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SENATE

ECONOMICS LEGISLATION COMMITTEE

Reference: Superannuation Industry (Supervision) Amendment Regulations 2004 (No.2)

MONDAY, 26 JULY 2004

MELBOURNE

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SENATE

ECONOMICS LEGISLATION COMMITTEE

Monday, 26 July 2004

Members: Senator Brandis *(Chair)* Senator Stephens *(Deputy Chair)*, Senators Chapman, Murray, Watson and Webber

Participating members: Senators Abetz, Boswell, Brown, Buckland, George Campbell, Carr, Cherry, Conroy, Cook, Coonan, Eggleston, Chris Evans, Faulkner, Ferguson, Ferris, Fifield, Forshaw, Harradine, Harris, Kirk, Knowles, Lees, Lightfoot, Ludwig, Lundy, Mackay, Marshall, Mason, McGauran, Murphy, O'Brien, Payne, Ridgeway, Sherry, Stott Despoja, Tchen, Tierney and Wong

Senators in attendance: Senators Chapman, Sherry and Watson

Terms of reference for the inquiry:

Superannuation Industry (Supervision) Amendment Regulations 2004 (No. 2)

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Committee met at 9.08 a.m.

ACTING CHAIR (Senator Watson)—We are here today to take evidence on the Superannuation Industry (Supervision) Amendment Regulations 2004 (No. 2) as contained in the statutory rules 2004 No. 84 and made under the Superannuation Industry (Supervision) Act 1993. On 16 June the Senate referred the regulations to the Senate Economics Legislation Committee for inquiry and report by 3 August, with particular reference to the extent to which defined benefit arrangements have been used for the purposes of tax minimisation, estate planning, reasonable benefit limit avoidance and for any purpose other than providing retirement income; the extent of past losses to revenue from the above measures; and the estimated future losses to revenue likely in the absence of these regulations.

Before we start taking evidence, I enforce for the record that all witnesses appearing before the committee are protected by parliamentary privilege with respect to the evidence they give. Parliamentary privilege refers to the special rights and immunities necessary for the discharge of the parliamentary functions without obstruction or fear of prosecution. Any act by any person which operates to the disadvantage of a witness on account of evidence given by that witness before the committee is treated as a breach of privilege. These privileges are intended to protect witnesses. I must also remind witnesses, however, that giving false or misleading evidence to the committee may constitute a contempt of the Senate.

[9.09 a.m.]

LORIMER, Mr Michael Dale, Director and Chair, Small Independent Superannuation Funds Association

McDOUGALL, Mr Graeme Robert, Chief Executive Officer, Small Independent Superannuation Funds Association

ACTING CHAIR—I welcome the witnesses representing the Small Independent Superannuation Funds Association. The committee prefers all evidence to be given in public, but should you at any stage wish to give any or part of your evidence in private, you may ask to do so and the committee will consider your request. I invite you to make a brief opening statement and then we will proceed to questions.

Mr Lorimer—I would like to start with a summary of the salient points of our submission to this inquiry. The appropriate starting point is our position that the regulations, to the extent that they deal with so-called defined benefit arrangements, should be disallowed. We have a number of reasons for arriving at that position, which are stipulated in our submission. We are primarily concerned with the obvious lack of empirical evidence to support the introduction of these regulations in the first place. Certainly we are not aware, in our representative capacity, of any evidence to suggest that the use of defined benefit arrangements was for any of the stated purposes. Further to that position, if in fact there is proof of these problems, whether actual or perceived, then our view is that there are quite clearly better ways of addressing those perceptions.

We note that one of the potential concerns, by way of background to the introduction of these regulations, was the so-called reasonable benefit limit compression. That is an industry-coined term and I will use that expression for the sake of clarifying our submission. We are really struggling, in relation to reasonable benefit limits, to understand what the real mischief was from a reasonable benefit limit perspective in terms of the attempts that these regulations have made to address the problem. If it really is a reasonable benefit limit issue, we submit that the regulations have done nothing at all to change how lifetime pensions or defined benefit pensions are valued for reasonable benefit limit purposes.

What these regulations have done is simply shut small funds out of that sector of the market in terms of being able to provide those sorts of income streams. The fact remains that, with respect to lifetime income streams from large superannuation funds and other defined benefit income streams, their RBL treatment or RBL valuation remains the same in spite of these regulations. The point I am making is this: if there was a reasonable benefit limit problem—and we are not convinced that there was in fact one—then these regulations have done nothing but shut small funds out of that sector of the market; they have not solved the problem. We are at a total loss to understand whether these so-called defined benefit arrangements have been used for any identified tax avoidance. That is a very sweeping statement, but we are struggling in our representative capacity to identify any specific areas where you could consider that such arrangements would constitute tax avoidance as opposed to genuine retirement income provisions.

We are also at a total loss—and I think this is a critical factor in the context of these regulations—to understand why fixed term or life expectancy pensions were also denied to small superannuation funds as part of this process. We are aware that the so-called market linked pensions have now been introduced to come online from 20 September this year, but we see no reason why the market linked pensions should be a replacement for the fixed term or life expectancy pensions that were previously available to all superannuation funds—large and small alike. Once again, these regulations have simply shut out small superannuation funds from the ability to provide other recognised forms of income stream.

A clear outcome from these regulations is that small superannuation funds have a significantly reduced number of income stream options available to them in terms of their ability to provide them themselves. From 20 September this year, small super funds will have the ability to provide directly only two forms of income stream—an allocated pension and a market linked pension. There are three or four other widely recognised forms of income stream available in the marketplace that from 20 September will only be available via a self-managed or a small superannuation fund if those funds purchase it from a retail provider. In our view, that is anticompetitive. It is going to introduce in a number of cases unnecessary capital gains tax liabilities and higher costs. It seems to us to be inconsistent from a competition perspective to suggest that, if small superannuation funds want to provide a certain form of income stream, they are compelled to purchase it from a retail provider when in the past they have been able to legitimately self-provide those sorts of products.

Mr McDougall—I would like to raise a starting point. In recent years, I have got to say that we have enjoyed extremely good relationships with Treasury in relation to prior consultation. Issues have come forward that Treasury have had some concerns with—whether it be legislative or regulatory concern—and that they would like to discuss, and many times this has happened under secrecy, under privacy. I do not believe in all those years, about six years, we have seen anyone breach that arrangement that has taken place. I know that at times in the past, even up to three months ahead of budget, we have discussed potential budget issues that have been coming forward, and we have been able to give Treasury an industry view on what those sorts of budget impacts would be and what the reaction would be.

We have in the industry, I must say, found that very encouraging, and I believe we have ended up avoiding a lot of problems that may have eventuated. So to have a set of regulations come forward in a budget without any prior discussion under the guise of integrity was of concern to us because, as Michael has said, if there was a problem or there was perceived to be a problem, why didn't they discuss it with the industry first to find out whether there was actually some fact behind the perception? I think it was disappointing that that did not take place.

Another area that Michael has touched on was that the reason given for this move on the regulations was estate planning issues. I want to put in very simple terms what we see as the estate planning issues in relation to a self-managed fund or any small fund for that matter—being a self-managed fund or a small APRA fund.

A person who takes out a defined benefit pension or a complying lifetime pension may pass away prior to that pension being used up. If that happens, two things can happen with the balance that is left of that pension. It can be bequeathed in their estate to their beneficiaries, and their beneficiaries fall into two categories. The first is another member of the same fund—and, if that is the case, the benefit goes into that person's accumulation fund and cannot be used until they move into pension phase. The alternative is that the pension balance goes to a beneficiary outside of the fund. If it goes to a person in that category, we have a tax act that already covers that point—the tax is triggered if the pension goes out and the tax is paid. We are at an absolute loss to find out where the estate planning avoidances are, which were named as one of the reasons why small funds could not pay these two pensions.

Another stated reason—and we found this in the consultation period that took place after the regulations had been put in the budget—was a perceived problem that the employer sponsor of any fund that had fewer than 50 members would not have the ability to pay the pension. We do not know of a case where it has not happened. If you are going to make such a broad, sweeping statement, particularly in relation to self-managed funds or small APRA funds, I believe we should have some proof on the table to show where it has happened. If there have been some cases of small corporate funds with fewer than 50 members having a problem, again, the evidence would be helpful.

When you are dealing with self-managed funds, you are dealing with the principle that, in by far the majority of cases, if you want to find an employer sponsor, the employer sponsor is most likely one of the members or trustees because they are mostly linked to small businesses. So they are the employer sponsor. If they—their adviser, their auditor or their actuary—have found that the fund has the capacity to pay the pension and not only sign off on it initially, but continue to sign off on it on an annual basis, what we have to ask is: where is the potential problem? Where is the actual problem if there is an actual problem? If there is not an actual problem, what is the perceived problem, because that can only be perception.

We would like to thank the government for putting in place a transition period after concern was expressed by the industry. That was important so this issue could be discussed and understood more fully. We also appreciate the opportunity to extend that transition period until June 2005. The purpose of that is, I believe, to allow the consultation process to take place to find out the issues, as Michael has outlined, in relation to the RBL and other problems.

The transition period has left an area of discrimination: anyone who is starting a fund from the date of the budget until June 2005 will be denied the opportunity to take on a complying pension or a defined benefit pension. A lot of people today come from other sectors—the industry sector, the corporate sector or even the government sector—and they start a self-managed fund for the purpose of creating an income stream through a pension structure. Our argument is: why should they be left out of the loop during this long transition period and be denied being able to start what they see as a legitimate pension? I do not think we can have a transition period for one group and not for another group. We would like to address that point. Those are just a couple of points that I wanted to add, and I think Michael has one more point before we invite questions.

Mr Lorimer—I would like to follow up quickly on the point Graeme made about the notion that small superannuation funds—which for the purposes of these regulations are defined as funds with fewer than 50 members—are somehow or other not financially viable in terms of their ability to pay so-called defined benefit pensions. In support of what Graeme said, I think the regulations defeat themselves in that respect. As far as defined benefit pensions are concerned, the requirement under the regulations is simply for any fund that pays a defined benefit pension to have 50 members—not 50 defined benefit pension members but rather 50 members. We have made the point in our submission—but I will highlight it—that conceivably you can have the situation of a fund with 50 members, only one of whom is in receipt of a defined benefit pension and the other 49 are accumulation style members. It seems absurd to us that that size of fund is in a better position to pay a defined benefit pension than a single-member fund. It is ridiculous. That is probably more of a technical issue. There are a number of other technical issues embedded in these regulations that highlight the broader concerns we have with their introduction in the first place.

