The Institute of Chartered Accountants in Australia

31 March 2005

The Manager
Retirement Income and General Rules Unit
Superannuation, Retirement and Savings Division
The Treasury
Langton Crescent
PARKES ACT 2600

Email: dbpensionreview@treasury.gov.au

Dear Erica,

Subject: Review of the provision of pensions in small superannuation funds

This submission is made by The Institute of Chartered Accountants in Australia (The Institute). The Institute is one of Australia's peak professional bodies and our members represent many of Australia's peak business and finance professionals. These members act as advisers and key decision-makers in all facets of the superannuation industry.

The submission below represents the views of The Institute and has been prepared based on input from a variety of members in their capacity as trustees, service providers and fund members of funds of all sizes.

Market Equity

In the interests of market equity we believe that all product types should be available to funds of all sizes. The restriction of defined benefit style pensions to funds with more than 50 members has the impact of increasing the costs of taking a defined benefit pension for those in small funds. This arises as the Trustee is required to sell all fund assets to purchase a pension. This creates a CGT event for the Self Managed Fund which will not arise for a larger fund. A larger fund is able to transition to the defined benefit pension as assets are disposed of in an orderly fashion and is exempted from tax on the funds earnings on assets held for pension purpose, including CGT on the disposal of assets.

This creates discrimination between fund types and leaves members which accumulate their savings in SMSF's with less money for retirement.

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Further complications arise for those with an existing defined benefit pension, as they are unable to commute the pension and recommence a new pension. Events which may require this to occur include divorce or a surcharge assessment. They are not necessarily events which can be predicted and planned for by the pensioner. For example the ability to split a benefit at divorce is relatively new and the pension may have been operating prior to this legislation being passed yet because of divorce the member may no longer be able to continue their pension.

We recommend that funds of all sizes be permitted to offer defined benefit pensions.

Defined Benefit Pensions

We believe that members of the Institute of Actuaries in Australia have adequately responded to the concerns raised by the government in relation to the ability of small funds to appropriately manage longevity risk. It is our understanding that the actuarial standard requires that there is a level of safety to ensure the longevity of the pension. This is further enhanced by the need to have an investment strategy for the fund which reflects the need to provide liquidity for pension payments and considers the safety of the assets used to support the pension. We support the view that longevity risk can be appropriately managed in a fund with less than 50 members and that government concerns about residual values and RBL compression should be addressed using different methods. The strongest concerns raised by government when considering whether small entities should offer defined benefit pensions relate to the asset test exemption and compression opportunities. We believe these can be adequately addressed as outlined below.

<u>Inappropriate age pension access</u>

The government has addressed the concern that those with significant levels of savings can structure their savings to ensure that the assets are exempt from the asset test and the income received is less than the income test. This results in the individual being entitled to a part age pension. The recent amendment to the asset test assessment of defined pensions has reduced the number of pensioners which would be eligible for social security benefits whilst in receipt of a self-funded pension. We also note those in receipt of social security benefits must meet the requirements of the government actuary to display that the pension paid is not too low and reserves are not too high and hence that the income test is applied equitably.

We believe there is no further need to restrict defined benefit pensions to address asset rich individuals receiving the age pension.

<u>Estate planning</u>

The government also has expressed a concern that pensioners who do not interact with social security can manipulate pension benefits resulting in lower income payments and a higher residual benefit for family members upon the death of the member i.e. they will receive the benefit of keeping monies in a tax concessional environment. We are concerned that in the current environment the focus is on leaving assets to an estate rather than focusing on ensuring those that have savings use this to fund their whole retirement. We believe a more appropriate method of addressing this concern is for the government actuary, in conjunction with the Institute of Actuaries in Australia, to specify guidelines that ensure pensions deplete the retiree’s capital in an orderly manner of the pensioner’s lifetime or the pension term.

We support the aim that pensions deplete the retirees capital over the pension term however feel this needs to be balanced with the need to encourage retirees to fund the whole of their retirement and not merely to life expectancy. We recommend the government actuary and The Institute of Actuaries in Australia work together to ensure this occurs when providing defined benefit pensions.

Reasonable Benefit Limits

The government has also expressed concern that the RBL formula for pensions can lead to a compression where by the amount counted for RBL purposes is less than the purchase price of the pension. The restriction of small funds offering a defined benefit pension does not address this issue it merely moves it to the large fund sector. Those prepared to forgo capital in the event of death will continue to have access to products that compress their RBL. As the life expectancy outcomes improve at higher economic levels those with large superannuation savings, i.e. in excess of their pension RBL, are able to select a portion of their assets to be used to purchase a lifetime or life expectancy pension from a product provider and obtain these benefits.

