Submission on inquiry into:

THE REVIEW OF THE PROVISION OF PENSIONS IN SMALL SUPERANNUATION FUNDS

From Taxpayers Australia Inc. and Superannuation Australia

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Introduction

The Government has proposed that superannuation funds with less than 50 members shall no longer be able to provide new Defined Benefit Pensions (DBPs) after 30 June 2005. Therefore Self Managed Superannuation Funds (SMSFs) will automatically be prohibited from offering these products.

The resulting scramble by members to make use of the current, albeit limited opportunity to place their SMSFs into a DBP mode could result in many members opting to take DBPs for the wrong reasons. What is very disappointing about the current amendment is that it specifically targets SMSFs. Large funds will continue to be able to provide DBPs but new SMSFs or existing ones that change their trust deed in any way after the 11th May 2004 will have to use more expensive retail products.

Body of Submission

1. Managing the risks of Defined Benefit Pensions

A significant bone of contention regarding the payment of DBPs is a view that the investment and mortality risk associated with such schemes necessitates a large pool of investment assets to guarantee the income stream. As a consequence it has been argued that large financial institutions are the only appropriate vehicle for these income streams.

That view should be challenged because SMSF members establish DBPs within their own funds on the premise that reasonable asset allocations can support levels of pension that are comparable or exceed those offered through retail offerings from large superannuation funds, on a sustained long term basis. In other words the risk that they perceive of a drop in performance of their assets is not worth the reduction in income that the additional premium entails.

SMSF members make decisions based on the available options and for the most part this is based on sensible judgments about their future well being. They do not have designs on abusing the system but are intent on making sound judgments about the inherent values of the different product offerings. Many have come to the realization that a DBP via an SMSF is a rational response, arrived at after due consideration that has included assessments of greater member longevities.

SMSF trustees recognize that the spirit of DBPs necessitates a conservative asset allocation policy and a tacit understanding that members will forego potentially higher investment returns in exchange for greater stability of returns and an asset test exemption. There are risks associated with any action they take, but by forcing members to pay the higher cost of complying pensions from large superannuation funds or Life Offices it is only likely to dissuade many from using those products. Surely this outcome is not the real intention of the new initiative of government.

The logic of denying SMSFs the right to provide DBPs while allowing large funds to continue in this role does not sit well. In addition it is unclear how it could be argued that a fund with just 50 members, all in the pension mode would be able to guarantee the defined benefit income stream in a commercial manner and that this could not reasonably be achieved by an SMSF. It arbitrarily denies SMSFs the right to offer DBPs, is totally unjust and needs to be redressed.

Why should SMSFs be penalized if they are able to provide a product that can very closely match the retail equivalent and at lower cost to the member? If the argument is that members should provide for their retirement, then this is a case in point where choice is being denied for no obvious good reason.

The proposed change will reduce the extent of choice within the industry as future retirees will be unable to commence DBPs from their SMSFs. It will also have the unintended effect of reducing competition in the marketplace for these pensions. The large growth in the SMSF market has elevated this category of funds to a position of significance in the industry, in competition with the Life Offices and other Large Superannuation providers.

These large entities seem to be the only winners from a proposal that will lead to a diminution in a significant competitor's ability to meet members' needs. The more cynical might wonder whether the Government was bowing to pressure from the big players who have been under pressure from the leakage of their funds under management to the SMSF market. This reduction in competition should also raise the interest of the ACCC.

It is extremely difficult to rationalize how a DBP – which has considerable merit in its own right-, somehow becomes illegitimate because it is operated through an SMSF. Clearly both large funds and SMSFs should be encouraged to provide DBPs as part of their product offerings.
The question shouldn't be one of *"What is the necessary membership level of a fund for it to be able to offer DBPs?"* rather it should be *"What sensible provisos should be met for funds to offer DBPs?"* The relevant issues should include a prudent asset allocation and risk assessment rather than an arbitrary 50+ member rule for DBPs. To this end Superannuation Australia, a wholly owned subsidiary of Taxpayers Australia Inc continues to be heavily involved in the education of its members to assist them in fully appreciating their duties and responsibilities as fund trustees especially when they are overseeing DBP income streams.

Recommendations

The arbitrary prohibition on the use of SMSFs to provide DBPs should be revoked.

Adequate ongoing risk management and actuarial controls should be implemented by fund trustee to ensure that DBP income streams are viable for SMSFs regardless of the number of fund members.

2. RBL Compression

Apart from the tax advantages available to all superannuation investments, the primary reason that members choose to accumulate funds under an **SMSF** umbrella is that it affords them greater *Choice and Control* over how their funds are invested and the income streams available to them in retirement. The greater the number of options available to retirees the better it is for them. Therefore a fund's ability to offer DBPs is essential to meeting members' needs. Since *"RBL Compression"* is an issue of concern then it should be addressed directly rather than through a blanket prohibition on SMSFs.

"RBL Compression" enables asset values to be deflated through the use of DBPs in certain circumstances and this result in superannuation assets that may have been in excess of lump sum RBLs being valued at lower levels. Clearly this is an unsatisfactory situation that should be sorted out. Unfortunately the calculations are based on the use of pension valuation factors that have been produced by the government. What is probably relevant is that the figures have been determined on the basis of inflation rates, investment yields and mortality rates that do not reflect the current reality. It also seems that the issue at hand may easily be addressed through a review and recalculation of the relevant lifetime **PVFs** using current data and assumptions. Such a move would then impact all providers of DB pensions –large fund providers as well as SMSFs-in an equitable manner.