ACTING CHAIR—In some sectors of the SIS industry, there is some confusion about the wording of the trust deed in terms of the ability to pay a pension. Could you give us your interpretation.

Mr Lorimer—As far as self-managed superannuation funds and trust deeds are concerned, it is generally accepted—and our membership base would support this proposition—that most modern trust deeds clearly are robust and articulate the terms of any form of income stream that is recognised under the SIS regulations these days. For funds that may have been set up in the past, the trend within the industry, from a best practice standpoint, is to continue to review trust deeds and ensure they are brought up to speed with legislative changes. It is less likely now to find a self-managed superannuation fund trust deed that does not clearly articulate the rules that would apply to the payment of any form of income stream that is provided under the regulations. If you can identify a fund that has a trust deed that may be deficient in that respect then the likelihood is it will be amended sooner rather than later, either in conjunction with a member commencing such an income stream or as a matter of best practice, as I said. It may well have been the case years ago, but the current trend is to have very robust documents that clearly set out the rules the trustees need to adhere to to pay these forms of benefits.

ACTING CHAIR—You could have an older trust deed with somebody just becoming entitled to take up a pension. Are they in trouble?

Mr Lorimer—If they commence the pension without upgrading the trust deed, they may well be in trouble. That is a very technical issue. From an income tax perspective, if a pension was commenced without the governing rules having been amended to support that form of income stream then it would be open, in our view, for the tax office to deny the 15 per cent pension rebate to the income stream and those sorts of issues.

ACTING CHAIR—Within the extended dates is it possible to amend the trust deed before you take the pension if you are becoming liable?

Mr Lorimer—Absolutely, and it is very common practice.

Senator SHERRY—Do we have any idea of the approximate number of people who move from the pre-retirement phase to the post-retirement phase through DIY or a small super fund? Treasury and Tax may be able to tell us, but do you have any idea of the numbers?

Mr McDougall—No, we do not. When the tax office became the regulator, they took on a role of research which had not previously been done by APRA under the old excluded funds. They were pushing out over two-year periods some very valuable and important information, which was giving us a better understanding of what was going on. Unfortunately, in the last 18 months, that has come to a stop—I do not know why. It would be very helpful to see that continue. What we give you is anecdotal evidence, but we do know, from practitioners' comments, that they are getting a lot more clients today coming to them and saying, 'I'm getting ready to retire. I'm in this sector, and I want to be able to run my own pension scheme.' That is happening more frequently.

Senator SHERRY—I just want to get more idea of the number. Is it in the hundreds, the thousands or the tens of thousands?

Mr Lorimer—In the tens of thousands.

Senator SHERRY—It is in the tens of thousands?

Mr Lorimer—Absolutely. If I put on my practitioner's hat for a moment, probably between 10 and 20 per cent of the client base that we look after are currently in receipt of a formed income stream. So if you applied that to the 280,000-odd self-managed funds in the marketplace—

Senator SHERRY—You made the statement, which I think is accepted even by Treasury and the tax office, that the DIY small super fund structure itself, standing alone, would not be able to offer a DB pension product. Would it still be possible for a DIY small super fund to offer the product if it were to purchase it from a life company, presumably? Is that a correct understanding?

Mr Lorimer—Absolutely correct.

Senator SHERRY—That is the intent and effect; I do not think there is any argument about that. What would that mean in terms of costs? Obviously you will have the existing cost structures for the DIY, whatever they are, and presumably you would have another layer of cost because you have had to buy the income stream product from another provider. Can you give me some outline of the sorts of cost scenarios that we are looking at, if that is in fact the path down which the DIY would go?

Mr Lorimer—I will address that question in broad terms, if I may. It is going to be difficult to quantify in pure dollar terms—

Senator SHERRY—You might be able to give us an example.

Mr Lorimer—If the trustees of a typical self-managed superannuation fund prior to these regulations were looking at commencing one of these income streams, they would simply review their investment strategy and investments to ensure that liquidity issues and those sorts of things were addressed and that the fund could meet its pension obligations, once the pension was commenced, without necessarily having to realise assets and all those sorts of things to commence the income stream. Under the regulations that we have before us, a self-managed superannuation fund or a small superannuation fund that intends to pay a defined benefit form of pension, which it will have to do via a retail provider such as a life office, will be forced to liquidate assets, and so there are going to be capital gains tax implications. Certainly there is no CGT rollover relief or any exemptions as part of these regulations. So there is a capital gains tax cost.

In addition to the self-managed fund's own operational costs, it is obviously going to have the underlying fees and charges associated with having to purchase a retail product. It is probably fair to say that with most life office annuities the fees and charges structures are less than transparent, if I could put it that way. It is very difficult to express in dollar terms how much those sorts of products cost you, because for the traditional lifetime type of product the costs are effectively built into the rate of return that you get. There are definitely underlying costs, the effect of which is a lower rate of return in relation to the investment. So you have fees and charges and capital gains tax; there is no question about that.

Senator SHERRY—But if the retail product charged an extra one or two per cent, which I understand is pretty common, that is effectively one or two per cent ongoing off your rate of return.

Mr Lorimer—Correct.

Senator SHERRY—Wouldn't it be most cost-effective if the individual and the DIY actually left the DIY altogether, were no longer a part of it and it was effectively shut down and the assets transferred to the retail provider? What are the capital gains tax implications if the assets have to be transferred to a retail provider?

Mr Lorimer—It is considered to be a disposal of assets, and capital gains tax would apply.

Senator SHERRY—At what rate?

Mr Lorimer—If the assets are being held in the self-managed fund for more than 12 months, it would be an effective rate of 10 per cent.

Mr McDougall—One of the reasons people go into self-managed funds and set up these income stream structures—and maybe this is where the perception about triggering this idea of the state planning benefits comes in—is that, if you buy a retail product and the person passes away early, any residual left goes to the retail provider. But if the small fund sets up the fund itself then the residual goes to the beneficiaries nominated within the fund. In a lot of cases, the money stays in the fund in an accumulation phase under another person's name if the other member is the beneficiary. The driving forces for why people start self-managed funds are: one, control and, two, ensuring that residuals do not go to other people extraneously.

Senator SHERRY—It would seem that, faced with this capital gains tax treatment, if you did not want that triggered you would still stay in the DIY fund but you would have no option but to add to the cost by going to the retail provider and paying an additional cost whatever that may be.

Mr Lorimer—Correct.

Senator SHERRY—That would be the impact.

Mr Lorimer—Bearing in mind too that the decision just to shut down the fund and put all the money with the retail provider is not necessarily that simple because there may be other members in the fund. It might be an entirely appropriate consideration if there is only one member in the fund, but with people of different ages and different retirement dates and those sorts of things, it just may not be a viable option.

Senator SHERRY—So separating out the assets, if you like, and selling some off may be commercially disadvantageous at that particular time, if in fact it was possible to do it in a practical sense.

Mr Lorimer—Absolutely.

Mr McDougall—We will highlight that point: we have to remember that under the current legislation there is the ability for a self-managed fund to own up to 100 per cent of their total assets and have that in one business real property investment. It is currently in the legislation and was put in by the government to ensure that there would not be an impact on self-managed funds where that had previously been allowed. If you have 80 per cent or 90 per cent of your total assets still tied up with that business real property and one or two other members are still running that business, how are you going to divide up the property?

Senator SHERRY—Faced with the practical problems of the internal structure, breaking up of assets, sale of assets and capital gains tax et cetera it would seem logical that you would maintain the structure but effectively be forced to add to your costs by purchasing the product from the life company.

Mr Lorimer—Correct.

Senator SHERRY—I have looked through all the submissions and people's views that I value in terms of their knowledge and expertise and there is only one organisation that has supported the government's approach and that is IFSA, who we will hear from shortly, which represents life companies of course. Does it surprise you that that is the only organisation supporting the government's approach?

Mr Lorimer—No, that does not surprise us.

Senator SHERRY—Do you think that is because it represents life companies?

Mr Lorimer—I have had the benefit of only a fleeting review of the IFSA submission. I believe that in their submission they refer to some possible problems from a regulatory perspective with self-managed superannuation funds in that the trustees and members are not at arms-length. IFSA seem to have some sort of concern, perhaps from an integrity standpoint, that that in itself might be relevant in the context of these regulations. We find it impossible to support that submission. We fail to see how the non-arms-length relationship between trustees and members in a self-managed fund really has anything to do with the ability of these funds to provide legitimate retirement income streams. In our view, there are enough regulatory and prudential requirements embodied in the income tax and superannuation laws to ensure that any superannuation fund, large or small, notwithstanding any relationship between trustees and members, is able to pay these sorts of benefits. So while it is a fact that trustees and members in a self-managed fund are not at arms-length, we fail to see how that has anything to do with the regulations before us today. Given IFSA's representative base, it really does not surprise us that they would have a position that would in most respects support these regulations.

Senator SHERRY—I have heard these regulations described as 'using a sledgehammer to crack a walnut'. Would you concur with that description—that is, that it is draconian legislation that adds to costs without clear evidence to justify the regulatory approach?

Mr McDougall—I think your latter point really is the issue, which is that there is a lack of evidence. Bringing about legislative change based on a perception is what makes it most difficult to understand. That is what we believe we are seeing in these proposed regulations. Until somebody puts something factually on the table for us to see, I do not think we can ever understand the issue.

Senator SHERRY—You mentioned earlier that you had had some sort of consultation with Treasury after the budget. Was anything placed on the table then—for instance, a representative survey or an analysis—to give us some idea of the scope of the alleged abuses occurring?

Mr Lorimer—Anything submitted at that forum was anecdotal at best. No hard facts or empirical evidence were put on the table at all.

Senator SHERRY—What do you think will be the reaction of people as they come to retirement having to purchase an income stream product through a retail company and having to pay additional costs as a consequence?

Mr Lorimer—It will not be particularly palatable at all, and it is not acceptable. On that point, what these regulations will do is add another layer of complexity and uncertainty to the average punter in the marketplace as far as superannuation is concerned. We cannot forget that.

Senator SHERRY—But they will get more choice. There will be another choice of product added to another choice of product. Wouldn't that seem to be a consistent theme?

Mr Lorimer—It is a case of giving with one hand and taking with the other, because the introduction of the market-linked pensions from 20 September is hardly any consolation for removing the ability of small funds to pay the other three or four forms of income stream that they have at the moment. The regulations as they sit at the moment put any person who was considering a self-managed superannuation fund or who is already in a self-managed superannuation fund in a very difficult position. People who are in existing self-managed superannuation funds are now asking themselves: 'Do I satisfy these transitional rules?' The tax office has issued a draft ruling about its very narrow interpretation of what constitutes a fund's governing rules, and many existing members of self-managed funds, in spite of the transitional periods, still cannot pay themselves a lifetime pension because of that very narrow interpretation. So there is just this air of further complexity and confusion as a result of these measures.

