GROWTH PENSIONS – AN ALTERNATIVE VIEW

1. BACKGROUND

Presently, managed retirement income streams are provided by two major product offerings – allocated pensions and asset test exempt annuities.

Allocated pensions emerged in the bull markets of the 1990's. Their great attractions are that:

(a) the member retains ownership/control of the funds accumulated during his/her working life. They can be switched between investment options within a single product provider, between product providers and even withdrawn from the superannuation system (subject to tax, of course).

(b) the level of income that can be drawn down is flexible within government prescribed age based parameters, and if necessary partial withdrawals of capital (again possibly subject to tax) can be made

(c) an agreeable degree of tax minimisation is available

(d) in the event of "early death", the unused capital is available to beneficiaries.

(e) if markets outperform the expectations built into the income stream, the upside belongs to the member.

While equity markets flourished, allocated pensions looked superb – many members saw their capital grow even as they drew down a thoroughly acceptable annual income. More recent market conditions have produced less gratifying results as some members have seen the effect of a double-whammy in their capital – declining capital markets and mandatory income draw-downs eating into their capital base.

This underlines an essential but sometimes forgotten element of the product structure – all investment risk is borne by the member, not the product provider. It raises the basic question – how many retirees are technically and emotionally equipped to meet this responsibility? Member reaction in the face of adverse market performance over recent years suggests that probably not as many as have been directed into the product by financial advisers.

Asset test exempt annuities are quite a different beast - much less flexible and the investors surrender ownership/control of the funds they have accumulated during their working life to the life insurance company. On the surface, that seems so unattractive a proposition that you wonder that any sane person would agree to it. However, asset test exempt annuities do have a number of redeeming features that do make them an attractive option for many people:

(i) As the name suggests, any money invested in them has been exempt from the public pension assets test. This enabled asset rich/income poor retirees to access the pension and to enjoy a substantially higher income level than would otherwise be available to them

(ii) They provide a guaranteed income stream for a known period – a pre-agreed number of years or until death. This is particularly attractive to those accustomed to a regular

weekly/fortnightly income, who are risk averse or simply lack the skills/confidence to manage investments themselves

(iii) They meet the requirements for an income stream for people needing to use a pension RBL, thereby avoiding penalty tax on benefits in excess of the lump-sum RBL scale.

(iv) While equity markets flourished, the returns provided by asset exempt annuities did not look particularly attractive, except to those who would not have otherwise qualified for the age pension. That is simply because the provision of the guaranteed income stream comes at a cost, as do all guarantees built into investment products. Nonetheless, returns of around 12% were being achieved – 7.8% via the aged pension and 4-5% from within the investment returns achieved by the fund manager.

This underlines an essential feature of asset test exempt annuities – the investment risk is in fact borne by the life insurance company. This means that if the investment returns are less than those assumed in the product design the loss is borne by the insurance company and its shareholders, not the member, as both income and capital are guaranteed. It is not surprising that many risk averse investors, a larger proportion of older people than in the community at large, find this feature attractive

We frequently read and hear of retirees with multi-million dollar superannuation accounts using complying or asset test annuities to plunder the aged pension system. No doubt there is some basis for the stories – more likely in the DIY application of complying pensions than in mainstream superannuation – but it cannot be too prevalent if the regulator's statistics are correct: the average sum invested in asset test exempt annuities was less than $140,000 in calendar 2003. That does not reflect a picture of multi-millionaires rorting the system.

In summary, we have two products that are quite distinctively different in nature and structure, each meeting the needs of a different sector of the community, although in many cases people choose to use both.

The government has recently announced its approval of a third product type – a "growth annuity" that is in effect a hybrid of the two existing products. Specific detail of the design features are hard to find, so much so that, post-announcement, the Treasurer has requested product providers provide him with more information in a move suggesting that maybe a cart has got before its horse. What has been made public includes:

(i) any money invested is 50% asset test exempt

(ii) the income stream is to be fixed – capital must be drawn down over the life expectancy of the investor – ie, we could reasonably expect half the investors to outlive their capital.

(iii) the assets are market linked – there is no guarantee of either capital or income stream and the investor, not the product provider, bears the investment risk. Obviously, depending on which way markets move, there may be an excess of funds at the end of the agreed term of the product, or there may be insufficient to fund the agreed income stream for the agreed period.

