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Manager
Retirement Benefits Unit
Retirement Income Policy Division
The Treasury
Langton Crescent
PARKES ACT 2600

12 April 2017

Subject: **Exposure Draft: Treasury Laws Amendment (Innovative Superannuation Income Streams) Regulations 2017**

Dear Laura

Mercer welcomes the opportunity to comment on the above exposure draft material.

Our comments are set out below and in the Attachment.

1. Confirm no impact on GSA products offered as an investment for an account-based pension

Mercer strongly supports the proposed new regulations as an important step in encouraging innovation and broadening the retirement income stream market.

In doing so we note that Group Self-Annuitisation products (GSAs) can already be offered as an investment option within an account-based pension. Under this structure the GSA balance forms part of the account-based pension balance and is counted in determining the minimum drawdown. Mercer's award-winning LifetimePlus product, which is a GSA structured as a unit trust, is currently the only Australian product of this nature that we are aware of.

Our understanding is that there is no intention for the new regulations to impact on the ability of small or large funds to provide GSAs as an investment option within an account-based pension. We request that the explanatory material confirm that this alternative avenue for funds to access GSAs will remain open and GSAs operated in this manner do not need to meet the requirements of the new regulations (e.g. capital access restrictions).

2. New regulations should be product neutral

We strongly support the clear intent of the draft regulations to provide product neutrality in terms of how the new retirement income stream product requirements are to apply to annuity and pension products.

However there is one area where this seems to fall down. The draft Explanatory Statement indicates that, because of SIS regulation 9.04E, funds with less than 50 members will not be able to provide pensions meeting the new standards unless the pension is wholly determined by reference to policies of life assurance

As a matter of principle Mercer recommends that, as well as annuity products, small funds should be able to invest in GSA products that meet the new standards and are offered as an investment product rather than as super product, and to provide the resulting pension as separate pension rather than as part of an account-based pension. Otherwise the legislation is not product neutral.

However clearly GSAs cannot provide meaningful longevity protection with only a small number of members and therefore SMSFs and other small funds should not be permitted to manufacture their own GSA products.

Subject to our comments below regarding prudential requirements, we therefore suggest that regulation 9.04E be modified to also permit small funds to provide pensions meeting the new standards where they are wholly determined by reference to an investment in a GSA product that has at least 50 investors. We have suggested a minimum of 50 as this is consistent with the offering of existing defined benefit pensions.

In addition, the desired outcome for product neutrality in respect of annuities and all types of GSAs should also extend to the drawdown rules.

3. Prudential requirements for innovative pension products

We suggest that further thought needs to be given to the implications of classifying pension products provided under the new standards as defined benefit pensions.

The SIS prudential regime for defined benefits has not been structured with GSA products in mind. For example, if these products are classified as defined benefit pensions, Prudential Standard SPS 160 *Defined Benefit Matters* would require annual actuarial valuations and reports covering various matters that are likely to be of little relevance to a GSA.

Would there also be other implications such as benefit certificates and funding and solvency certificates? What would be the impact on wind-up priorities?

Therefore, while classifying pension products provided under the new standards as defined benefit pensions might enable the use of SIS regulation 9.04E to prevent inappropriate provision by small funds, in our view it would likely result in unintended and inappropriate outcomes. We recommend instead that:

- these products be excluded from being defined benefit pensions
- a specific provision be included to prevent product manufacture by small funds (using wording similar to that suggested in section 2 above); and

- consultation be undertaken on an appropriate prudential regime for the financial management and actuarial control of these new pension products.

Other comments

We have set out comments on a number of other matters in the Attachment.

Who is Mercer?

Mercer is a global consulting leader in talent, health, retirement and investments. Mercer helps clients around the world advance the health, wealth and performance of their most vital asset – their people.

Mercer Australia provides customised administration, technology and total benefits outsourcing solutions to a large number of employer clients and superannuation funds (including industry funds, master trusts and employer sponsored superannuation funds). We have over $150 billion in funds under administration locally and provide services to over 2.4 million super members and 15,000 private clients. Our own master trust in Australia, the Mercer Super Trust, has around 230 participating employers, 213,000 members and $20 billion in assets under management.

Please contact me on 03 9623 5464 or Paul Shallue on 03 9623 5061 if you would like to discuss this submission.

Yours sincerely

Dr David Knox
Senior Partner

ATTACHMENT

Sections 1 to 3 of our comments are set out in the body of letter. Our further comments are set out below.

4. ITAR307.205.02D Definition of collective defined contribution scheme income stream (CDCIS)

Draft R307.205.02D (3) specifies that:

> 'A ***collective defined contribution scheme income stream*** is a superannuation income stream supported by an individual's superannuation interest if:
> (a) the interest is in a superannuation fund; and
> (b) once payments of the income stream start, the income stream is to continue for the remainder of the individual's life; and
> (c) the amounts paid under the income stream depend on:
> (i) the age or life expectancy of each individual who has that kind of superannuation interest in the fund; and
> (ii) the returns on a collective pool of assets in the fund.'