Senator SHERRY—It touches on an issue I should have got to earlier. The actuary seems to me to be the key in evaluating the pension level, the income stream level, that is payable. But at the end of the day the actuary is an independent professional. It seems to me that if the actuary certifies that pension X is payable—it might be only $1,000 a year or it might be $50,000 a year—regardless of the level, how do we go beyond that and question the actuary's professional judgment in this regard?

Mr McDougall—I cannot speak for actuaries. Today the institute is here and there will also be an independent actuary giving evidence this afternoon. I hope, Senator Sherry, that you ask them those questions. If there is a perception that there is something wrong with the actuarial process that is currently in place, one can only assume—and maybe we can perceive—that the problem came from the government actuary saying that they had a problem. But no evidence has been put before us to say that a problem was perceived by the government actuary.

Senator SHERRY—If these rules were 'too loose', presumably you could tighten up the rules by which an actuary can make their determination.

Mr McDougall—Absolutely.

Senator SHERRY—Was the government actuary at that meeting you had?

Mr McDougall—No.

Senator SHERRY—It would be useful, at the end of the day, to know. We might be hearing from the government actuary this afternoon when we hear from Treasury.

ACTING CHAIR—Do you have a copy of that ruling from the tax office?

Mr Lorimer—Not with me. I would be able to get my hands on a copy for you very quickly.

ACTING CHAIR—It would be handy. Could you get it before we leave today?

Mr Lorimer—Yes.

ACTING CHAIR—Thank you.

Senator CHAPMAN—Can you just explain to me what is meant by RBL compression? You used that term.

Senator SHERRY—You thought we had heard them all, Senator Chapman.

Mr Lorimer—That is a curious one. To clarify what it is all about, a lifetime pension—that is, a superannuation pension that is payable for life—is required to be valued for reasonable benefit limit purposes under the tax act on a formula basis. How that formula operates is that the initial annual level of pension that is calculated by the actuary, or that is provided for under the fund's governing rules, is multiplied by a set of

prescribed factors under legislation to produce an RBL value which is then reported by the relevant fund for reasonable benefit limit purposes. It is not appropriate to say that in all cases, but in some cases that formula based approach would have the effect of a lower amount being reported for RBL purposes than the actual amount of capital supporting the pension. Because of the number of variables involved in the formula, it is impossible to draw any broad conclusions that that would always be the case or whatever. But if you are talking about RBL compression, from an industry perspective, that is what is being referred to.

Senator CHAPMAN—As I understand it, the RBL is determined by the amount that is accumulated in the fund at the time that the pension commences. Is that correct?

Mr Lorimer—For pensions that are payable for life, no.

Senator CHAPMAN—So it is by the formula.

Mr Lorimer—Yes, the formula.

Senator CHAPMAN—But apart from that, it is by the amount that is accumulated in the fund at the time that the pension commences.

Mr Lorimer—Correct.

Senator CHAPMAN—It is probably not directly relevant to the regs, but do you think that is a reasonable approach to determining what the RBL should be, given that no-one can predict what return one fund as against another might get on its investment over the life of the fund? Would the RBL be more fairly determined by the amount that is actually contributed rather than the amount that is there at the end?

Mr Lorimer—Quite possibly. We have covered that point in some detail in our submission. It is difficult to suggest that that would be a better outcome in all cases. For example, for traditional defined benefit superannuation schemes where there is no underlying amount of capital that approach obviously cannot work. There has to be a basis for covering those sorts of situations. But, conceptually, where there is an identified amount of capital that has been used to purchase a particular type of income stream, yes, I think it would be quite reasonable to suggest its RBL value is how much it was bought for. Just on that point, it is interesting to note that, even with these regulations on the table, if a small superannuation fund purchased a lifetime annuity from a retail provider but provided it through the self-managed superannuation fund, they would still have the formula based approach to the RBL situation. So, once again, we would question how effective these regulations are, if at all. Are they really dealing with the problem?

Senator CHAPMAN—Do the transition arrangements mean that, if a fund in its deed had the capacity to pay a defined benefit pension, it will now be allowed to do so or does it have to start paying that defined benefit pension before 30 June next year?

Mr Lorimer—The transitional rules that operate between 11 May 2004 and 30 June 2005 operate in the following way. Firstly, to avail themselves of the transitional rules a person has to have been a member of a fund as at 11 May. So you cannot have a new entrant; they would have to have already been a member of the fund. The regulations will allow the fund in that transitional period to amend its rules to provide for the payment of a defined benefit pension, if the rules do not already provide. The pension has to commence within 12 months of the person becoming entitled to the payment. They have to become entitled to the payment of the pension on or before 30 June 2005, and they have to ensure that it is commenced physically within 12 months of that time. It is not a transitional period; it is more of an attempt to grandfather existing arrangements under the main regulations. That grandfathering attempt is such that if a fund's governing rules, as defined, already provided for the payment of these pensions then they would be able to continue to do so, notwithstanding the introduction of these restrictions.

The draft determination that I referred to earlier—I will obtain a copy for the committee later today—would suggest that the regulator's interpretation of what constitutes a fund's governing rules is so narrow that there will virtually be no fund in the marketplace that would be in a position to satisfy the grandfathering arrangement. It is such a ridiculously narrow interpretation and one, it is probably fair to say, which would not accord with what the industry's mainstream view is of what constitutes a fund's governing rules. So it is an ineffective grandfathering provision. The transitional period is similarly a very limited one. It only applies to people who are in existing funds, and there is only a very short time for them to make up their minds whether they want to retire and those sorts of things. So, once again, more confusion and uncertainty.

Senator CHAPMAN—In effect, the transition provisions are only relevant to someone who either has retired or is going to retire in the next 12 months or so?

Mr McDougall—That is correct.

Mr Lorimer—I think it is fair to say that the provisions do not help the families either when someone dies. The transitional period only deals with people who either have retired or are looking to retire. It does not allow the families of deceased people to look at these arrangements.

Senator SHERRY—Not even Treasury can predict when someone will die, can they? I have given them a lot of kudos for a lot of things but not that.

Senator CHAPMAN—On that note, in relation to someone dying, if in their estate the remainder of the fund goes to another member of the fund but it then puts that member's accumulated capital in the fund over the RBL, then they are subject to the excess tax on that.

Mr McDougall—Exactly. A lot of people believe that they would prefer to see that happen than for it to go to the coffers of a retail fund—and that is why they do it.

ACTING CHAIR—The 50-member rule will basically cut out all the small funds, won't it?

Mr McDougall—It cuts out all self-managed funds; it cuts out all small APRA funds. I cannot help but think that one of the triggers for it to come up with this wonderful figure of less than 50 was as another tool which APRA were using to get rid of these small corporate funds that they have been trying so hard to get rid of for so long. That is another issue which is not in our area, but we know that that is an actual case.

ACTING CHAIR—Why are APRA interested in getting rid of small corporate funds?

Mr McDougall—I can only say from my experience in discussions and Senate hearings that they have a dislike for them.

ACTING CHAIR—Why? What is the rationale for it?

Mr McDougall—In full honesty, if I could find the rationale behind a lot of what APRA thinks I would learn a lot.

Senator SHERRY—Just on this 50 members, as you have pointed out you could have 49 members, with one person a DB and 48 in the accumulation.

ACTING CHAIR—You cannot have any less than this.

Mr Lorimer—The argument is that that style of fund would be more financially viable or in a better financial position to pay the pension, and it is very difficult to follow that logic.

Senator SHERRY—Presumably, the financial viability of the funds are signed off on by an auditor as well.

Mr Lorimer—Correct. The auditors and the actuaries play a pivotal role.

Senator SHERRY—There is an auditor, isn't there? There is not an actuary.

Mr Lorimer—Yes.

ACTING CHAIR—Thank you very much.

[9.58 a.m.]

SHALLUE, Mr Paul, Convenor, Legislation Subcommittee, Institute of Actuaries

WARD, Mr John, Member, Legislation Subcommittee, Institute of Actuaries

ACTING CHAIR—Welcome. Thank you very much for your submission. I invite you to make an opening statement.

Mr Shallue—As you would sense from our submission, the institute was very concerned with some aspects of the 12 May regulation changes. Our submission of 10 June to Senator Coonan set out detailed comments on what we regard as serious deficiencies in the changes and the resulting problems for bona fide superannuation funds. Some of these concerns in regard to DIY funds had been recognised and addressed, to some extent, by the transitional measures and the review announced by the government on 23 June. We look forward to participating in this review and are hopeful that it will lead to better targeted and more effective measures than were legislated on 12 May. In the meantime, however, funds which have certainly not been vehicles for abuse are being adversely affected. I would like to ask my colleague John Ward to provide some brief comments on the problems from the point of view of corporate funds, in particular, and potential solutions, after which I will make some concluding remarks to our opening comments.

Mr Ward—One of the first things that struck me when I read the new regulations was: what on earth do these regulations mean? They use terms that I—a person who has been involved in the industry for 30 years—found very confusing and difficult to interpret. There are already two different definitions of a defined benefit fund in the regulations, depending on what purpose we are dealing with. There are effectively different definitions for a defined benefit member. And now we have a new set of regulations which imposes in effect a limit of 50 defined benefit members for any fund that wants to provide defined benefits, be they lump sums or pensions. We now have another regulation which imposes a 50-member limit—not 50 defined benefit members but 50 members—which restricts funds with less than 50 members from providing defined benefit pensions. So I am totally confused. I do not know whether a defined benefit pensioner is actually a defined benefit member under the definitions in these regulations. I am even concerned that an accumulation style member who has insurance cover is actually classified as a defined benefit member.

These confusing aspects need to be clarified. We do not want a situation where a 48-member fund that has a rump of maybe 10 defined benefit members being provided with lump sum defined benefits as a sort of grandfathering provision cannot invite a new accumulation member to join that fund because, technically, I have interpreted the definition of defined benefit member to include that accumulation member. Also, in regard to vesting, the regulations use very strange words. The new regulations say that ‘minimum benefits are all of the member’s benefits’. I really do not know what that means. Is it all the benefits that can be provided if the member were to resign today or is it his death benefit? I do not know.

That is all very technical, and I will now move back to each of the various regulations and look at some of the impacts that these new regulations are having. Firstly, a new defined benefit fund must have at least 50 defined benefit members in order to commence, and an existing defined benefit fund cannot invite a new defined benefit member to join if it has less than 50 defined benefit members. I note that this applies to funds that provide only lump sum defined benefits as well as those that provide pensions.

