File Name:

22 September 2004

Mr Trevor Thomas
General Manager
Superannuation, Retirement and Savings Division
The Treasury
Langton Crescent
Parkes ACT 2600

Dear Mr Thomas

Submission to the *Review of the provision of pensions in small superannuation funds*

This letter from the Association of Superannuation Funds of Australia is in response to the call for preliminary comments and suggestions on the provision of pensions in small superannuation funds. In addition to this submission, ASFA would be happy to participate in direct consultations with Treasury in pursuit of appropriate solutions to issues such as 'RBL compression', inappropriate access to social security benefits, estate planning and the pooling of risk in small funds.

About ASFA

ASFA is a non-profit, non-party political national organisation whose mission is to protect, promote and advance the interests of Australia's superannuation funds, their trustees and their members. As such it is the "Voice of Super". ASFA has a strong focus on the interests of consumers. These interests range from improving consumer protection to enhancing the financial security and retirement income of all Australians.

ASFA's 600 or so constituent members have been estimated to be responsible for around $430 billion assets, about 80 per cent of the total superannuation funds under management. ASFA member funds in aggregate also represent around 80 per cent of Australians with superannuation.

General Comments

ASFA supports a superannuation framework where individual members have similar opportunities available, and constraints imposed, irrespective of the whether they are in a large fund or a small fund. To this extent, ASFA supports the broad intent of the Government's budget announcement to target strategies such as forfeiture of benefits, evasion of tax liabilities and manipulation of RBL values that were generally only available to members of small funds. However, ASFA also supports all funds being able to provide benefits, primarily income streams, that meet the retirement income needs of their members.

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In this context, ASFA, while supporting the government's objectives, is concerned that the measures adopted are not the most appropriate for dealing with the issues involved. In some areas, the adoption of a universal approach might not be warranted. Specifically, in the areas of risk pooling and funding, it is considered necessary to look at funds with fewer than five members (SMSFs and SAFs) separately from other funds with small numbers of defined benefit members.

Comments on Specific Issues

Is there a need for pensions with defined benefit characteristics in small funds?

When questioned on this issue, ASFA members state that there is a natural desire among SMSF members to fully fund their retirement incomes from their own superannuation fund. Retirees with SMSFs appear driven by a need for control over their savings and also by a desire for those savings to both provide an adequate income and provide income throughout their retirement years. These retirees see the need to have access to the full range of products:

- Allocated pensions, to provide an income whilst retaining access to lump sums in emergencies;
- Life expectancy pensions, to provide a guaranteed annual income for a set period; and
- Lifetime pensions, to provide a consistent level of pension.

While the new Market Linked Income Streams may provide SMSF members, and others, with the opportunity to receive a higher income, it will not solve the problem of guaranteed income for life in the circumstances where the pensioner survives through to the end of the pension term. Some advisers are suggesting that, going forward, an appropriate strategy may be for holders of an MLIS to convert it to a lifetime pension approximately five years before the end of the term.

From the above it is apparent that there will always be a demand for lifetime pensions from some SMSF members.

ASFA considers the issue is not one of whether these products should be available from an SMSF, but rather how to allow the products to be provided but overcome 'problems' such as 'RBL compression' and estate planning objectives whilst addressing funding capability concerns.

The ability to achieve 'RBL compression'

'RBL compression' is said to occur when the value of a pension, for RBL purposes, is less than the actual purchase price of the pension. The effect of 'RBL compression' is to enable the pensioner to potentially avoid having part of a superannuation benefit counted as excessive for taxation purposes. That 'RBL compression' and its associated tax and other benefits is achievable flows directly from the method of valuation of pensions as set out in the relevant legislation.

The RBL value of a lifetime pension is determined by multiplying the first year's payment by the appropriate pension valuation factor (PVF) specified in the SIS Regulations. These factors have remained unchanged since 1994. As such, they underestimate life expectancies and overestimate current interest rates. The combined effect is to underestimate the true value of the pension.

There are valid reasons for valuing a pension using the PVF method, particularly when the pension is not provided in exchange for a lump sum but is based on such things as a final salary amount and or years of service, as occurs in most government schemes.

One could, however, question the validity of using the PVF method of pension valuation when a pension is received in exchange for a lump sum benefit entitlement as generally occurs in the SMSF / SAF segment of the market and where pensions are purchased from a life company.

Because of the requirement, for RBL purposes, to value a 'purchased' lifetime pension using outdated PVFs, careful use of actuarial assumptions may result in a considerable part of the capital used to purchase the pension being disregarded for RBL purposes. Where there is only one member in the pension arrangement, and the pension is 'purchased', this obvious disregarding of capital is difficult to justify on both equity and policy grounds.