Like many half-bred animals, this product can be seen to have acquired the weaknesses of each of its forbears.

2. WHO BENEFITS FROM THE PROPOSED CHANGE

In looking for winners and losers out of this announcement it is hard to see how consumers are major winners. For a start, those seeking to maximize their aged pension entitlement have had the deduction granted in respect of money's invested in asset exempt annuities for the assets test halved. This has the immediate effect of reducing the retirement income of a significant proportion of that group of people, notably those less well off. It is worth noting that 75% of those aged over 65 receive a full or part pension so the number of people we can expect to be worse off under the new rules is considerable. In return, that group of consumers are granted the option of investing in a market linked product which provides the same relief from the assets test as the asset test exempt annuity product, but which comes without the guarantee of capital and income that gives so many cautious investors comfort.

Almost certainly, those previously investing in allocated pensions will not be attracted to the growth pension, since it contains the features which made the asset test annuity unattractive to them – most notably much reduced flexibility and loss of control/ownership of their capital accumulation.

So, from a consumer's viewpoint, the new structure provides little or no attraction to those who presently buy allocated pensions and the major attraction of asset test annuities has been substantially reduced. Indeed, there is no evidence that there is any consumer led pressure for these changes – they are entirely initiated by, and for, the product providers.

So who are the winners? We need look no further than the parties who negotiated this package, the government and the product providers represented by IFSA.

Let's look first at the product providers – they certainly are bigtime winners. Now they have a new product which gives asset test relief (albeit at 50% of the rate presently available) for which they do not need to reserve capital or maintain and operate within a life licence (as they do with the current complying annuity) and in which the investment risk is transferred from the product provider to the investor. If they under-perform in their investment manager role it is their clients, not their shareholders, who carry the cost.

Depending on the final product structure, they may also have an asset-test exempt product that can be transferred between providers after it has been established, unlike the current product. This would be a major attraction to financial planners – the inability to churn the present asset test exempt annuity and secure a second or third round of commissions has long been seen as a major product deficiency by financial planners. And who owns the companies which employ 80% of the financial planers in Australia? – the members of IFSA, the major driver of these changes.

But in the end, it might just be that the government itself is the biggest winner. Some people who have previously qualified for full or part aged pension will now secure a lesser pension – for some, this will result in quite a significant reduction in income and, hence, lifestyle in retirement. Remember, this has the potential to adversely impact around 75% of people over the age of 65.

Let me illustrate with a couple of examples:

(a) Single Pensioner

Peter is a 65 year old single male planning to retire. Never a high income earner, he has worked hard and saved carefully throughout his working life so that he now owns his accommodation and:

▪ owns a car, caravan & house contents valued by Centrelink at		40,000
▪ retains the shares he was issued in AMP,CBA & Telstra now valued at		35,000
▪ has bank account & term deposits totalling		40,000
▪ a super fund of		120,000
	TOTAL	$235,000

His asset test valuation by Centrelink is $235,000

Peter has seen a financial planner and is aware that under the present arrangements he faces a choice between two extremes – to retain ownership/control of his full super money by investing it in an allocated pension or to maximise his income by surrendering part of that money to a life insurance company by investing in an asset test exempt (complying) annuity. The table below illustrates the two options outlined.

	$120,000 Allocated Pension	**$34,500 Allocated Pension $85,500 Asset Test Exempt Annuity**
Income from shares, bank accounts	3,750	3,750
Income from Allocated Pension	7,655	2,208
Income from Asset Test Exempt Annuity*	-	5,712
Income from Age Pension	5,531	12,200
Total	**$16,936**	**$23,870**

Peter is likely to find the extra $6,934 irresistible, and who could blame him – he is not going to live like king on $23,870 anyway.

But fast forward to the brave new world of 50% deductibility for asset test exemption of money invested in asset test exempt products, and the maximum income he will secure is

Income from shares and bank account	3,750
Income from asset test exempt growth pension	2,208
Income from Asset Test exempt annuity*	5,712
Income from Aged Pension	10,211
Total	**$21,881**

* 17 year term rate quoted on Challenger website

What has happened to Peter? First, the new rules mean that his assets are assessed by Centrelink to be $175,000 - $115,000 of non super assets and $60,000 of super (ie 50% of his $120,000) resulting in the reduction of $1,989 or 8.25% in his pension entitlement.