The institute is at a loss to understand why this limit has been imposed. Is it tax avoidance? We have seen no evidence of these corporate funds avoiding tax. Is it to protect consumers because of a perception that these funds are difficult to monitor? There is some indication that the Government Actuary has indicated that there is a problem there. I think the Institute of Actuaries disputes that perception. Actuaries have been successfully monitoring defined benefit funds for decades. There is no reason why a defined benefit fund cannot operate with less than 50 members. Sure, there are insurance risks—they can be covered by appropriate insurance. There are investment risks, sure, but they are just as valid for a fund with 10,000 members as they are for a fund with 40 members. Again, an appropriate investment strategy can help to minimise any perceived risks. So as an institute we are very concerned with the perceived logic behind this change.

The new regulation has created a number of problems. Firstly, we are in an environment where many corporate funds are winding up. The whole superannuation business is just getting too difficult. So funds are winding up. In many cases the employer would still like to provide the benefits that he has provided for many years and is trying to arrange for a transfer to a master trust, where in many cases the same benefits will be provided.

Introducing these new regulations on 12 May created havoc for many funds who were proposing to wind up before 30 June. Even though they were proposing to wind up and provide the same benefits in another structure—a master trust—that was no longer possible because the master trust arrangement was considered to be a new arrangement, a new fund. So they had to comply with the existing rules. So if there were less than 50 defined benefit members, that transfer could not happen unless an exemption from APRA was obtained.

In a number of cases, those exemptions were obtained, but it took so long that the transfer had to be delayed, and went past 30 June, which meant that the fund has incurred considerable additional costs, another APRA levy, more audit fees and more administration fees. That has had a significant adverse impact on some of those funds. It has also created some problems for some employers who have got a small fund. They are currently providing defined benefits for their employees. They may no longer be able to provide the same benefits for a new employee who joins. That means they have to set up a different structure of superannuation for their new employees. Again, it might be possible to get an exemption from APRA. I am certainly aware of at least one case where that exemption has not been forthcoming. So not only does the employer now have to discriminate between existing employees and new employees, but there are various cost implications on setting up new arrangements. One of the fears I have is that many of these employers will say, 'Why bother? Let's just give our new employees the minimum SG entitlement'—which could be significantly lower than the benefits being provided for existing employees. It seems to be in conflict with the intention of the government to improve retirement saving.

Going back to some of the technical difficulties I mentioned earlier, it would seem that a defined benefit fund that has four defined benefit pensioners and, let us say, 50 accumulation members—so overall it has got more than 50 members—can provide those defined benefit pensions. But it seems that a defined benefit fund that has got four members being provided with lump sum defined benefits and 50 accumulation members cannot continue to provide lump sum defined benefits. It seems absurd that with two similarly structured funds one cannot provide lump sum defined benefits but the other can provide defined benefit pensions.

The next point I wanted to discuss was the requirement for full vesting or, as worded in the regulations, 'minimum benefits are all the members' benefits'. We have assumed that what that means is that it is no longer possible to provide vesting entitlements. So it is no longer possible for an employer to, say, contribute 12 per cent of salary to a fund. The nine per cent is SG, so that has to be paid out when a member leaves the fund. But the employer can no longer put rules around the other three per cent contribution. It might be using those three per cent contributions as an incentive for employees to remain in employment until, say, five or 10 years, when those contributions might become vested.

Certainly we have seen vesting disappear very quickly from the superannuation market in recent years as the SG requirements have increased. But there are still some circumstances where employers make voluntary contributions on top of the SG and would like to use those as some form of incentive to retain employees. These regulations appear to retrospectively change the rules. These regulations do not apply only to future contributions, they also apply to past contributions. We are concerned with the retrospective nature of this change. We consider it inappropriate that a contribution made five years ago under certain rules agreed with the member on joining the fund and clearly set out in the fund's governing rules now gets overturned overnight.

We note that the regulations provide some exemptions, but these exemptions are so badly designed that we find it very difficult to see any particular case where the exemption would apply. The exemption applies when there is a written agreement between the employer and the employee that sets out particular vesting rules. In our experience it is extraordinarily rare for that to occur. The vesting rules are normally set out in the fund's governing rules, set out in the member booklet and in the product disclosure statement. If anything, there is an agreement between the member and the trustee; the employer is not really involved in that agreement. So at the very least we would need to see clarification of the wording around the regulations on what they really mean and a better written exemption to enable bona fide arrangements to continue in place. We believe that would remove some of the retrospectivity problems as well.

The third point covers the allocation of contributions to superannuation funds. In many cases employers of corporate funds will agree to pay the fund's expenses and sometimes the insurance costs for members. Rather than debiting those costs from members' accounts, the employer pays an amount to the fund to cover those costs. Under the new regulations it appears that that will no longer be possible to do easily. Let us say the fund gets a bill for $750 for doing some work and the employer pays the $750. What the new regulations seem to require is that that $750 be allocated amongst all of the members, so, if there are 500 members, $1.50 is

credited to each members' account, and we then take it out straightaway to pay off the expense. Let us say that a month later there is another expense of $800 and this time there are only 490 members in the fund. We divide the $800 by the 490 members and we credit $1.28—or whatever the number is—to each member. Then we deduct it again straightaway from the members' accounts.

This is administratively complex and confusing to members. In some cases it will conflict with what the employer has told the members. The employer might have agreed that fees and insurance costs would not be deducted from members' accounts. They now have to go back to employees and say, 'Sorry, we can no longer do this; the government doesn't let us'. There is a lot of additional cost in changing systems and a lot of confusion for members. Again, I am concerned that employers will say, 'This is all too hard. Let's stop paying these amounts; let's just do the minimum we have to and get the expenses and insurance costs deducted from members' accounts. Let the members pay.'

Why is this regulation being introduced? Again, we are not sure. Is there some sort of avoidance? We have certainly seen no evidence. Is it because the government thinks that members are avoiding surcharge on some of these contributions that are not specifically allocated to their accounts? Certainly in my experience that cannot be the case. I know that, in my organisation at least, where there are such amounts they are notionally allocated at the end of the year amongst members for surcharge purposes. It does not actually go through the member's account balance but it is reported for surcharge. So there is no surcharge avoidance. If other funds in the industry are avoiding surcharge, the problem is not what they are doing; the problem is that the tax office is not properly auditing, following up and clearly telling those funds what the appropriate surchargable contributions should be.

Likewise, perhaps the government is concerned that employers are overclaiming tax deductions and trying to get around the age based tax deductible limits. Again, our view would be that, if that is the problem and there is evidence to say that that is the problem, you fix the problem—you go and clarify the rules around tax-deductible contributions. There is no need to add extra layers of compliance and confusion onto superannuation funds, particularly where employers are trying to do the right thing and assist their members in meeting these costs.

Mr Shallue—To make some brief comments on the specific question raised by the inquiry about the level of abuse, the institute does not have any data on the level of abuse. Indeed, as you might have gathered from John's comments, we have not seen much detail about the specific abuses that this legislation is trying to target. We recognise that there are some opportunities for abuse, but we do not believe it is necessary to await widespread evidence of abuse before trying to close off any loopholes or anomalies. However, we do believe that far better targeted measures would achieve the results without the spin-off consequences on bona fide superannuation funds.

We would like to see substantial amendments to these regulations to clarify them. As John indicated, there are also areas where we believe that the regulations will not achieve their intended effect because, in regard to the wording of how subfunds or master trusts might be able to be used to get around the 50 member rules, people who are very keen to use whatever loopholes there are in the system will continue to find ways to do that. We feel that measures which target the root causes of the abuse are likely to be more effective than using a sledgehammer which tries to crack everything and winds up leaving some room for specific areas of abuse to continue.

Mr Ward—There were a couple of points I might have forgotten to mention. In regard to the allocation of contributions, a fairly simple change to the regulations would be to allow contributions that have been used to provide administration and insurance costs a 12-month window, so that if they were actually used to pay administration and insurance costs within a 12-month window they would not need to be specifically allocated to members' accounts. That might avoid any other perceived issues with allocation. On the full vesting issue, some changes to the exemption provisions in the regulations that would actually refer to vesting built into governing rules would probably solve that problem.

ACTING CHAIR—What are the better measures to overcome the alleged abuses? You and previous witnesses have said that there are better ways of attacking alleged abuses. For example, do we change the factors that apply to reasonable benefit limits? Are those factors out of date? Have circumstances changed? Are the factors no longer appropriate?

Mr Shallue—Certainly the factors were set some time ago in different economic conditions. Two things have happened since then: life expectancies have increased dramatically and we have moved from a high-interest, high-inflation environment to a lower interest, lower inflation environment. Because of both of those

factors, the current evaluation for factors in the SIS regulations tends to understate the value of pensions. There certainly is a case for looking at those factors and updating them. That is one instance.

Senator CHAPMAN—Understate or overstate?

Mr Shallue—Understate.

Senator CHAPMAN—If people are living longer, you actually need more funds if anything.

Mr Shallue—You need a higher factor. The current factors are low, so they are understating the true value of the pension.

ACTING CHAIR—You mentioned a narrow window of opportunity and that even the opportunity of moving moneys into a particular type of pension arrangement may not be available now because of the time cut-off—for example, putting the money into a master trust. Could you elaborate on that issue.

Mr Ward—What we have seen with corporate funds is that they have been trying to cope better with the new financial services reform legislation and trying to cope better with safety and super by transferring money across to a master trust, and keeping an employer subfund in that master trust so there is very little difference from the existing arrangements. For example, even though an existing fund might be able to continue with 40 defined benefit members, once it goes into the master trust it is a new vehicle and it needs an APRA exemption.

I saw one example of a fund that had several hundred members, but it had four pensioners. I think the total pension was about $8,000 per annum. They were long-standing pensions. There were no new pensions being provided; it was just trying to meet the original pensions that had been promised many years ago. That fund wanted to transfer to a master trust arrangement and the trustees were concerned that in the new environment, if that fund ever fell below 50 members, it would not be able to continue to provide those four defined benefit pensions of $8,000 per annum. The fund was not able to get an exemption from that at that point from APRA. Technically, it did not need an exemption at that point from APRA because it had more than 50 members, but it was felt that it really needed some sort of commitment if it was going to move to a new arrangement. What happens if the membership does fall to below 50 at some point? APRA could turn around and say, ‘Sorry, we can no longer provide those pensions.’ There was no certainty available in that particular case. I think the trustee decided, ‘The likelihood of membership eventually falling to below 50 is small and, gee, for an $8,000 a year pension it is unlikely to be a problem.’ It is just the uncertainty that was created that was the concern.

