it may be desirable to allow retirees to select a term through to age 95 or 100.

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

33. *Smoothing the annual TAP payments* - we would support the introduction of a mechanism which provides for some smoothing of the annual payments each year for TAPs to give the retiree some certainty on their year-to-year payments, provided the mechanism is relatively simple and flexible enough to have the desired effect in practice. For example, we believe that it would be reasonable to provide minimum and maximum drawdown factors for TAPs with a range sufficiently wide enough to achieve a reasonable level of smoothing in practice. The discussion paper's suggestion to base smoothing on previous years' drawings, however, would appear unnecessarily complex and cumbersome.

34. *Updating the allocated pension drawdown factors* - given that the allocated pension drawdown factors have not been updated since the product commenced, we would also support the updating of these factors.

35. Whilst we believe that the options supported above may increase the demand for these products, a one-size fits all approach which inevitably comes from prescribing standard factor tables is unlikely to suit all retirees. For example, a standard set of factors will not allow for the differing investment/risk profiles of each retiree. A retiree who invests primarily in cash or capital guaranteed products may need to draw a lower income than one who invests in higher returning growth assets.

36. Consequently, we do not believe that the above modifications alone will meet the needs of all retirees.

Alternative pension designs (Your ref: 5.4)

37. The discussion paper also considers the option of introducing an alternative pension design.

38. Until the introduction of TAPs in 2004, one of the key drivers of retirees commencing a defined benefit pension was the ability to access the pension RBL without using an external insurer.

39. The TAP has introduced an alternative way of accessing the pension RBL from a small fund. However, inherent weaknesses in the design of these pensions have resulted in the continuing popularity of defined benefit (particularly lifetime) pensions.

40. For most retirees, we would submit that it is not purely the fact that these pensions are "defined benefits" (together with RBL compression and estate planning opportunities) that makes them attractive. It is simply the fact that defined benefit

lifetime pensions are currently the only way of meeting the needs of a number of retirees. If the Government wishes to continue with the ban on defined benefit pensions in small funds, what is required is simply an account based income stream that meets those needs without the supposed weaknesses of the defined benefit structure which have given rise to the Government's concerns.

Ideal features of an income stream

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

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

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

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

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

    41.5 No investment restrictions (other than the practical limits which apply to any fund paying a pension, such as not investing in illiquid and indivisible assets, etc).

42. TAPs might well meet the last three of these needs, but fail to meet the first two. The current lifetime pension regime is (on the other hand) ideally suited to do so.

43. If we are to construct an account based income stream which is capable of replacing the lifetime pension in terms of meeting these needs, important features will need to include:

    43.1 The ability to structure capital draw downs so that it is not drawn down too quickly and has a good chance of lasting for the likely lifetimes of both members of a couple (in reality, superannuation is often a joint financial resource intended to support both members of a couple in retirement).

    - TAPs make the first tentative step in the right direction here – they at least allow the spouse's life expectancy to be taken into account in setting the term of the pension. However, these pensions are very focussed on ensuring that the pensioner draws down their super (entirely) within an individual's life expectancy or shortly thereafter. While this appears to be based on the concern that some pensioners may die with money left in their account, we believe that it would be of greater concern to the community as a whole if vast numbers of retirees outlive their capital.

- Standard life expectancies are a very poor proxy for actual lifetime, as they represent an "average". They also do not take account of selection, nor do they take in account likely future improvements in longevity. The result is that basing pension draw downs on life expectancies will inevitably result in a large number of retirees (expected to be well over 50%) outliving their capital.

43.2 Certainty of income from year-to-year via the ability to smooth pension payments rather than having payments which fluctuate with investment returns. This could be achieved by either permitting a range of payments (and allowing the pensioner to choose within that range – essentially "self smoothing") or considering something akin to the current system for lifetime pensions with flexible indexation (where a professional experienced in this process (eg an actuary) is asked to assist in guiding the pensioner as to the "right amount" to take).

43.3 The ability to structure draw downs to recognise the specific features of a particular fund. For example, consider the case where two pensioners have the same amount of capital and both wish to have their superannuation last for their lifetimes. If one invests entirely in cash while the other invests entirely in shares, it is likely that the first retiree will (over time) experience lower investment returns than the second. Ideally then, the process by which capital is drawn down should be sufficiently flexible to recognise this fact and permit the first pensioner to draw lower payments for a given capital sum. Note that standard draw down factors which apply for all funds simply cannot achieve this (refer to page 21 of our original submission for more details).

43.4 The ability to adjust pension payments (ie "self correct") when experience deviates from the expectation at the outset. For example, if investment returns are particularly strong / weak or ongoing improvements in mortality suggest that life expectancies are increasing, the pension structure should be sufficiently flexible to allow periodic "corrections" (either increases or reductions) in pension payments, effectively spreading the remaining capital over the pensioner's remaining lifetime. A single scale of payment factors which is applied to an account balance at an arbitrary point in time (30 June) is a relatively blunt instrument for this purpose.

44. If new alternative income stream options are to be introduced in lieu of defined benefit income streams, we believe that they should be designed to meet the above objectives.

Options proposed in the discussion paper

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

45.1 Problems with the lifetime annuity approach (Your ref 5.4.1):

- Only aims to maintain real level of income until age 85, which will be inadequate for many;
- Jumps in income are likely to occur by forcing individuals to use the central PVF as soon as the minimum/maximum drawing limit is reached;
- The approach applies a standard factor table for all and applies them at a single point in time – it does not recognise the specific circumstances of each individual.

45.2 Problems with the annuity certain approach (Your ref 5.4.2)

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

46. The alternative pension designs put forward in our original submission were designed with the above objectives in mind. We would refer you to our previous submission for more detail (pages 22-26).

The Institute would welcome the opportunity to discuss the issues raised in the Treasury review paper. Please contact the Chief Executive, Catherine Baldwin on catherine.baldwin@actuaries.asn.au or phone (02) 9239 6106.