We have received conflicting feedback from members as to the best way to address RBL compression opportunities the two methods of addressing this are:

1. Using a purchase price method of valuation i.e. the lump sum equivalent of monies used to purchase a pension is the RBL. The purchase price method would apply to accumulation funds and funds where the defined benefit pension is based on the lump sum available i.e. where the benefit is determined as a multiple of salary which is calculated to give a lump sum and then used to purchase a pension.

2. Using updated pension factors and considering the age of the reversionary when performing calculations. This would balance the term with the discount period applied for RBL purposes and reduce the compression that occurs when a fund has a reversionary.

We recommend that a consistent approach to RBL measurement be adopted for all retirees to ensure there are no equity issues between lump sum and pension recipients.

Residual Capital Value

We believe that it is appropriate to enable all funds to offer defined benefit pensions with a residual value. The demand for these pensions will depend on the expectations of longevity of the retiree and will be selected where the individual believes they will outlive their life expectancy.

Residual capital values are an important tool in making provision for spouse and dependants. This includes adult children with a legal disability. The ability to leave a residual benefit which can be used as suits the requirements of the recipient gives the pensioner the comfort that there are assets which can be used to retire debt or provide an accommodation bond as well as the ability for a continuing income stream.

The residual benefit is also an important tool in an environment of increasing longevity as it gives those pensioners who outlive their live expectancy assets to enable them to continue to support themselves during their lifetime.

The market linked income stream only recognises the reversionary for calculation purposes where this is the members spouse. This assumes that all retirees are married and have adult self-sufficient families. The use of defined benefit pensions with a residual value is important to those families that do not fit this scenario. These pensions enable the retiree to make provision for an income stream to dependants other than a spouse and enable a parent to make arrangements to protect dependants financially in the event of their death.

We recommend that all pension types be able to be structured to offer a residual capital value.

Account based Pensions

The government is clearly orientating pension products towards account-based pensions. These pensions transfer longevity risk, i.e. the risk of out living a pension, to the pensioner while at the same time prescribing draw down rates which are based on average life expectancy at present rate. As life expectancy in the general population increases this will lead to an increasing number of people out living their savings.

Smoothing of income streams

The significant advantage of defined benefit pensions is the ability to smooth income over lifetime. Account-based pensions fluctuate, as financial markets move, which can result in individuals falling in and out of the social security system. This is an added burden for retirees. We would recommend that account based pension rules be amended to enable smoothing of income. This can be achieved by averaging earnings to remove significant fluctuations in income. Smoothing should occur over an extended period, i.e. 5 years to ensure that short-term market fluctuations, particularly those which may occur at 30 June, do not adversely impact the member's income

We support averaging of income over an extended period to reduce the risk of sharp fluctuations in annual pension income.

Pension Valuation Factors

In order for account based income streams to adequately reflect the needs of the population the rates need to consider the improvements in lifestyle and medical advances which are resulting in an increase in life expectancy. This can be achieved by the regular review of the factors used. As noted in the paper the factors for allocated pensions have not been updated since their introduction.

We recommend the allocated pension rates be revised to reflect improvements in life expectancy.

We also note that the pension valuation factors for allocated pensions and annuity products do no distinguish between male and female life expectancy. This leads to a draw down rate that does not reflect the differences in longevity i.e. a male and female with the same lump sum will draw down all monies in the same timeframe. However the deductible amount is based on life expectancy and will therefore be lower for a female. This results in females in receipt of allocated pensions paying more tax than a male.

We recommend the government introduce steps to ensure equity in this area is restored.

New Pension Products

There is at present a diverse range of pension products in the Australian market and we would prefer to see modifications to existing arrangements rather than the introduction of more new products to the market. The introduction of additional products will result in increasing complexity in the market place and lead retirees away pension products in favour of simple lump sums.

Centrelink Consequences

The paper does not clearly set out the possible changes to the social security assets test to correspond with these changes. This makes it difficult to assess whether these products will be appropriate to those with modest levels of savings that wish to use income streams.

To provide market clarity a whole of government approach is required in relation to superannuation pensions.

Should you wish to discuss this further please do not hesitate to contact Susan Orchard (03) 9502 4371.

Yours sincerely,

Bill Palmer

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