ACTING CHAIR—So are you suggesting that where a fund is paying a pension and the number falls below 50 they have to cease paying those pensions?

Mr Ward—That is my interpretation, unless they can get an exemption.

ACTING CHAIR—You say exemptions are particularly rare, except in isolated examples where there is a written agreement.

Senator SHERRY—Thank you, Mr Ward. That was as damning a critique of the motivation for and the specifics of a bill or regulations as I have heard for a long time. I want to deal with the practical impact of these regulations. Take a person who is a member of a DIY SMF. They get to the point of retirement. They want a particular income stream in retirement. My understanding is that the impact of this is that, depending on the type of income stream, they can continue in the DIY SMF but the income stream has to be provided by the retail provider as an add-on to the existing structure. Is that correct?

Mr Ward—I am not an expert in the DIY area. It is not really my area of expertise.

Senator SHERRY—Is it correct in the case of a small superannuation fund? Is that the way they would adhere?

Mr Ward—It is my understanding that they would need to purchase a retail product.

Senator SHERRY—So, if they stay in the fund, the fund then purchases a retail product. That is an additional cost, presumably.

Mr Ward—It is, because there are expenses incurred by the life insurance company in issuing the product. The life insurance company needs to maintain significant reserves. I think there would be a lot of concern that, if the particular pensioner dies in the near future or even lives to his life expectancy, those reserves would be lost to the insurance company. Obviously the insurer needs to cover the risk of those people who live much longer than life expectancy, so you have to expect that those reserves will exist.

Senator SHERRY—You have this additional layer of provision and cost as a consequence of legislation. We were discussing with the previous witnesses—I do not know if you were here—the issue of why the trustee does not just transfer their assets over, get out of it and go into the retail product, whatever the income stream is. It was explained to us that to liquidate the assets and transfer them over is not a simple thing to do. There were some capital gains tax issues as well. Can you give us your view on this transferring over of assets of the individual to a retail fund? Why is it not easy to do?

Mr Ward—Looking at it from the viewpoint of a corporate pension fund, the rules of that pension are defined in the fund's governing rules. There are normally a whole set of rules on how the pension is indexed, when it is indexed, what happens when the pensioner dies, who it is paid to after that, the term certain and so on. Firstly, it is not always possible to find a life insurance company that is able to provide a pension that exactly meets those terms. If that is not possible, what does the trustee do? Again, life insurance companies do not want to issue 300 different types of pensions to cover the various multiplicity of rules that might apply in a particular pension fund.

You mentioned the capital gains tax implications. There can also be capital gains tax implications, particularly in a DIY environment, in the corporate fund area, where, if you have to pay $200,000 or $400,000 to a life insurance company to buy the pension, you have to realise assets to buy that pension. That will incur capital gains tax liabilities. If you can provide the pension from within the fund, there is no realisation of assets and no capital gains tax is incurred.

Senator SHERRY—Presumably, if it were disadvantageous in either a practical or a financial sense for a member to move assets out and then move into a retail provided product, because the regulations require that the retirement income product must be offered by the retail provider, you have added another layer of cost. You have no option but to go to that retail provider for the pension product.

Mr Ward—In effect, yes, for a small fund.

Senator SHERRY—As you were speaking, it struck me that if a person is a member of a defined benefit fund and in law that is what is promised to them, then the government effectively is saying in some cases that the defined benefit fund can no longer provide the income stream, that it must be purchased from a retail provider. You are suggesting that at least in some cases a retail provider may not provide that. You may not be able to find it. How do you overcome the problem where the trustees have, in law, committed themselves to a defined benefit fund of type X, to indexation and perhaps reversionary benefit, but the law requires the individual to take it from a retail provider who cannot provide the product? It seems to me that we are getting into very difficult legal territory where a binding legal commitment has been entered into by the fund but it cannot be met in some circumstances because the retail provider cannot be found to meet the legal commitment.

Mr Ward—You would have to fall back on applying to APRA for an exemption.

Senator SHERRY—It would seem to me that APRA would have to give an exemption. Otherwise, the legal commitment—which, I would argue, under the Constitution has strong legal validity—cannot be overturned. It has to be met. It is a promise. My advice is that you cannot retrospectively change a superannuation benefit without the member's agreement.

Mr Shallue—You cannot, unless it is required under the superannuation legislation, which, in this instance, it would be. Effectively it would override the member's rights.

Senator SHERRY—Can you override the member's rights constitutionally, adversely affecting their—

Mr Shallue—Yes. There is a specific 'out' in the SIS regulation that does not allow you to reduce a member's benefits unless it is required under the legislation.

Senator SHERRY—Yes, but has the legality of it ever been tested in the High Court?

Mr Shallue—I do not know.

Senator SHERRY—It is a side issue. Mr Ward, I think it was you who suggested that it is not clear under the regulations that an accumulation fund member who receives an insurance death and disability, which is pretty common, could be treated as a DB member. Is that because there is a guarantee for a payout? Why would that be?

Mr Ward—No. The definition of 'defined benefit member' is a member where part or all of the benefit is defined in terms of a member's salary or salary near retirement, or a specified amount. So if the death benefit is whatever you have in your account plus $40,000 or $50,000 ensured benefit—

Senator SHERRY—A specified amount.

Mr Ward—That is a specified amount, in my interpretation; so, technically, that person could be considered a defined benefit member.

Senator SHERRY—It is a guaranteed payout if a certain event occurs.

Mr Ward—That is right.

Senator SHERRY—In the case of DB, we would normally regard it as retirement. In the case of either a disability or a death, that would be an event that triggered the guaranteed payout and therefore that person could be a DB.

Mr Ward—That is right. There are specific provisions in the family law sections of SIS that exclude that insured component from being treated as a defined benefit, but those exclusions do not apply to the normal definition of defined benefit.

ACTING CHAIR—What is the effect of this? Are they in breach of the law?

Mr Ward—The effect is total confusion.

Mr Shallue—I think historically it has always been interpreted that that did not make you a defined benefit member, but we now have the situation where it might be attractive for some people to interpret it such that they are defined benefit members so that they get over the 50 members rule and are not caught by these new legislative requirements. It is through this sort of thing that we feel that unscrupulous operators, if you like—or those who operate to the absolute letter of the law—will try to find ways to get around these requirements if they are not properly put together.

Mr Ward—Up until now those sorts of definitional problems have not really caused any issues, because nothing too much hung off them. But under these new regulations the definition becomes far more critical.

Senator SHERRY—I do not know whether we will hear from the Government Actuary this afternoon, although I hope we do. I would hope he has been consulted on all this stuff. Has the Government Actuary had any consultations with the Institute of Actuaries about these measures?

Mr Ward—Not as far as I am aware.

Mr Shallue—There has been no direct consultation on these measures. Occasionally, the Government Actuary makes known to the institute areas of concern and the institute responds to those. There has not been any particular consultation on this matter that I am aware of.

Senator SHERRY—This has caused a lot of anxiety. There have been other issues in recent times that have caused a lot of anxiety for people with these forms of superannuation products. Wouldn't it be reasonable to expect that the Government Actuary would consult with the Institute of Actuaries—particularly where, it seems to me, actuaries are almost being targeted in terms of the abuse with respect to the RBL compression of the issue?

Mr Ward—I was surprised that there was not some consultation with Treasury rather than the Government Actuary. It is Treasury's role to implement new laws, and I was a little surprised that there was not some discussion with industry on the issues before they were introduced.

Senator SHERRY—Surely Treasury would have had to have consulted with an actuary on this stuff. From what you are outlining in your critiques, they may not have; but surely they would have needed to consult with an actuary of some description on these measures. Do you think it is a reasonable proposition that they would have done that? I will ask them but, if they did not, do you think they should have?

Mr Ward—I think they should have.

Mr Shallue—I thought there was some reference to consultation within the explanatory memorandum or the announcement.

Senator SHERRY—The announcement gave me the impression, when I read it in the budget papers, that there were some actuaries who were to blame for all of this. It seemed that there were some sorts of dodgy tax minimisation practices being vetted and signed off by actuaries and that actuaries were at least part of the problem in this area. Do you have any comment to make about that?

Mr Shallue—We certainly have actuaries active in the small funds area. We would expect them to be operating in line with the professional standards which the institute sets. We are happy to look at any instances that are drawn to our attention where there are concerns about the activities of actuaries.

Senator SHERRY—Have you had any? Has the tax office referred actuaries who have signed off on so-called 'RBL compression' for discipline under the ethics of the Institute of Actuaries? Has that happened so far?

Mr Shallue—I do not believe that there have been any specific referrals. We have had comments referred to us which we have acted on to the extent of sending notices to members about the need to comply with standards.

Senator SHERRY—In this area that this regulation deals with?

Mr Shallue—It was particularly in relation to sign-offs for small funds, so I believe it is in the area, but it partly related to the degree of auditing that went on, as opposed to certifications of amounts which were inappropriate. I think the other thing which is pertinent is that within the area of pensions from self-managed funds there are somewhat contradictory requirements. In order to provide a defined benefit pension from a small fund, you have to now have a certification of a high-probability statement, which effectively requires the fund to hold some reserves. So in order to provide a defined benefit pension, the fund might require assets of $1 million and the value of the pension being provided is $700,000, so it appears from that that assets being held are in excess of what is required to pay the pension. There are contradictory requirements. The assets in excess of the $700,000 should not be the subject of a tax exemption, but that depends on the investment mix adopted by the fund. I think there are some difficulties for actuaries within the small funds area in complying with the different requirements and it may appear that there are practices being allowed by actuaries which are inappropriate. The institute is as keen as anyone else to clarify any of those requirements and to make sure that they are not inappropriately taken advantage of.

ACTING CHAIR—Where you have a small fund, wouldn't you need as a hedge some significant amount over and above the assets to pay the pension and to account for changes in investment values because you have less opportunity to spread the risk?

Mr Ward—I think this is one of the difficulties with the payment of lifetime pensions from single member funds. Where you have a corporate fund or a public sector fund with a defined benefit pension, then you effectively have a guarantor. Where you have a payment from a life office, you have a guarantor who is effectively covering the risk. In a self-managed fund you do not have a guarantor and therefore you have the choice of maintaining reserves to protect against the event of poor investment experience or living longer than your life expectancy. But that inherently involves some deferral of receipt of income, but you have to set the income stream lower in the first place in order to do that. I would say that the defined benefit income stream from a self-managed fund is a different beast to that paid from a life office or a corporate fund or a public sector fund. It could be that it is better to look at the nature of the beast and redefine the beast in a manner which is more acceptable and avoids some of these difficulties that we have in trying to make a square peg fit in a round hole by getting actuaries to try to chip around the edges of it.