Second, under the present rules he maximised his pension and retained $34,500 in an allocated pension which he could access in an emergency. Now he has lost that flexibility.

Peter is no high flyer, but he certainly is savagely treated by the new rules. So too will be many of the people who would qualify for a full or part pension under the present rules. Nobody can reasonably quarrel with any tightening of the rules which results in those with superannuation payouts in excess of $500,000 manipulating their affairs to secure full or part pension, but does Peter fit into the category of people whose activities we need to be reining in? Surely not.

(b) <u>Married Couple Pensioners</u>

Jack and Betty are retired and are seeking advice on how to maximise their Social Security Aged Pension entitlements. Both are aged 65, own their own home and have the following assets:

- $204,00 in term deposits
- $40,000 in lifestyle assets (care, home contents etc)
- Jack has $230,000 in an allocated pension (min: $14,650, max $28,395)

Total assessable assets: $474,000

Couples means test summary table

Couple Scenario	Assets Test	Income Test
Both pensioners	**Combined test** Every $1,000 pf assets above lower threshold reduces benefit by $1.50 p.f. each $212,500 for homeowners and $320,000 for non-homeowners)	**Combined test** Where joint income exceeds $212 p.f., each benefit is reduced by 20c in the $1

In the first instance, Jack and Betty are both ineligible for the age pension because they exceed the assets test cut-out threshold for partnered homeowners $473,000). At present, a partnered aged pensioner home owner can have up to $212,500 in assets outside their own home while still qualifying for a full pension, and are eligible for a part-pension if those assets do not exceed $473,000

All quoted thresholds and rates are current up to 30 June 2004

Jack and Betty have been advised that they both may be eligible for some age pension by investing in an asset test exempt income stream.

Jack's life expectancy is 16.21 years. Upon advice, Jack decides to invest $180,000 in a 15 year term, ordinary money, non-commutable annuity that will pay a yearly (non CPI indexed) income of $16,335.

Jack and Betty's age pension is determined as follows:

1. Prior to 20 September 2004

Assets Test

Assessable Assets (excluding ATE income stream)	$40,000 (lifestyle assets) $254,000 [other assets ($230,000 in allocated pensions, $24,000 in term deposit)]
Total assessable assets	$294,000
Asset test threshold (maximum pension)	$212,500
Maximum age pension	$775.20 per fortnight $20,155.20 per annum
Asset test reduction ($3 per forthight for every $1,000 above asset test threshold)	[$294,000 - $212,500 / 1000] x 3 = $244.50 per fortnight $6,357.00 per annum
Age pension entitlement	$20,155.20 - $6,357.00 = $13,798.20 per annum or **$530.70 per fortnight**

Income Test

Social security deductible amount – Term annuity	$180,000 / 15 = $12,000 per annum
Social security assessable income – Term annuity	$16,335 (annual income) - $12,000 (deductible amount) = $4,335 per annum
(Jack) Social security deductible amount - Allocated pension	$230,000 / 16.21 = $14,189 per annum
(Jack) Social security assessable income - Allocated pension	$14,650 (minimum income) - $14,189 (deductible amount) = $461 per annum
Deemed income (on $24,000 term deposit)	$24,000 x 3.0% = $720 per annum
Total assessable income	$5,516 per annum
Maximum age pension	$775.20 per fortnight $20,155.20 per annum
Income test threshold (maximum pension)	$212 per fortnight $5,512 per annum

Income test reduction (40 cents per $1,00 above income test threshold)	[$5,516 - $5,512] x 0.40 = $1.60 per annum
Age pension entitlement	$20,155.20 = $1.60 = $20,153.60 per annum or **$775.14 per fortnight**

Jack and Betty will receive an annual age pension entitlement of **$530.70 per fortnight (lower of two tests) or $265.35 each.**