What is very disappointing about the current amendment is that it specifically targets SMSFs. Large funds will continue to be able to provide DB pensions and enable RBL compression for their members but this will no longer be possible for new SMSFs or existing ones that change their trust deed in any way after the 11th May 2004, unless they use large fund retail products. Clearly if the problem is related to RBL compression it is anomalous for large funds to be allowed to provide this product while SMSFs are denied similar treatment. Both large funds and SMSFs should be able to provide DBPs and amendments that target RBL Compression should treat both SMSFs and large funds equitably.

Recommendations
SMSFs should continue to be allowed to offer DBPs.

Revise the Pension Valuation Factors (PVFs) so that they are more representative of the current climate.

Change the way that pension capital values are assessed so as to prevent the use of a lifetime pension lowering the overall superannuation asset value from a level above the Lump Sum RBL to one below it. The proviso is that such a change should not be applied selectively to SMSFs but to all funds including the large ones.

If it should be decided however that this change is not warranted then clearly the singling out of SMSFs should not be pursued either.

3. Estate planning issue

A regulated superannuation fund has to satisfy the Sole Purpose Test (section.62) by providing benefits to members after they reach retirement age or to the member's dependants upon the member's death. SMSFs are not on their own estate planning vehicles and are not used primarily for that purpose.

Nevertheless they do provide the opportunity for certain beneficial estate planning outcomes where the residual in a fund following the premature death of a member becomes available to other members of the fund or their respective estates. This feature is not available with DBPs paid from large institutions because on average premature deaths of members are supposed to be offset by the benefits that are paid to other members who outlive their life expectancies. The funds are thus designed to be in balance.

The question then arises as to whether this estate planning opportunity has an adverse impact on the overall integrity of the superannuation system. It is clearly not a case of double dipping into the social security system and it clearly does not compromise the superannuation system. Furthermore the extent of this so called abuse is imperceptible in comparison to the total assets in the SMSF pool.

Thus if there is a view that there is rampant abuse of the spirit of the superannuation laws generally or SIS Act and regulations specifically then relevant evidence should be collected to support that view but in the absence of such evidence that position should be refuted.

In practical terms, the effect of this arrangement is for residual assets to be transferred *inter-generationally* to family members rather than into the coffers of financial institutions and often after the assets have yielded higher levels of pension to the retirees when compared to yields from the retail funds! A blanket prohibition can't solve a non-existent problem! In fact it is likely to create some unintended problems simply by forcing SMSF members towards a greater reliance on Allocated Pensions or Term Allocated Pensions. Neither of which may best suit their particular needs.

The government is to be applauded for the imminent introduction of greater choice in superannuation in the financial service industry. In that light the new regulation for DBPs limits members' choice of suitable pension products via SMSFs and is clearly at odds with the sentiment of choice. The proposed change cannot be viewed as being either in the best interests of either retirees or of the community.

As a position of last resort, it would be preferable to maintain the ability of SMSFs to pay a DBP even if it was necessary to use a prescribed benchmark yield that was comparable to a yield from a *large fund* providing complying DBPs.

Recommendation
Whilst we concede that SMSFs should not be used as primary estate planning vehicles we do not believe that estate planning considerations should be given unnecessary weight in the committee's deliberations.

4. **Assets test exemption reduction.**
A further question that comes to mind is why the assets test exemption is being reduced from 100% to 50% for complying pensions for those of age pension age. The policy would seem to be aimed at the "so called" wealthy to ensure that they cannot use lifetime income streams to claim social security benefits.

However the fact remains that currently, individual account balances for SMSF members on average do not even approach half the lump sum RBL. These members will no longer receive the full 100% assets test exemption. Equity considerations would demand that an absolute asset value limit would be preferable to a reduction by 50% in the assets test exemption
This has been recognised by the fact that existing complying assets test exempt income stream pre 20 September 2004 will continue to receive full asset test exemption.

Recommendation
The reduction in the assets test exemption from 100% to 50% cannot be justified particularly when considerations of equity are raised. We strongly recommend that the exemption should revert to the previous 100% figure.

5. **Issues for retirement policy**
The issues that retirees have raised in relation to retirement incomes policy include a preference that income streams provide a degree of certainty but also flexibility in meeting changing needs and the likely longer life expectancies and greater opportunities to fulfil retirement plans. The concept of on-going part-time work should also be catered for so that smaller amounts can be taken out of the superannuation system than is currently possible via an allocated pension for example.

Whilst all retirees would prefer to maximise their incomes and social security entitlements for current consumption and their estate and other assets for intergenerational transfer, by and large they appreciate that budgetary constraints, equity arguments and other policy imperatives faced by government call for greater restraint in these matters. However what is clear is that they seek fairness in the way that their retirement income policy is administered and they also seek a degree of certainty in order that they can plan for their future without new rules being introduced that limit freedoms that were previously available.

Retirees prefer to see changes that provide a greater menu of options for them in relation to flexibility and opportunities to set their affairs in a way that maximises their benefits. Changes should not generally reduce these outcomes; be they current or future levels of income, issues of investment performance or psychological and security ones. This is not the case with the recent reduction to 50% assets test exemption for complying pensions. It will be particularly onerous on those intending retirees in their early 60's whose plans included a reliance upon the 100% asset test exempt pension and who are unable to bring forward their retirement plans to meet the 20th September 2004 deadline.

Recommendations

The flexibility of A/Ps could be improved by enabling a 25% reduction in the minimum pension currently possible from an allocated pension. This will enable greater flexibility and also meet the particular needs of retirees in part-time work.

Adequate lead times must be introduced to ensure that reasonable planning periods for retirees is provided, particularly where it is intended to revoke traditional benefits.