



The Voice of Super

File Name:

18 June 2004

The Secretary
Senate Community Affairs Legislation Committee
Parliament House
Canberra

Family and Community Services and Veterans' Affairs Legislation Amendment (Income Streams) Bill 2004

The Association of Superannuation Funds of Australia (ASFA) thanks the Committee for providing an opportunity comment on the above legislation. ASFA supports the concept that Social Security Payments should be targeted at those most in need. The modification to the level of exemption that a complying income stream will receive from the asset- test post 19 September 2004 is a step towards achieving this.

The Committee's term of reference "to examine the impact of the changes to asset test exemption on retirement income adequacy and take up of income streams" is a matter that this Association has given brief consideration to.

However, it should be noted at the outset that the change to the asset-test exemption cannot be looked at in isolation. The asset-test exemption change is accompanied by the recognition of a new asset-test exempt income stream known as a *market linked income stream* and the replacement of the '10 year' rule with a '20 year' rule. Each of these changes has the capacity to affect an individual's attitude towards income streams. Recent changes in the superannuation rules, particularly as applicable to non-arms length superannuation arrangements, further muddy the waters.

The impact of market linked income streams (MLIS)

As originally envisaged by their proponents, MLISs were expected to both increase the overall incomes of retirees, and to promote innovation and competition in the retirement income stream market. The increase in income was seen as coming from retirees switching from income stream products overwhelmingly invested in low – yielding interest based securities to products with a significant exposure to growth assets. Consistent with this, modelling by the Investment and Financial Services Association, for instance, indicated that \$100,000 in a 15-year MLIS would return about \$30,000 more in real terms than \$100,000 in a 15-year CPI-indexed pension or annuity.

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What is likely to be the likely impact of market linked complying pensions?

For those with assets within the range over which the Age Pension reduces, a MLIS might be of interest given its relatively strong returns over the longer term and its concessional treatment under the assets test. However, the combination of the introduction of the MLIS and limiting the asset test exemption to 50% rather than the 100% applying to the pre-20 September 2004 complying pensions is a mixed blessing for these retirees. They will be able to achieve a level of income not dissimilar to what they might have achieved under the old arrangements, but they will have to take on more investment risk and will have less flexibility and access to capital as more capital has to be locked away to get asset test benefits.

In essence, the retiree will have a higher private income but lower Age Pension entitlement, with the retiree bearing increased investment risk as well. There is unlikely to be a rush of current recipients of complying pensions commuting their pension and converting to a new MLIS unless they could retain the 100% asset-test exemption.

However, for those unable to take out the older style complying pension, the MLIS will reduce the 100% effective withdrawal or tax rate facing income in retirement from additional savings over certain bands above the asset test threshold to around 50%. In other words, if a retiree achieves a net investment return of about 8% from their MLIS, after the reduction in the Age Pension of \$3.95 a year for each additional \$100 of assets, this return in effect is reduced to around 4%. This is why the MLIS is likely to deliver total retirement incomes over at least some income ranges not that much different to a 100% asset test exempt complying pension from a life company with an underlying 4% investment return.

However, different analysts come up with different figures on the effective return from an MLIS, because the effective withdrawal rate depends on assumptions about investment returns, the drawdown pattern of other retirement income products held by the retiree such as allocated pensions, the age of the retiree and the mix and type of investments and pensions held by the retiree. Some rather complex spreadsheet analysis is needed to take into account both the income and asset tests and taxation, especially given there are varying deductible amounts reflecting return of capital. There also are different impacts between year 1 and later years, requiring net present value analysis to be truly accurate.

Accordingly it is not too hard for an analyst seeking to show disincentive effects to calculate an effective marginal tax rate of 60% using some quite reasonable assumptions, and for those seeking to emphasise the advantages of the new measure a rate closer to 40%. Whether any known consumer will be able to undertake these calculations without assistance is debatable. The new measure may have some advantages, but simplicity for retirement planning is not necessarily one of them. However, the choice will be easy for some.

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A further, and for some more important, consideration is the capacity with an MLIS to have any residual capital on the death of the beneficiaries paid to the estate of the beneficiary. This feature alone would encourage many who would not otherwise purchase a life expectancy product from a commercial provider to reconsider the situation.

For the current majority of retirees with financial assets (including superannuation) and other means tested assets of less than \$149,500 for a single person and less than \$212,500 for a couple, a market linked complying income stream (MLIS) is unlikely to be of much interest. They do not have the luxury of an RBL problem to worry about, there is little or no tax payable on retirement income regardless of how the financial assets are invested, and a full Age or Veterans Pension is available. If a superannuation product is to be made use of by such retirees, generally an allocated pension will provide more flexibility for those willing to take on some market risk, and for those who want an assured income stream in retirement a traditional life expectancy or lifetime pension will have some attractions.