2. After 20 September 2004

Assets Test

Assessable Assets (including 50% ATE income stream)	$40,000 (lifestyle assets) $344,000 [other assets ($230,000 in allocated pension, $24,000 in term deposit and $90,000
Total assessable assets	$384,000
Asset test threshold (maximum pension)	$212,500
Maximum age pension	$775.20 per fortnight $20,155.20 per annum
Asset test reduction ($3 per fortnight for every $1,000 above asset test threshold)	[$384,000 - $212,500 / 1000] x 3 = $514.50 per fortnight $13,377.00 per annum
Age pension entitlement	$20,155.20 - $13,377.00 = $6,778.20 per annum or **$260.70 per fortnight**

Income Test

Social security deductible amount – Term annuity	$180,000 / 15 = $12,000 per annum
Social security assessable income – Term annuity	$16,335 (annual income) - $12,000 (deductible amount) = $4,335 per annum
(Jack) Social security deductible amount - Allocated pension	$230,000 / 16.21 = $14,189 per annum
(Jack) Social security assessable income - Allocated pension	$14,650 (minimum income) - $14,189 (deductible amount) = $461 per annum
Deemed income (on $24,000 term deposit)	$24,000 x 3.0% = $720 per annum
Total assessable income	$5,516 per annum

Maximum age pension	$775.20 per fortnight $20,155.20 per annum
Income test threshold (maximum pension)	$212 per fortnight $20,155.20 per annum
Income test reduction (40 cents per $1,00 above income test threshold)	[$5,516 - $5,512] x 0.40 = $1.60 per annum
Age pension entitlement	$10,155.20 - $1.60 = $20,153.60 per annum or **$775.14 per fortnight**

Jack and Betty will receive an annual age pension entitlement of **$260.70 epr fortnight (lower of two tests) or $130.35 each.**

Again, one needs to ask whether Jack and Betty are the sort of people that we need to be attacking with these measures.

3. CONCLUSION

The picture emerging is that the group promoting this new product [IFSA] and the government that agreed to its introduction each emerge as substantial winners, and those not represented in the discussions – consumers - pay the bill. Surely this raises a few questions. Was there a deal done? Is the halving of the deductibility of money invested in asset exempt products the price extracted for agreement to introduce the new product style?

More importantly, perhaps, in an election year, does this decision reflect a policy by the present government to effectively reduce the availability and quantum of aged pensions to people in relatively humble circumstances? What other "presents" do they have for us? After all, surely by coincidence [?], the deeming rate was increased within a few days of this announcement, and that too has the impact of reducing the level of pensions paid to those who have been successful in accumulating a few assets.

It is true that one of the frequently expressed fears of government is that people "double-dip" – they get tax concessions on super throughout their working life and then "blow" their retirement benefit on things like long holidays, cars and generally wild living before settling into retirement on the full age pension. These proposed policy changes do nothing to alleviate the risk of that practice occurring – indeed, when you think about it, they provide incentive for it to occur. Take Peter – he can secure the full pension by having a slap-up round the world trip and "blowing" some of his savings .

Would you be tempted?

In case readers should think that this is just a case of sour grapes caused by mainstream financial institutions securing an advantage through a legislative change, let me point out that those super funds that want to provide a range of retirement income products to their members are also winners – the growth annuity gives them a product which provides relief for the assets test provisions to go alongside their allocated pension.

I am sure that there will be a number of funds and related entities (like IFS) that will produce highly competitive product offerings, and that their members will be better off using those products than those from the commercial sector – it has never been our intention that the 25-35% superior retirement benefit achieved through industry superannuation funds would be translated into higher earnings for commission agents. The reality is, though, that we have got a product of doubtful quality at enormous cost – far too great a cost for us to be comfortable.

And we can't be sure if this is not just the first phase of an assault on the level of aged pension benefits.

The announced policy intent of the asset test changes was to ensure that retirees with substantial means were not free to access the social welfare system at the expense of more needy people and the public purse. Even the most cursory analysis of the impact of the proposed measures is that they have a substantial impact on people with modest means and will be a further disincentive for low-middle income earners saving to have a measure of self provision in retirement.

Several questions beg to be answered:

(i) how much will the government "save" in reduced pension payments as a result of these measures

(ii) how much will the major financial institutions advance their financial position by "winning" these changes

(iii) what is the reduction in benefits payable to lower/middle Australian retirees, and what impact will it have on their quality of life in retirement.