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Review of the Provision of Pensions in Small Superannuation Funds

Submission to Treasury from Rice Walker Actuaries

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1. Background

This submission is made in response to the request contained in the press release from Mal Brough, Minister for Revenue and Assistant Treasurer, entitled "Terms of Reference for Review into DIY Super" issued early in August 2004.

We note that the Government Actuary and others have expressed concerns in a number of areas relating to self-managed superannuation funds (SMSF's), which are also known as DIY Funds. We note also that other actuaries have commented on pooling of risks in conjunction with guaranteeing income payments for the term of a pension. We have therefore restricted our comments to each of the other areas of concern.

2. About Rice Walker

Rice Walker Actuaries is an independent actuarial consultancy with a strong focus on superannuation and the broader "wealth management" industry. Our clients include Australian companies, superannuation fund trustees, financial institutions and the legal profession. We also advise Government agencies and several industry bodies.

Rice Walker brings together some of Australia's leading consultants to the financial services and superannuation industries within a single independent advisory firm. We have no financial ties with any organisation and do not promote or sell financial products. We do not accept commission, provide any administration services to super funds nor operate a master trust.

We have been active in public policy in the retirement field in a number of areas, including:

- representation of some of our Principals on various submissions made by the Institute of Actuaries of Australia;
- client work including product development and business strategies; and
- the preparation of various professional Papers and presentations on retirement matters.

Geoff Dunsford and Michael Rice produced a paper[1] for the Institute of Actuaries of Australia earlier this year on related matters, and a copy is attached with this submission. It provides commentary on some of the broader issues which are relevant to the concerns raised by the Government Actuary and others. Please note that some of the comments in the Paper have been superseded by subsequent legislative change, but the gist of the commentary remains relevant.

3. General Comments

Many of the concerns of Treasury re the activity of SMSF's can equally arise from the activities of other superannuation funds.

SMSF's need to comply with all the SIS Regulations relating to private (as opposed to Public Offer) funds. The major difference between SMSF's and other complying funds relates to the restriction on the number and composition of members, and the need to report and provide returns to the ATO rather than APRA.

[1] Retirement Incomes Integration: Superannuation/Social Security/Tax

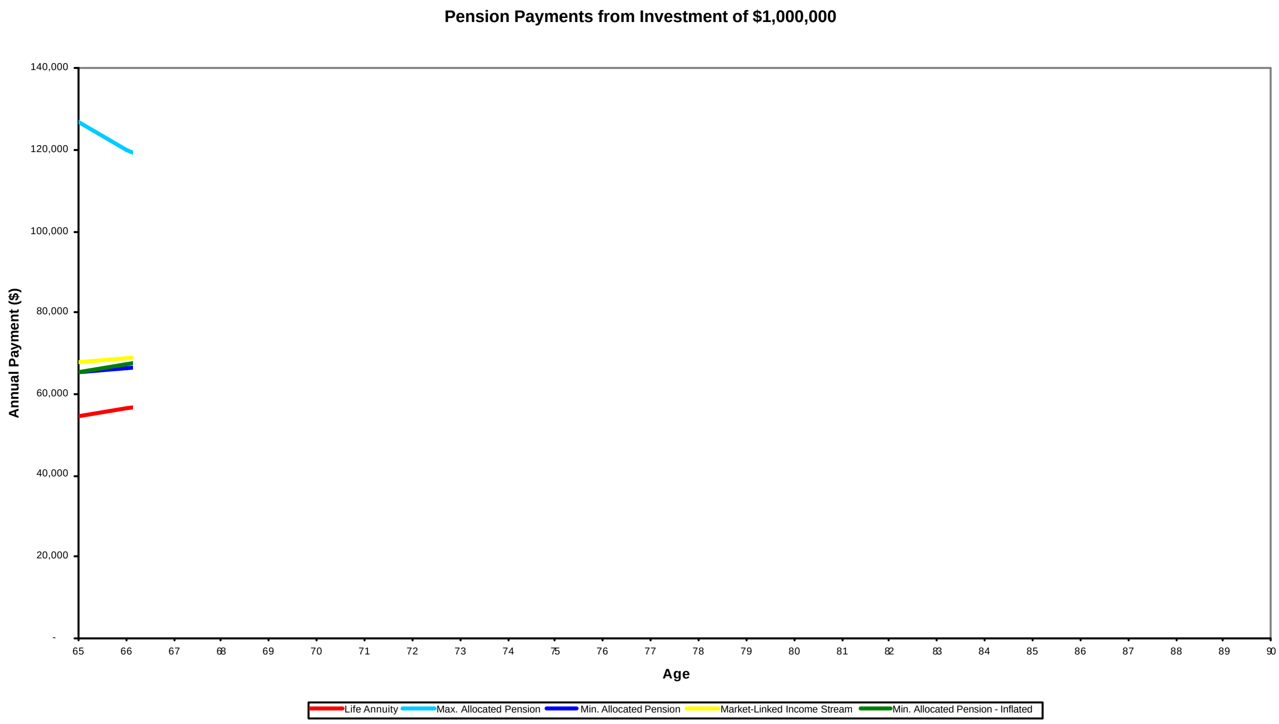
Consequently, any amendment to legislation or regulations to address Treasury concerns re SMSF's, other than being specifically focused on fund membership qualifications, will affect all superannuation funds.