It is noted that the undervaluation of the benefit for RBL purposes arising from the use of outdated PVFs is not restricted to small funds. The same is true for all defined benefit fund members, including public servants, politicians and members of large corporate DB funds.

ASFA considers that the RBL compression problem could be overcome by a two-pronged approach to RBL valuations:

- *Where a pension is purchased from a third party or by book entry within a small fund, the RBL value of the pension is the purchase price. This is consistent with the RBL valuation of Market Linked Income Streams.*
- *For pension benefits that are not purchased, such as in a traditional corporate or public sector scheme, pension valuation factors would continue to be used. However it would be necessary to ensure that the pension valuation factors in the relevant legislation are up to date and that there are mechanisms in place to ensure that these factors are updated on a regular basis.*

The result of the above measures would be as follows:

- Where a pension is purchased, or implemented through a book entry, the RBL issue is avoided; and
- Where the pension is not purchased a more realistic RBL value would be calculated.

Persons purchasing a pension for value would be given equivalence to persons making lump sum withdrawals, and those in traditional defined benefit arrangements would be assured that the valuation of their benefit was appropriate. Consideration may need to be given to potential impacts flowing from the initial updating of the factors.

Estate planning issues

The estate planning issue arises through a requirement to 'overfund' in order to meet the APRA requirement of a high (70%) probability level that pension liabilities will continue to be met. Actuaries need to certify against current life expectancies and interest rates, not those that underlie the current PVFs and this automatically results in a funding level in excess of the valuation for RBL purposes. There is also scope for actuaries to use a higher probability, 99% or more, should they so desire. Where probabilities greater than 70% are used there is an increasing likelihood that significant assets will remain on the death of the pensioner. Currently these residual assets form part of the fund's reserves and may be made available for allocation tax free to the accounts of other fund members.

The government's concern appears to be that there is a potential that any tax that would otherwise be payable on these assets had the pension liability not been overfunded, might be permanently deferred and thus any social security consequences of payment of a residual death benefit avoided.

ASFA considers that the estate planning problems could be substantially overcome through the implementation of the following measures:

- *Specify 'high probability' as a probability of at least 70% and no more than say 80%.*
- *Require residual assets (those remaining after all pension entitlements have been met) to be paid as a death benefit in respect of the final pension beneficiary.*

The result of the above measures is that there would be a lower probability of significant assets remaining at the end of the pension term and those assets so remaining would exit the superannuation system and be subject to appropriate taxation and social security treatment.

ASFA considers that, should the measures suggested above be adopted, there should be ongoing monitoring to ensure that the measures are effective.

Risk pooling and guaranteeing of income payments in funds with fewer than five members (SMSFs and SAFs)

Capacity to fund the promise can be a problem in SMSFs and SAFs due to the small pool of lives (one or two persons usually). The lack of averaging between members is taken care of to some extent under the current arrangements whereby each fund is required to have an actuary's certificate indicating that there is at least a 70%

probability that the fund will meet its obligations. In order to satisfy this requirement the fund has more assets for the member than would be the average amount of assets needed per member when there are a larger number of lives in the pool. There is also scope to adjust the pension payment, in that a pension that cannot obtain an actuary's certificate can be commuted and used to start a new pension at a reduced level that the actuary will certify.

Risk pooling and guaranteeing of income payments in non SMSF / SAF arrangements

The capacity of a non-SMSF/SAF superannuation fund to meet the pension promises it has made is a function of the number of members in the pool, the stage in the superannuation cycle of those members, the degree to which the current promises are fully or over funded and, where the fund is employer sponsored, the financial resources of the employer.

While the Government may have received support from the Australian Actuary for a minimum size limit (in the order of 50 DB members) in arms length arrangements (such as in divisions of corporate funds, master trusts and industry funds), it needs to be noted that in many such arrangements the capacity of the fund to meet the pension promise rests not on the size of the pool of lives, but rather on the financial strength of the sponsoring employer.

This concept is supported by the capacity of an arms length DB fund to approach the regulator for relief from the operating standard.

As a general principle, ASFA considers that funds, other than SMSFs and SAFs, should be able to offer life pensions and defined benefits provided they satisfy the relevant accounting and actuarial solvency standards on an ongoing basis.

In considering this issue, note should be taken of the role that the access to defined benefits plays in employee remuneration. Many of these benefits are provided through funds backed by a company with sufficient financial capacity to ensure that benefit liabilities are met. The funds are funded in accordance with solvency requirements and fund membership often is an integral part of senior executive remuneration packages. For these employers, the capacity to offer a defined benefit on retirement has been an important part of their remuneration package to attract and retain key employees.

ASFA would be pleased to discuss any of the matters raised in this submission directly with The Treasury.

Yours sincerely,

Dr Michaela Anderson
Director Policy and Research