Institute of Actuaries of Australia

19 October 2004

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

Dear Sir

Review of the Provision of Pensions in Small Superannuation Funds

The Institute of Actuaries of Australia (Institute) welcomes the opportunity to make a submission in relation to the above review. We believe that actuaries are one of the few professions that have a comprehensive understanding of all issues relating to retirement incomes. The Institute has many members practising across all aspects of the superannuation and retirement incomes sector. We welcome the opportunity to contribute to this area of Government policy.

The detail of our submission is contained in the attachment to this letter. A summary of the key points of our submission are as follows.

Executive Summary

1. The recent ban on small funds providing life-time and fixed term (fixed payment) pensions reduces the income stream choices for self-funded retirees and seems inconsistent with the Government's general policies of encouraging people to save for their own retirement, take more control over their retirement funding and encouraging the use of income streams, rather than lump sums.

2. Allocated pensions and Term Allocated Pensions (TAPs) are not likely to meet everyone's needs. However, post 30 June 2005, the only other retirement options from a small fund are to:

   (a) purchase a retirement product through an institution; or

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(b) take a lump sum.

For a number of people, purchasing a product through an institution is not considered an attractive option for a variety of reasons. There are over 500,000 people currently in small superannuation funds because they prefer these arrangements to the other products available in the market. Institutional products certainly have their place, but they do not suit everyone. In terms of post-retirement products, annuities in particular are often not perceived to offer value for money, while retirees who have saved all their working life may be unwilling to risk leaving the capital remaining on their death to a large institution, rather than to their dependants. We do not believe that the lump sum option is in the longer term interest of protecting Government revenue.

3. We believe that the concerns raised by Government in the terms of reference for this review can be adequately addressed by making certain modifications to the existing rules for life-time and fixed term (fixed payment) pensions, rather than applying a blanket ban for small superannuation funds.

Access to unintended tax benefits, particularly from the use of "RBL compression"

4. Concerns regarding unintended tax benefits, particularly from the use of "RBL compression", could be dealt with via one or more of the following:

   (a) Updating the SIS Schedule 1B factors to better reflect the true value of a life-time pension;
   (b) Amending the RBL capital value formula for "purchased pensions" to ensure that large undeducted contributions cannot be used to manipulate the RBL assessable value (an issue raised at the recent Senate Committee hearings – refer to our full submission for further details). We note, however, that updating the SIS Schedule 1B factors under (a) may actually address this issue as well, reducing the need to amend the formula.
   (c) An alternative to updating the SIS Schedule 1B factors would be to base the RBL capital value on the purchase price of a purchased life-time pension.

Access to unintended social security benefits

5. In terms of concerns over access to unintended social security benefits, the recent change in the asset-test exemption from 100% to 50% for purchased pensions should minimise the ability of wealthy individuals to access the social security system via complying pensions.

6. If the ban on small funds providing complying life-time and life-expectancy pensions was reversed, consideration could be given to extending the application of the reduced 50% exemption to all complying pensions from SMSFs and SAFs (ie regardless of whether they are "purchased" or not).

7. If the Government is of the view that the reduction in the asset-test exemption to 50% will still not adequately resolve the issue of unintended access to social security benefits, other measures that could be considered include:

   (a) placing a cap on the amount of assets that can qualify for the asset-test exemption;
   (b) extending the application of the 50% exemption to all complying pensions from all sources, including defined benefit income streams. This change would affect members of larger funds, but would result in all complying pensions being treated the same for social security purposes, regardless of the type of fund that was providing them;
   (c) amending the income test relating to complying retirement products (the asset test is only one aspect of the overall means test).

Use for estate planning outside of what was intended and not available to other superannuation fund members

8. We assume that concerns over estate planning arise from the belief that some retirees are deferring capital in retirement by drawing a lower pension than can be supported by their assets and building up large reserves over time.

9. Under the current legislation, it is possible for a person to draw an unreasonably low pension relative to the level of assets supporting the pension, thereby deferring income and building up reserves. We believe that the attraction to do this is limited somewhat by the fact that the exemption from tax on the investment income earned on the assets is limited to a "best estimate" value of the pension, with any income arising from surplus or reserve assets being taxed at normal superannuation tax rates.

10. In order to ensure that a reasonable level of income is drawn for a given purchase price, a number of different measures could be considered:

    (a) Require, under the SIS Regulations, that if a pension is a purchased pension, the amount paid as the purchase price must be wholly converted into income.

    (b) Prescribe a set of pension valuation factors which define the minimum level of a purchased pension that must be drawn on commencement.

    (c) Place some limits on the reversionary beneficiaries that can be included in the calculation of the pension.

    (d) Amend the high probability test for Centrelink purposes from an annual test to a once-off test on commencement.

    (e) Limit the level of indexation allowed for in commencing life-time pensions under SIS Regulation 1.06(2).

11. In terms of building up excessive reserves over time and transferring monies on death, we believe that the attraction for using superannuation as a tax concessional vehicle for such purposes is limited by a combination of:

    (a) tax applying to the investment income each year on the reserve component within a fund; and

    (b) potential surcharge and/or additional RBL assessment arising from the distribution or payment of any residual assets on the death of a pensioner.