The distinction between a CDCIS and a deferred GSA needs clarification. What characteristics does a CDCIS have that a deferred GSA does not?

Pending this clarification, we are concerned that having different valuation methods could give rise to unintended biases towards equivalent products.

Also, the definition of CDCIS needs refinement e.g. to include reference to variation due to mortality experience. It should also refer to the scheme's relevant governing conditions (as for r1.06A and the definition of deferred superannuation income stream in r1.03(1)) and make clear that it does not need to depend on each of the potential factors mentioned and may also depend on other factors – these could include items such as the expense experience relating to the product, the age and mortality experience of reversionary beneficiaries, choices made by the holder (e.g. re commutations or drawdowns).

We suggest the definition be amended along the following lines:

> A ***collective defined contribution scheme income stream*** is a superannuation income stream supported by an individual's superannuation interest if:
> (a) the interest is in a superannuation fund; and
> (b) the governing conditions for the provision of the benefit provide that:
> (i) once payments of the income stream start, the income stream is to continue for the remainder of the individual's life; and
> (ii) ~~(c)~~ the amounts paid under the income stream depend on one or more of the following, amongst other factors:

(A) ~~(i)~~ the age or life expectancy of each individual who has that kind of superannuation interest in the fund; and
(B) the actual and expected mortality experience of the individuals who have or had that kind of superannuation interest in the fund; and
(C) ~~(ii)~~ the returns on a collective pool of assets in the fund.

5. Life expectancy period

It appears that the life expectancy period does not include any allowance for the likelihood that holders of these types of products will experience lower mortality than the general population or for mortality improvements.

If unimproved Australian Life Tables are to be used, we recommend that the life expectancy period allow for lighter mortality and improvements by rating down the age of the holder by 3 years.

6. SIS R1.06A(3)(c) No unreasonable deferral of income stream payments

New paragraph 1.06A(3)(c) of the Regulations applies the following factors to determine whether there is any unreasonable deferral of benefit payments:

(i) to the extent that the payments depend on the returns on investment of the assets supporting the benefit—when the payments are made and when the returns are derived;

(ii) to the extent that the payments depend on the ages or life expectancies of other individuals who are beneficiaries of that kind of benefit—the age or life expectancy of each of those other individuals;

(iii) to the extent that the payments do not depend on the returns mentioned in subparagraph (i) or the ages or life expectancies mentioned in subparagraph (ii)—the relative sizes of the annual totals of the payments from year to year;

(iv) any other relevant factors;

Why is the unreasonable deferral provision necessary? It is unclear to us how benefit payments could be set in a manner that circumvents the commutation rules or provides estate planning benefits.

This restriction makes no sense when the deferral period is unlimited.

An example given in the draft Explanatory Statement is that a reversionary annuity purchased for $250,000 at age 60 with payments starting at age 80 would likely be considered unreasonable if the payments for the first twenty years were $1,000 per annum, but then were very large, such as $50,000 per annum for any following payment year. We do not follow the rationale given that this pattern of payments represents less deferral than a product where no income commences until age 100.

If this provision is retained it should be modified to include reference to “the actual and expected mortality experience of the individuals who have or had that kind of superannuation interest in the fund” or similar, as recommended in section 4 above for the definition of *collective defined contribution scheme income stream*.

7. SIS R1.06A(3)(c) and R1.06B Death benefit provisions

The references to commutation on death do not make any sense where there is no reversionary income stream payable. The provisions do not appear to cater for death benefits payable to a person other than a reversionary beneficiary. They should permit lump sum payment of the maximum death benefit to any SIS beneficiary.

8. SIS R1.03(1) Definitions and R1.06A(2)

With respect to the definition of ‘retirement phase start day’, why is death of the primary beneficiary not a relevant condition of release that triggers commencement of the earnings tax exemption, given that an eligible reversionary beneficiary could start a retirement phase pension at that point?

9. ITAR307-200.05C Value of a deferred superannuation income stream

The formula for calculating the value of a deferred superannuation income stream (DSIS) requires compounding of notional earnings on the anniversary of the date each payment was made. This is impractical. The regulations should allow the value to be compounded at 30 June each year for ease of administration and reporting of accumulation phase value each year at 30 June.

10. Transitional Arrangements

We query why existing products that meet the new rules should not be permitted tax exemption on earnings – for example deferred defined benefit pensions and contingent spouse pensions (where the retiree has commuted 100% of the primary pension but their spouse remains entitled to a lifetime pension commencing on the death of the retiree, if they are still alive at that time).

11. Purchase via contributions

It is unclear whether or not the new products can be purchased directly by new contributions to superannuation or whether they are required to be purchased with moneys from an existing superannuation interest.

If they can be purchased directly by new contributions, the formula for determining value of the interest will need to allow for the deduction of contributions tax, where applicable.

12. Amendments to definition of transition to retirement income stream

The Explanatory Statement does not appear to mention the purpose of the amendments in Items 19 and 20 to the definition of transition to retirement income stream. Do these amendments have any practical impact?