Senator SHERRY—By way of example, let us take three years ago when everyone was focusing on and arguing over surpluses and DBs. Very quickly, within 18 months or two years, it was deficits. You would argue that it is valid. Let us take a period of very high growth, with high rates of return over a long period of time. Is it valid to be conservative on the valuation of those assets at the time a person is entering into retirement in order to provide for some safety margin, if you like, in the event of a market downturn?

Mr Shallue—What is required with regard to assessing for tax exemption purposes is to use the best estimates. Conservative margins are not meant to be built in. The requirement to hold reserves in small funds in order to give a high probability statement was brought in a couple of years ago. It requires effectively a 70 per cent probability. In a way, you could say that is like being more conservative with your assumptions.

Senator SHERRY—Yes.

Mr Shallue—There are other ways of doing it. For example, you could say that we have a different beast here. A self-managed fund, if it has only got a set amount of assets, cannot guarantee to provide a fixed, lifetime income stream. You can control the level of income stream, but if investments experience is poor or the person lives long enough that will run out. You have to reduce the level or it runs out. This is a personal view: it would be preferable to redesign the beast so that it better fits the capabilities of the fund that is paying it. Then we would not get into arguments about what the certified value of it should be.

Mr Ward—Alternatively, you could restructure what happens when a small fund can no longer provide a pension. In many cases the fund will be able to provide it, with or without the reserves, but when things go

wrong you start manipulating the pensions. It may be possible to structure some different requirements as they apply to circumstances. When the pension continues unaltered, let it run.

Senator CHAPMAN—Earlier, you said that the current arrangements understate the value of pensions.

Mr Shallue—Correct.

Senator CHAPMAN—As a consequence, does that mean that they are currently overstating the value of accumulated funds?

Mr Shallue—It means that a pension that might cost $1 million to start might have an RBL value of $600,000. Someone looking at it from the outside might say, ‘Someone’s used this pension to get around an RBL issue, because they’ve turned $1 million into $600,000.’ Does that make sense?

Senator CHAPMAN—Yes, that makes sense. I was just looking at it from the point of view of whether, given the lower returns on investment and the ageing of the population, there is a case for increasing the RBL.

Mr Shallue—That is a contra-argument.

Mr Ward—You certainly need more money to provide the same pension.

ACTING CHAIR—We appreciate your evidence.

Mr Shallue—Could I make one concluding remark. The institute would be keen to provide input to the government’s review of the changes to DIY funds in particular. We would be hopeful of putting forward, via that forum, some suggestions that might deal better with some of the issues, after we have had the chance to seek comments from across our membership.

ACTING CHAIR—We always appreciate the views of the Institute of Actuaries.

Proceedings suspended from 10.49 a.m. to 11.00 a.m.

STANHOPE, Mr Bill, Senior Policy Manager, Investment and Financial Services Association

ACTING CHAIR—Welcome. We invite you to make an opening statement.

Mr Stanhope—The first point I would like to make is that these were integrity measures announced on budget night and, as you might expect from integrity measures, they were not the subject of prior consultation, so we have only seen them once they were made. The regulations target particular practices. It is certainly true that they do not target the self-managed super fund market or the DIY super market as a whole. The particular practices they target are what you might call 'contrived strategies'. Obviously there is a long history of contrived practices in superannuation for taxation benefit. IFSA has long supported the integrity of the retirement income system, which we see as threatened by contrived strategies in two ways. First is the obvious direct circumvention of the rules in terms of tax revenue loss. Secondly, and possibly more importantly in the long run, the ability to use contrived strategies and their public and wide availability can lead to a perception of the rules being beatable, which leads to less faith in retirement income system rules on the whole.

When we are dealing with small funds, and particularly with self-managed superannuation funds, IFSA make a critical distinction that is not really present in these regulations—that is, that the arrangements are not at arm's length. As we pointed out in our submission, that certainly means that, for instance, where you have reserves, they are not reserves available to a wide spread of membership, and in a single member fund, of course, they are passing either to the individual or their estate.

Turning to the regulations themselves, I have a couple of brief remarks. Firstly, the regulations relating to forfeiture reserves and vesting generally appear to be targeting very particular contrived arrangements, but it is a little difficult for IFSA to comment, as we suggested in our submission. We would point out, however, that the ATO has long indicated that some of these strategies seem to be for the purposes of avoiding a tax, and they might have attracted a part IVA examination. Therefore, in the broad sense these rules clarify that position and, on the basis that clear law is good law, we see seem merit in them.

The regulations do create problems for our members who have vesting scales in arms-length funds, both corporate master trusts and corporate funds administered by IFSA members. The Institute of Actuaries spoke briefly about those earlier. As we mentioned in our submission, we see the softening provision, which is regulation 5.08(2), as being a reasonable model, but of course it does not cover all the arrangements in the marketplace. As the explanatory note to the regulation says, we are looking to APRA to use its modification declaration powers under section 328 of SIS to ameliorate those problems. The initial discussions we have had with APRA on those have been very encouraging. We think they are taking a very sensible and reasonable approach. After all, what might have been perceived as mischief in these arrangements does not occur in arms-length funds.

Secondly, on defined benefit funds, we have suggested in our submission, and made the fairly obvious point, that defined benefits are all about risk pooling, and a single member fund, and perhaps small member funds as well, cannot have the sort of risk pooling that you might think sets up a defined benefit. That seems a fairly sensible distinction to us. In our submission we pointed out what we thought people were trying to achieve in a reasonable sense in terms of taking out lifetime pensions through a defined benefit arrangement in a self-managed fund or a lifetime pension generally, and we pointed out that Australians, when we talk to them, seem to be very clear that one of the things they do not want to do when they retire is put large amounts of their capital into a risk pool that goes to somebody else if they die early. We are not talking about creating a large estate here—that is a separate distinction; we are talking about people who do not want to pool longevity risk. They do not want to join risk pools, and you can see that in the purchase data of income streams on the IFSA web site. Around 1½ per cent of the market in any year goes into lifetime annuities; it is clearly not a product that a large slice of the market is looking for.

One of the other problems that retirees were addressing through small funds was that you could not have a complying fund; that is, a fund that qualifies for the social security asset test concessions—100 per cent or 50 per cent, or the higher pension RBL—on the market with a growth asset. So you could not have a balanced portfolio. Both of those problems are being addressed in market linked income streams which, as we have indicated in our submission, will generally be known in the market as term allocated pensions.

The real need that retirees seem to have to control their assets in a self-managed fund, to get access to growth assets, can be met just as much inside a self-managed fund as it can in an on-market fund through a combination of allocated pension and term allocated pension to build up the right kind of tax, social security

and annual income profile that retirees want. That is now a level playing field so that retirees can either go to an on-market solution for that with an allocated pension fund provided by retail superannuation or indeed they can go to a self-managed super fund arrangement and access largely the same assets. Of course, the requirement for actuarial certification is being lifted off those investment strategies because there is no pooling of risk that needs to be monitored by an actuary. We see there being a reasonable consumer solution in place and, therefore, it is an appropriate time to deal with the use of defined pension benefits in self-managed funds. We have mentioned a little in our submission generally how the process, which has been referred to as 'RBL compression', works in the super fund. I think that is clear.

The last comment I would make is that there has been some comment earlier about the problem of on-market defined benefit funds which have members below 50. We have talked a little about that in our submission. That can occur where member numbers fall or where, for instance, a small employer fund that has a defined benefit structure wants to roll that fund into a master trust, whether by successor fund or otherwise, and the master trust will create a sub-fund but that fund still does not have 50 members. In those circumstances it seems reasonable to us that APRA should again use its section 328 powers to make sure that these integrity measures do not have an unintended consequence. Our initial discussions with APRA on this have been very positive.

ACTING CHAIR—Thank you very much. What are the actuarial risks associated with paying a fixed term pension?

Mr Stanhope—There are none for a fixed term pension that has no income guarantee. A fixed term pension such as a term allocated pension is a very transparent product.

ACTING CHAIR—I am not talking about an allocated pension. I am talking about a fixed term pension.

Mr Stanhope—A fixed term guaranteed pension?

ACTING CHAIR—These have now been banned, haven't they?

Mr Stanhope—Yes.

ACTING CHAIR—Along with defined lifetime pensions.

Mr Stanhope—The way the regulations work is that—

ACTING CHAIR—No, what is the actuarial risk?

Mr Stanhope—In the complying income stream where the income level is guaranteed but the term is fixed, the risk is involved in guaranteeing the level of income. We have made much of this in our submissions on growth pensions, now known as term allocated pensions. Somebody has to guarantee that the level of income will not fall and, as you may be aware, the Social Security Act demands that income not fall in order to get an assets test exemption. So that market has been largely driven, certainly at the smaller end, by those social security rules. Somebody has to give that guarantee. That has generally meant for our members that the investments have been in fixed term, fixed interest products—there are a couple of exceptions to that, obviously—in order that you do not have a large difference between the call on income and the income flowing from the investments.

ACTING CHAIR—You have not answered my question about the actuarial risk.

Mr Stanhope—To the extent that you have actuaries involved in assessing the risk that income from investments will not match income required to pay pensions, that is an actuarial risk.

ACTING CHAIR—But that is determined on a regular basis by the actuaries. I submit that you could put a case for lifetime pensions, because of age and longevity and those sorts of issues.

Mr Stanhope—As soon as you talk about a 'lifetime' then you bring longevity into it.

ACTING CHAIR—I am talking about fixed terms, not lifetime. I want to try to work out the rationale of excluding fixed term pensions.

Mr Stanhope—I am not quite sure that the issue is so much actuarial as it is the promise: who can make the promise to pay an income stream at a fixed level for 15, 17, 18 or, under the new rules, 21 or 22 years for a 65-year-old male? What sorts of assets do you need to back that and how do you match them with the income flows? The industry has used actuaries to assess those asset matches or mismatches. There is a strong argument for that sort of guarantee to be subject to some form of prudential supervisions, and so it is. I think that you will see that the nature of that guarantee is perhaps best expressed in the fact that the managed fund side of the IFSA membership has not offered those products. It is not easy to offer those products without the

backing of a life office statutory fund and the prudential supervision and strategies that a life office has available to it. The guaranteed income stream market—the arms-length market—in Australia is almost exclusively a life insurance market because it is very difficult to offer those products without a life office. I think that illustrates to you that somebody has to make that promise. Can a person make that promise to themselves? Yes, but again you would need somebody to assess whether the assets backing the income stream match it or do not match it and what coverage there is for the risks inherent in that mismatch.