At the upper end of the market, it will no longer be possible for millionaires (apart from those with million dollar residences) to have access to the Age Pension. Even couples who put all of their financial assets into a complying pension will not be eligible for any Age Pension once their financial assets reach \$946,000. However, millionaires with an RBL problem might find the MLIS an attractive option for at least part of their superannuation retirement savings. For instance, a fully rebatable MLIS in conjunction with an allocated pension might be more tax effective than the traditional planner strategy of one rebatable and one non-rebatable allocated pension. The closing off of certain RBL strategies with the new SMF measures might also lift demand for both allocated pension and growth pension strategies.

For single home owners with financial assets between approximately \$150,000 and \$450,000, and couples with assets between approximately \$215,000 and \$700,000 an MLIS might have a potential role to play in maximising retirement income. However, decisions about what exactly to do will not generally be easy. In most cases it will not be a decision of relying solely on a MLIS or solely on an allocated pension. Generally retirees will need to assemble a mix of an allocated pension, a MLIS, and the Age Pension. Attitudes of the retiree to the target income level (relative to the assets available), the need for availability of capital, and attitudes to risk and variability of income will need to be considered in constructing a retirement income strategy.

For instance, under the new rules a couple with \$400,000 in financial assets and \$20,000 in personal assets requiring \$47,600 in total income per year would need to put \$376,500 in a complying pension in order to get the full Age Pension. However, if they were willing to part with some Age Pension entitlement they could achieve the same income by taking a complying pension worth \$207,500 and an allocated

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pension, taking more than the minimum annual income, of \$192,500. Numerous other permutations of risk and access to capital are possible.

In summary, the mix of factors impacting on a retiree's decision concerning income streams makes it impossible to isolate the direct impact of the change in the asset-test exemption level to the take-up of asset-test exempt income streams.

ASFA understands that the changes contained in this legislation will be mirrored in new regulations to the *Superannuation industry (Supervision) Act (SIS)*. Close integration of the SIS and social security rules is essential

Comments on specific changes

The following comments are on specific items in the bill.

Item 1: Recognition of the new "market linked income streams"

ASFA supports the proposed recognition of market linked income streams, a proposed new superannuation product that can be issued by superannuation entities from 20 September 2004. It is anticipated that this new product will enable pensioners to achieve a higher income over the product term than could be achieved with a traditional life expectancy or annuity product. Recognition of this new product will encourage its adoption and provide social security and veterans' entitlements recipients with the opportunity to increase their total income.

Item 3 and 12: Replacement of the 10-year period with the life expectancy period that relates to the particular product

Currently, a major consideration for individuals considering commencing a life expectancy income stream is the potential loss of capital should the pensioner die before the end of the pension term. The capacity of a product provider to now offer a pension that would permit the payment of the remaining payments up to the lesser of the life expectancy of the pensioner or 20 years should substantially address these concerns and make life expectancy income streams more attractive.

ASFA supports this change as an effective mechanism to encourage retirees to take retirement benefits as a regular income stream.

Item 13: Removal of the requirement for an asset-test exempt income stream to commence on or after the person achieves age-pension age

ASFA supports this change as it will simplify the planning required and reduce the cost involved in a person establishing an appropriate retirement income stream. Under current requirements, a person taking early requirement with a complying income stream is required, on reaching age pension age, to commute that income stream and commence a new income stream if the income stream is to be treated as

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assets-test exempt. This simple change means that this costly process, in terms of both income lost and time involved, process is no longer required.

Item 14 and 21: Criterion for a life expectancy income stream to be treated as asset-test exempt and definition of reversionary partner

These items limit the extent to which an income stream, when it is paid to a reversionary beneficiary, can retain its asset-test exempt status.

ASFA notes that the requirement for the 'reversionary partner' to be 'a member of a couple with the primary beneficiary' is not as expansive as the proposed 'interdependent relationship' rule that will extend tax exemption on the payment of superannuation death benefits to a broader class of persons.

Item 19: The term of a life-expectancy income stream

ASFA supports the proposal to allow the term of a life expectancy income stream to be extended by allowing the use of a life expectancy for a person up to five years younger than the primary beneficiary or, where there is a reversionary beneficiary, a life expectancy for a person up to five years younger than the younger of the beneficiaries.

The proposal provides consistency with the proposed arrangements for the new market linked income streams and will provide encouragement for retirees to take their benefits as income streams.

Item 24: Market linked income streams

ASFA supports the granting of asset-test exempt status to the proposed market linked income streams.

The rules set out for these income streams appear consistent with statements made about these income streams by the Assistant Treasurer, Senator Coonan.

Integration of the social security and superannuation rules in areas such as the recognition of 'complying' products is essential for effective retirement planning

Item 28: Reduction in assets test exemption from 100% to 50% on certain non-commutable income streams purchased from 20 September 2004.

ASFA supports the change in the level of exemption from 100% to 50% of the value of any partially asset-test exempt income stream as it generally will limit access to the age pension and certain veterans' affairs benefits to those in most need.

Yours sincerely,

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