4. Types of Retirement Products

The majority of pensions issued in Australia do not involve the pooling of risks, nor the passing of the longevity risk to a financial institution. A lifetime annuity issued by a life company does take on these roles, but the current rates are unattractive for most retirees.

From the relative sales of different products, retirees (or their advisers) appear to favour products where they have more control over the investments within the product. Hence, allocated pensions, and the complying pensions of an SMSF, have been much more popular than a lifetime annuity purchased from a life company, even though this provides better financial security as well as certainty of income.

Most retirees focus on their income in the early years of retirement, so they are influenced by initial yields. The chart below shows the income pattern of various retirement products. It is based on a male retiring at age 65 with a lump sum of $1,000,000.



The income from the products selected by most retirees will expire before death in around 50% of cases. Many of these survivors will simply need to fall back on the Age Pension.

Clearly, the lifetime annuity should be the favoured option – both from the point of view of the retiree and the Government. However, the lower initial yield means that sales are lower compared to other retirement products.

5. RBL "Compression"

This arises as a result of the ATO using a formula and assumptions to value guaranteed pensions at amounts significantly less than their cost in the current investment markets, allowing for modern expectations with regard to improvement in longevity.

Consequently we have a typical comparison of cost and value of pensions as follows:

	Actual Cost	Cost/Value for RBL Purposes
Complying Lifetime Pension	$1,000,000	$800,000
Allocated Pension	$ 800,000	$800,000
Total Value		$1,600,000
Total Cost/(Transitional) RBL	**$1,800,000**	**$1,600,000**

The simple correction to this anomaly is to amend the valuation formula and assumptions to those appropriate to the current market environment.

6. Unintended Tax Benefits

We are unsure what tax benefits arise which are considered "unintended". In general we believe that members of SMSF's gain no legal tax benefits that are not available to members of other superannuation funds.

The taxation of pensions generally is arguably generous, and the availability of reversionary pensions to dependents and children of the deceased prolong the period during which tax benefits continue.

Perhaps the most obvious tax benefit arises from the investment of superannuation benefits arising from "Undeducted Contributions" into allocated pensions – highly popular and well used by many retirees, many of whom are not in SMSF's. The advantage comes from treating undeducted contributions as capital (and therefore not taxable in the hands of the pension recipient).

This rule was reasonable when the majority of undeducted contributions were member contributions made from after-tax income. However, an increasing amount of contributions made are from high-income earners shifting assets into superannuation a short period before retirement.

The following example shows the different treatment of a drawdown from an allocated Pension compared to the tax treatment of a normal commercial loan. It is based on $100,000 pension or investment for a male retiree aged 60. The life expectancy is 20 years and investment earnings are assumed to be 5% p.a.