ACTING CHAIR—Doesn't that ignore the ability of the paying organisation to be able to continue to pay that benefit via the income support for it?

Mr Stanhope—The paying organisation has to make a promise to continue to pay that income stream for the term—either fixed or indexed, depending on the contract. That requires a guarantee and that guarantee is difficult to achieve without a life office in our market. In a way, it is difficult to see how that promise could be made in a self-managed fund. After all, that would simply be somebody making that guarantee to themselves. Conversely, that guarantee is not required in a term allocated pension because the annual income is simply a function of the balance at the beginning of the financial year and the years remaining in the term. There is an income stream in that space that a self-managed fund can use that does not need a guarantee, so it is difficult to offer a guarantee through a self-managed fund. There is still a place for those funds to go and that is in the term allocated pension arrangement. Certainly the risk in that is no different from that in an allocated pension. There is no reason why a self-managed fund cannot offer those and they will be able to offer those.

ACTING CHAIR—You seem to be undervaluing the ability of a small fund to maintain an income stream which is dependent on the sponsoring company and also improving the investment abilities and performance of the fund. Obviously companies do not enter into these sorts of arrangements without having a reasonable assurance of being able to discharge those promises.

Mr Stanhope—The question is: who can provide the guarantee? Who can ensure the income does not fall? As we just heard from the Institute of Actuaries, you would need reserves to do that in a small fund to make sure that, to a high standard of probability, the income will continue to be paid through the life of the pension. Tax and social security concessions are given because of that guarantee.

ACTING CHAIR—Can you give us some examples of the alleged problems? Why, for example, has the tax office not been auditing in terms of part IVA?

Mr Stanhope—I understand they have considered those. I cannot speak for the tax office. This is an area in which IFSA member companies are not directly involved, so it is not an area that I am particularly authoritative on. As you would be aware, our members provide some administration services to self-managed funds on a platform basis and some investment services.

ACTING CHAIR—You cannot give us an example?

Mr Stanhope—It depends which strategy you are talking about. If you are talking about forfeiture of benefits, then that strategy on its face looks fairly contrived. Why would you be forfeiting benefits into a reserve? What is the person's interest in doing that? If it does not seem to be to their benefit otherwise and it does have a tax benefit, it would obviously be open to the tax commissioner to conclude that it is principally or primarily for the purpose of avoiding or reducing tax and therefore comes within the scope of part IVA.

Senator SHERRY—Have they run a test case on it?

Mr Stanhope—I do not know.

Senator CHAPMAN—What is the actual mischief there? In an era where the government is providing incentives for people to make superannuation contributions for their spouses and providing incentives for co-contribution, if someone finds that through investment success or whatever they are approaching or likely to exceed their RBL, what is the mischief in allocating some of that to their spouse who is also a member of the fund?

Mr Stanhope—You cannot do that in an on-market arrangement; you cannot do that at arm's length. If I were approaching retirement and my investments had done spectacularly well, I would dream of having an RBL problem, like a lot of Australians. If I am doing spectacularly well and under the tax system I have investments that exceed either the lump sum RBL or the pension RBL—$600,000 or $1.2 million respectively—then all that happens to me is that the amount above either of those is an excessive component and I simply pay my marginal rate of tax without a rebate in retirement. The structure of the Australian

retirement income system is that those tax concessions in retirement are given up to certain asset levels as a way of equalising.

Senator CHAPMAN—What I am saying is that perhaps the RBL concept has not caught up with other changes that are now being made to encourage spouses to also have their own independent retirement—

Mr Stanhope—IFSA is on the record as supporting the split of superannuation benefits between spouses—not contributions but benefits—for pretty much the reason that you are talking about. But so long as those strategies are available by arrangements in only one sector of the market and not across the board, you have a competitive neutrality issue. Certainly people who have the resources and means to do those sorts of things can achieve them, up until these regulations. But your average Australian who may have had a similar issue but at the bottom end, where one member of a couple does not exceed the ETP low rate threshold, does not have that strategy available to them.

Senator SHERRY—I was a little surprised at your response to Senator Watson's earlier questions. In your opening remarks you said that these are integrity measures, that the ATO has been aware of the avoidance of tax and that the rules need clarification et cetera. Wouldn't you expect therefore that the ATO and/or the Treasury could outline in detail where there have been breaches and where it is necessary to provide safeguards in the form of integrity measures? We have not had that to date from the ATO.

Mr Stanhope—The point that I was making was not to really comment on the nature or extent of these arrangements. The charge is that they are contrived. If they are contrived and if they do beat policy then we see some clear consequences. We are not expert on the extent of mischief, if you like. As a general comment, part IVA is an involved process. It creates case law not clear codes—

Senator SHERRY—I will get to part IVA in a moment. I am challenging you. You say integrity measures; you are supporting them broadly; and you say that the ATO has been aware of some tax minimisation and that the rules need clarification. They are all your comments.

Mr Stanhope—They are.

Senator SHERRY—Good. Wouldn't you expect—if that is what you believe on behalf of IFSA—that the ATO could produce some sort of survey or documentation about the level of malpractice that requires integrity measures?

Mr Stanhope—I think the first comment is that, from what we read in the media, the ATO is clearly doing that.

Senator SHERRY—I hope so. We have not got it yet, though.

Mr Stanhope—Certainly. But the second point and the one that I was making was that clear law is good law. Law that is made by tax determinations and tax rulings of one kind or another is not very accessible law. I have trouble with it and I imagine most people do. Certainly the ordinary Australian who wants to run a self-managed or do-it-yourself fund for perfectly legitimate reasons of control or using business or property, which is hard to do on the market, would like clear law. They would like to know what they can do and what they cannot do. If somebody is coming to them with a strategy that says, 'We can forfeit benefits into this fund—we can get you around an RBL this way,' the ordinary Australian is not in a position to judge.

Senator SHERRY—We can get to the issue of what is clear law and whether these regulations are in fact clear. Certainly the Institute of Actuaries have challenged the clarity of the proposed changes. You maintain 'integrity measures' and that there is some abuse going on. Can you present to this committee more than the odd anecdotal case? Can you say to us from knowledge that you have from ISFA, or indeed your own knowledge from your contact with the ATO, that X amount of revenue is being lost that should not be lost, that there are X number of cases of abuse? Does ISFA have any knowledge in this area?

Mr Stanhope—No, Senator. As we clearly said in our submission, and as I have repeated in my opening remarks, we do not have direct knowledge and cannot comment. What I said in my opening remarks was that these were termed 'integrity measures' and they address what is described obviously as an integrity problem or a mischief in the system that needed to be remedied. Taking that as read, which is how I framed by remarks, it makes sense to address them clearly in legislation that everyone can read.

Senator SHERRY—You are taking that as read. You are accepting the tax office and taking their word for it. Would you like to see some data on the levels of abuse taking place to justify these regulations: revenue loss, how widespread it is—those sorts of details?

Mr Stanhope—Certainly I would. The point is that there is an a priori justification for having good and clear regulation. You can do X; you cannot do Y. That is how our retirement income system has been framed all along so you cannot forfeit benefits into a reserve, for instance, or, as these regulations term it, benefits must be vested with a member. That is simple and clear. There is nothing wrong with that, even were there no mischief. That said, it would be useful to see some data. We certainly have not seen a lot to date. I deal with anecdotes all the time and I usually try and find the source of them. In some cases I have had first-hand remarks, but they are anecdotes; they are not evidence.

Senator SHERRY—Thanks for acknowledging that. If there were a problem—and you have alluded to part IVA; it has been alluded to during the evidence this morning—and the tax office were concerned, why wouldn't it mount a test case under part IVA?

Mr Stanhope—You would have to ask the tax office.

Senator SHERRY—You are not aware of any test cases in this area.

Mr Stanhope—I think we are all aware of the ATO's compliance activity with self-managed super funds, but that is a question you will have to ask the tax office.

Senator SHERRY—I just thought you might be aware of the issues that are being dealt with in these regulations.

Mr Stanhope—Only in the broad sense that we are all aware from Tax's public comments.

Senator SHERRY—The practical implications of these regulations are that a person is in a small superannuation fund, the regulations come into force and they want a defined benefit pension. My understanding is that, as a result of these regulations, the way to achieve that is to purchase that product from a life company institution. That is the reality for those people if they wish to go that way.

Mr Stanhope—I think the premise of your question is flawed. My question would be: why does somebody want to buy a defined benefit—

Senator SHERRY—No, I am not asking that. I can pose the question as I like, and the question I pose is: what if a person wishes to do that? You do not think this species of person is particularly prevalent, but there might be one out there who wishes to do that.

Mr Stanhope—No, the point I am making is: what is the nature of the income stream that the person is looking for? We have talked quite a bit, as you know, to retirees and new retirees about what they want in retirement income streams and how they want to achieve it. We can see things thereafter. We can also see the purchase data—actual decisions in the market. So if a retiree is looking for an income stream that runs for life and is indexed, those are available in the market. If a retiree is looking for control, to have a balanced portfolio including growth assets in an income stream in a self-managed fund environment, they will be able to do that. They will be able to do that in the allocated pension world in which they have been able to do it all along, for people who are not particularly affected by lump sum RBLs, with less than $600,000 in their superannuation; and for people between the lump sum RBL and the pension RBL and even beyond it, they will be able to get significant tax concessions by using market linked income streams that meet the provisions that are going to apply from 20 September. So people can get income streams with the sorts of features they tell us they want.

Senator SHERRY—But what about a defined benefit?

Mr Stanhope—A defined benefit is only an income stream that is set by reference to itself not by reference to its purchase price. A defined benefit pension purchase in a sense is something of a contradiction in terms. You have to create something for it to be a defined benefit pension.

Senator SHERRY—I understand that, but, under these regulations, a fund with fewer than 50 members can no longer directly supply them from within the fund. Is that correct?

Mr Stanhope—Yes, that is how the regulations are written.

Senator SHERRY—So let us look at the options. If, as a consequence of these regulations, you want that product, option 1 is that you go to a retail provider, presumably a life company, to obtain that product.

Mr Stanhope—Yes.

Senator SHERRY—If you remain part of the small superannuation fund, the fund would go and purchase that product, whatever the cost charged by the provider. Is that correct?

Mr Stanhope—Yes, that is how the regulations are written. A fund can go to a life office, on behalf of the member, and purchase a lifetime income stream.