12. In order to address the issue of managing reserves and limiting estate planning, consideration could be given to one or more of the following:

    (a) Limit the ability to structure residual capital values past the compulsory cashing age for pensions that do not meet the pension RBL or asset-test exempt requirements;

    (b) Prescribe a mechanism for SMSFs and SAFs which limit the build up of excessive reserves by forcing out additional income in the form of increased pension payments (detailed suggestions put forward in the attached submission);

    (c) Rather than attempt to control the build-up of reserves, consider the introduction of an additional tax that applies to the residual assets following cessation of a pension (although this is not our preferred approach).

Whether a small number of members can effectively pool risk and guarantee income payments

13. The concern regarding the ability to pool risk and guarantee income payments arises, we believe, from a prudential standpoint (as opposed to revenue concerns).

14. As compared with traditional defined benefit lifetime pensions (provided by corporate or public sector employer-sponsored superannuation funds or life offices), small funds are unable to use pooling of lives to manage mortality risks and usually have no guarantor to support payment of the pension should there be poor investment experience and/or the pensioner lives longer than the money lasts.

15. We consider that these differences should be (and are in general) well understood by pensioners from these small funds. Furthermore, in our view, the legislation (together with available investment products) allows a small fund to manage its risks reasonably effectively via other techniques, such as reserving, variable indexation and regular actuarial review and control. A specific mechanism also exists in the legislation to allow a small fund to adjust the level of income if ever required (in the form of commuting and repurchasing).

16. In order to avoid any confusion over the characteristics of pensions from small funds, it may be appropriate to consider a different name for the small fund version of a defined benefit pension (eg such as a "Re-settable lifetime pension").

17. In the absence of a redesign of the small fund version of a defined benefit pension, we believe a simpler and more efficient mechanism should be introduced to allow a "purchased pension" to be adjusted downwards if ever required, such as on the advice of an actuary where this was required to maintain the fund in a satisfactory financial position. In order to protect arms-length members in larger funds, this would only apply to purchased pensions and only where the written consent of a pensioner has been obtained prior to any reduction in the pension level.

Summary

18. While our submission sets out a range of different options for dealing with the Government's concerns regarding the provision of defined benefit pensions from small funds, we believe these concerns can be adequately addressed by targeted amendments to the current rules through a combination of the following:

    (a) modifying the calculation of the RBL capital value to avoid RBL compression (eg updating the SIS Schedule 1B factors or using the purchase price where appropriate);

    (b) inserting a return of purchase price test into the requirements for purchased defined benefit pensions (as currently exists in 9A and 9B of the Social Security Act);

    (c) simplifying the mechanism for allowing a purchased defined benefit pension to be reduced if ever required for solvency purposes (eg on the advice of the actuary and subject to agreement from the pensioner);

    (d) introducing a mechanism to limit the build-up of excessive reserves supporting a purchased pension; and

    (e) considering a limitation on structuring RCVs for SIS Regulation 1.06(6) pensions past the compulsory cashing age, as well as possible restrictions on reversionary pension beneficiaries.

    Points (a) and/or (e) could be applied for all defined benefit pensions, or just "purchased pensions", while (b), (c) and (d) would be more appropriate to be restricted only to "purchased pensions".

19. From a simplicity of implementation point of view, the simplest amendments required to address the Government's concerns would be as follows:

(a) base the RBL capital value calculation for purchased pensions on the purchase price (although this does not address the undervaluation of traditional defined benefit pensions from larger funds);

(b) replicate the existing return of purchase price test currently in the Social Security Act into the SIS Regulations for purchased pensions;

(c) allow a purchased defined benefit pension from an SMSF or SAF to be reduced if required on the advice of an actuary and subject to agreement from the pensioner.

We have also suggested including a mechanism for limiting the build-up of excessive reserves within the SIS Regulations for pensions provided from SMSFs and SAFs if the Government is not satisfied that the current taxation rules applying to these reserves are sufficient to address its concerns. Although more difficult to define than the first three suggestions above, we believe that an appropriate mechanism could be implemented with careful thought and consultation. We would be willing to assist the Government to draft appropriate wording if desired.

If considered desirable by the Government, restrictions on structuring RCVs past the compulsory cashing age for SIS Regulation 1.06(6) pensions could also be achieved by relatively simple amendments to the SIS Regulations.

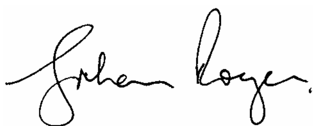
Alternative Pension Designs

20. We have also set out a number of alternative pension designs in our submission that could be given consideration by the Government. These designs would increase the options available to retirees to take their retirement income in pension form (which should further assist implementing Government policy in this regard) and would not cause the issues of concern to Government in the current review.

Please refer to our full submission attached for a more detailed discussion of the above points.

If you have any queries in relation to this submission, please do not hesitate in the first instance to contact Catherine Baldwin, Chief Executive via email: catherine.baldwin@actuaries.asn.au or phone (02) 9239 6106.

Yours sincerely



Graham Rogers
President