Year	Allocated Pension (Minimum Drawdown)			Loan, with Repayment simulating Allocated Pension Minimum Drawdown		
	Investment Earnings $	**Payment $**	**Taxable Income $**	**Investment Earnings $**	**Repayment $**	**Taxable Income $**
1	5,000	5,618	**618**	5,000	5,618	**5,000**
2	4,969	5,712	**712**	4,969	5,712	**4,969**
3	4,932	5,802	**802**	4,932	5,802	**4,932**
4	4,888	5,890	**890**	4,888	5,890	**4,888**
5	4,838	5,973	**973**	4,838	5,973	**4,838**
6	4,782	6,091	**1,091**	4,782	6,091	**4,782**
7	4,716	6,165	**1,165**	4,716	6,165	**4,716**
8	4,644	6,233	**1,233**	4,644	6,233	**4,644**
9	4,564	6,339	**1,339**	4,564	6,339	**4,564**
10	4,476	6,394	**1,394**	4,476	6,394	**4,476**
11	4,380	6,488	**1,488**	4,380	6,488	**4,380**
12	4,274	6,525	**1,525**	4,274	6,525	**4,274**
13	4,162	6,606	**1,606**	4,162	6,606	**4,162**
14	4,039	6,622	**1,622**	4,039	6,622	**4,039**
15	3,910	6,684	**1,684**	3,910	6,684	**3,910**
16	3,772	6,675	**1,675**	3,772	6,675	**3,772**
17	3,626	6,716	**1,716**	3,626	6,716	**3,626**
18	3,472	6,677	**1,677**	3,472	6,677	**3,472**
19	3,312	6,623	**1,623**	3,312	6,623	**3,312**
20	3,146	6,623	**1,623**	3,146	6,623	**3,146**
Withdrawal		**59,445**	**-**	**Repayment**	**59,445**	**-**

The taxation of the loan is clearly more consistent with general taxation principles, and logically could be applied to allocated pensions and other types of pension and annuity purchased by undeducted contributions. However, any change to the taxing of pensions would impact on all pensioners, not just those receiving benefits from SMSF's.

7. Unintended Social Security Benefits

We are unsure what benefits arise which are “unintended”. We consider that members of SMSF’s gain no legal advantage over members of other superannuation funds.

Perhaps the greatest advantages arise for those whose cost of a complying pension is between the amounts equal to twice the minimum and maximum thresholds for Age Pension eligibility under the Assets test.

For a couple this is a superannuation benefit lying between $435,000 and $956,000.

As an example, take a male 65 and female age 63 with $435,000 of super benefits and no other resources, using the whole of the super benefits to effect complying lifetime pensions. The 50% assessment under the Assets test of $217,500 equals the threshold for the couple to receive the full Age Pension, subject to the Income Test.

Pension income is, say, $27,000 p.a., but this is reduced to $6,800 for the purposes of the Income Test, when allowance is made for the “deductible amount”.

This means that this couple is able to receive part Age Pensions totalling $19,962.

A comparison with an investment in a Bank Deposit earning 5% p.a. is as follows:

	Complying Lifetime Pension	Bank Deposit
Private Income	$27,000	$21,750
Age Pension	19,962	3,471
Taxation	Nil	Nil
Net Income	**$46,962**	**$25,221**

In their paper “Retirement Incomes Integration – Superannuation/Social Security/Taxation”, Geoff Dunsford and Michael Rice suggested that this position was anomalous and unnecessarily generous. Their solution, which we support, was to assess the full payment received under a complying pension under the Income Test.

8. Estate Planning

A perceived advantage of SMSF's is the ability of a retiree to create a lifetime pension which will leave any surplus assets remaining in the fund on death. Such assets can then be used to purchase a lifetime pension for a spouse. On his or her death, any surplus remaining can then be used to purchase a pension for a "child".

Such an "estate planning" exercise can however be carried out under other complying funds, with suitable Trust Deed provisions and a co-operative Trustee.

The "estate planning" aspect of this process can be limited by requiring super fund pensions to be restricted to single life or reversionary only to a named spouse at the time the retiree's pension is effected.

An additional, more drastic but still reasonable, measure would be to tax pensions and annuities purchased by undeducted contributions on the *fund* investment earnings component as income in the hands of the pensioner each year. *Refer to example in Section 6.*

A separate issue is the fact that "reserves" can continue to be held in the fund where the income on the assets is only taxed at 15%. Arguably, there should be some limit as to the size of the reserves needed to be held within the fund to receive superannuation environment tax concessions.

As suggested in our comments on Management of Risks in Section 10 below, assets in excess of the "70% probability" valuation are arguably in excess of solvency requirements. Incomes on such excess assets could be treated as assessable at a higher rate than the 15% concessional rate for superannuation funds to provide the incentive to use such assets to purchase an additional (taxable) pension.

Such changes would, however, need to apply to *all* super funds to make any sense, and existing arrangements for current pensioners would have to be grandfathered or some retirees would suffer an immediate fall in income.

9. Complying Pensions Design

The Review team seek suggestions for "design features of prospective (complying) pensions that address the government's concerns".

We suggest that the government's concerns are best addressed by focusing on the tax and social security anomalies.

Estate Planning concerns could be addressed by the restrictions on the payment of pensions suggested under that heading above.

10. Management of Investment, Liquidity and Mortality Risks

We consider that these risks are capable of adequate management under current rules, together with the necessary allowances for risk actually undertaken, by the actuary in providing annual certification of the ability of the funds to pay the pensions.

Actuarial valuation of pensions requires a minimum 70% expected probability of future support. One measure that the Review could consider is to treat as a (taxable) reserve only assets held in the fund in excess of those needed to support the "70% probability" valuation (rather than those over "market value" under current rules).

It is worth noting that achievement of the "70% probability of payment" requirement suggests that there would be a 30% chance that the fund will not meet the pensions *if no earlier action is taken*. In practice, in circumstances when the probability has fallen significantly below 70%, the actuary should recommend a reduction in future pension payments such that after the reduction the "70% probability" position is restored. In most cases the reduction will not be large, and also not undermine the "raison d'être" for complying pensions.

Complying pension rules do not recognise that such action will be necessary for many complying pensions supported by actuarial certificates. It would be helpful for the avoidance of doubt, if the potential and expectation for such a situation can be codified in legislation.

There is no doubt that pooling of the risks for a number of pensioners would minimise the need for any future pension reduction. However, this is arguably not an issue that SMSF's members are overly concerned about. In any case, a minimum of significantly more than 50 *pensioners* is required to provide an adequate pool, and it is not practical for such pooling unless lifetime annuities are to be purchased in all cases.

11. Likely Future Demand for Defined Benefit Pensions

We believe that all retirees should have lifetime pensions which keep pace with living standards in dollar terms, at least equal to the Age Pension.

The government has an incentive to encourage the funding of such pensions privately, as this reduces the strain on the budget otherwise resulting from (higher) Age Pension payments.

Arguably, the government already provides such incentives.

At the same time, it is noted that the government gets much less benefit from the provision of Life Expectancy Pensions and Market Linked Income Streams (MLIS) which will expire while 50% of the pensioners will continue to live – and possibly fall back on the Age Pension.

Also, the MLIS does not satisfy regular expenditure needs as it provides fixed, but volatile income.

The bottom line is that the demand for defined benefit pensions will continue for as long as the government provides adequate incentives, relative to other forms of investment.

However the cost of guaranteed annuities from life companies is perceived to be high, due to the low interest rate environment and the need for solvency support. Consequently, if incentives for MLIS remain equivalent to those for guaranteed annuities, demand for defined benefit pensions from life companies will fall.

Defined benefit pensions, with the guarantee supported by an Actuarial Certificate, will however continue to be popular, even if the Social Security advantages are reduced (further).

12. Conclusion

We hope that we have provided the Review team with some useful material and thoughts. We would be happy to discuss our submission with them if required.