Senator SHERRY—That is right, and they will pay for that, whatever the rate.

Mr Stanhope—Yes.

Senator SHERRY—Isn't that an added cost, above and beyond what would occur at the present time? In option 1 there is an extra process—an extra supplier or provider.

Mr Stanhope—That might be an additional cost, but you have risk pooling, so the cost for someone who takes out a lifetime income stream at 65 and dies at 78 is very different to the cost for someone who takes out an income stream at 65 and dies at 108.

Senator SHERRY—I understand all that. But they are in a small super fund that can no longer offer the product because it is forbidden by law from doing so. Therefore, under option 1 they can go to the retail provider and purchase that product.

Mr Stanhope—They certainly can. Under rule changes that will apply from 20 September, they can have a guarantee on that product for up to 20 years.

Senator SHERRY—I understand all about these growth pensions; we have been hearing a lot about them. I want to look at the impact of these regs on behaviour at a future date. Option 2 would be for the individual to transfer their assets out of the small super fund when they get to retirement and buy something from a retail provider. That approach has been criticised by witnesses this morning. They claim that there may be a practical problem in removing the assets. There are also capital gains tax issues. Do you accept that there may be practical problems and also capital gains tax issues?

Mr Stanhope—I am not a tax expert. There are practical issues, but I am not really qualified to comment on whether they are a problem. There are an awful lot of on-market defined benefit superannuation funds—and some very large ones—that do not offer income streams. There are self-managed funds that accumulate money to retirement. A senior actuary who left our industry made the comment—I think it was reported in the *Financial Review*—that the last thing he wanted to do in retirement was to manage money. He took his money and invested in a range of on-market products.

Senator SHERRY—Let us get back to this practical issue. I am surprised that you do not have some knowledge in this area. You have knowledge in most areas that I have asked questions about on previous occasions.

Mr Stanhope—I am not a tax expert.

Senator SHERRY—It has been claimed that there is a capital gains tax problem if a member wishes to leave and that there are practical issues about liquidating assets et cetera. Can you go away and get us some advice on that? I am sure that with IFSA's enormous resources—they are going to be well flagged next week—you are quite able to do that for us.

Mr Stanhope—I think that is a question you should probably ask the tax office. It depends on when the transfer occurs, of course. It depends on whether that transfer occurs in the retirement phase and is part of a rollover. Frankly, the arcane rules that apply to capital gains tax at unit and trust level make my head spin.

Senator SHERRY—You are starting to sound as though you have some knowledge about this. You have just denied that you had any knowledge.

Mr Stanhope—Only at the overview level.

Senator SHERRY—These arcane rules!

Mr Stanhope—They are very arcane.

Senator SHERRY—ISFA is a very well-resourced organisation. I am surprised you do not have the knowledge to have a view in this area. Could you come back to us in writing on these practical problems and capital gains tax problems that have been alluded to buy the Institute of Actuaries and the Small Independent Superannuation Funds Association. In principle, why should an individual be forced, because of a change in the law via these regulations, to purchase a product from another provider that they do not wish to purchase that product through? This is the concern that a number of people have made representations to me about.

Mr Stanhope—I will not comment on whether it is right or wrong, but what underpins that comment is the view that any vehicle on the market might be able to provide any product. As we have often said describing

the problem with guarantees in the on-market income stream world, not every vehicle in the market can do everything. I do not expect they should be able to or that they can.

Senator SHERRY—But at the moment, Mr Stanhope, there are many people complaining to my office, by email and verbally, saying: 'I expected to be able to purchase a defined benefit from my small super fund. That is what is on offer. The law is being changed and that defined benefit product will now only be on offer through a provider with more than 50. That is a change in the rules and I do not like this change.' They are complaining. What is your response to that, Mr Stanhope?

Mr Stanhope—The first thing is that what is on market is not a defined benefit product—that is about the structure of the fund. Secondly, as we have pointed out in our submission and as you have discussed earlier, it seems to be an issue that exists for Australians who have more than the pension RBL. So, by definition, these people are already millionaires in superannuation; they are not ordinary Australians. If they wish to purchase a product, they have a trust deed that needed some changes to its governing rules in order to actually provide the product and they retire before the end of the current financial year there is now a regulation that will allow them through. As we said in our submission, we thought that was a fairly sensible solution to address exactly the problem that you are raising, which is that people had legitimate expectations.

Senator SHERRY—It does not, because if you do not retire during that period you are caught by the new rules, aren't you?

Mr Stanhope—You will be, yes.

Senator SHERRY—That is right. Say you are 63 and retiring in two years, unless you bring forward your retirement you are caught by the new rules.

Mr Stanhope—Yes. If you do not retire, the regulation will not—

Senator SHERRY—We do not endorse 'work till you drop'. That is not an option on our radar screen. It seems to defeat the purpose of wanting a DB in the first place.

Mr Stanhope—You seem very fixed on defined benefits. Defined benefits is simply the structure in the fund. They have been typically provided in arrangements where risk was genuinely pooled. It is hard to see how the sort of risk inherent in a classic defined benefit fund can be pooled in a single member.

Senator SHERRY—Let us just touch on this issue of risk and guarantee and promise. Isn't it true that there is no such thing as a risk-free investment? There is absolutely no such thing as a risk-free investment—everything has a degree of risk. It is about minimising the risk, isn't it?

Mr Stanhope—No, it is about appropriate risk. Putting your money under your mattress to keep it until retirement, provided nobody breaks into your house, is a reasonably risk-free investment.

Senator SHERRY—It is not risk-free, though.

Mr Stanhope—No, but it crystallises one very big risk, and that is that you will not have enough money to live on in retirement.

Senator SHERRY—There is no such thing as risk free, is there?

Mr Stanhope—I would not think so—not in the investment world and not elsewhere in life.

Senator SHERRY—That is right. If a person purchases a product through a dodgy financial planner who steals the money and puts it his own bank account, as I have seen first-hand, it is not risk free, is it, even though there might be minimal risk and a guarantee on the product? The poor punter's money has been stolen. There is a risk.

Mr Stanhope—Having dealt in a previous life with exactly those sorts of cases, I was say yes, there is.

ACTING CHAIR—Mr Stanhope, your evidence seems to buck the increasing trend for individuals to want to move away from institutions due to the level of fees, poor performance—both perceived and real—lack of control and lack of choice of investments. Also, I submit to you that the legislation still allows for most of the rorts to continue through the institutions but penalises those who are legitimately using the pension structures.

Mr Stanhope—I do not think my evidence says that.

ACTING CHAIR—No, I said it suggests that.

Mr Stanhope—That is certainly not the intention of the submission. What the submission says quite clearly is that a range of solutions to the sorts of income structures that people seem to want is available in self-managed funds or on the market. In fact, from the introduction of term allocated pensions, which deal with the

complying income stream end—that is, above the lump sum reasonable benefit limit—there are as many choices in the retirement income stream market for self-managed funds as people seem to want.

ACTING CHAIR—Don't you think there is something wrong with a system where we have $1 of a taxed element in the fund being equal to $1 of RBL, yet by using this convoluted formula we find that that is not the case? You are saying that we should have rules that are clear, transparent and easily understood. I would have thought that $1 of taxed element should equal $1 of RBL. But it does not.

Mr Stanhope—Not under the strategy that Senator Sherry referred to this morning—RBL compression.

ACTING CHAIR—That is the problem—we are talking about the strategy.

Mr Stanhope—The strategy means that some Australians with more means can, it appears, get around the tax settings that apply to ordinary Australians.

Senator SHERRY—We do not know how many are doing it yet, do we?

Mr Stanhope—No, we do not have that kind of data.

Senator SHERRY—It is a bit of a worry.

Mr Stanhope—It is a worry that there is no data.

Senator SHERRY—It is a theory but we want to see from the tax office how many people are doing this outrageous practice, don't we?

ACTING CHAIR—Can't we get away from that situation? If people take lifetime pensions, you separate two factors—the undeducted portion from the taxed element—and run separate pensions. If you do it that way, you can never construe that the pension was commenced for any RBL reason. Would that not be a simple rule to effect?

Mr Stanhope—That presumes people would continue to use these arrangements if there were no tax advantage in them. I think we are confusing two issues here, and that is part of the problem. One is the issue of longevity risk and who can provide for it and the risk of outliving your capital—

ACTING CHAIR—I am just putting up a number of proposals to try to overcome this blanket prohibition. There are some simple solutions.

Mr Stanhope—The critical thing about a defined benefit pension, apart from the fact that you wind up not having your actual asset value counted for taxation purposes but the number that arrives from this process being counted towards tax purposes—

ACTING CHAIR—By my formula of using these tax components for a particular pension stream, you are going to overcome all the allegations that you are raising with us.

Mr Stanhope—The problem would not arise if you used—

ACTING CHAIR—So it won't arise? So you now agree with me?

Mr Stanhope—Let me finish. The problem would not arise or the strategy would not be needed if the asset value of the retiree holdings in their self-managed fund belongs to them—particularly if they are the only person in it, then clearly the assets belong to them. Under this process, a number that is not that number is used to value those assets against the pension reasonable benefit limit. As the actuaries suggested this morning, there is perhaps some justification for a risk reserve but it is not difficult to put together a number under an RBL compression strategy that turns, say, $4 million to $4½ million into a million dollars for the purposes of tax. Ordinary Australians looking at that are going to say, 'Why should you be able to do that? I cannot do that down at my level; it does not make any difference to me down at my level.'

The second issue is: who in the economy can bear the risk of longer life? That is very much wrapped up in what you are suggesting—that is, somehow or other individuals should be able to provide against their own longer life from their assets. But what happens at the end of that life, whether it is longer or shorter, in a do-it-yourself fund environment is that the remaining assets, should there be any, will pass pretty much tax-free to other people. Is the purpose of the retirement income system to provide retirement incomes or to provide estate benefits?

Senator SHERRY—You have just endorsed the splitting of contributions. It is exactly the same principle.

Mr Stanhope—I endorse the splitting of benefits, and it is not the same principle. The issue there is to equalise the tax treatment among the members of a couple.

Senator SHERRY—It is passing a tax benefit over. Come off it!

Mr Stanhope—But at a level that occurs much below this one.

Senator SHERRY—It is still passing a tax benefit over—

Mr Stanhope—Certainly.

Senator SHERRY—and can lead to tax minimisation.

Senator CHAPMAN—You actually pay a severe penalty if you exceed the RBL. You do not just pay your marginal tax rate, do you?

Mr Stanhope—It depends on whether you take it as a lump sum or as an income stream. If you take it as an income stream, any excessive component is simply taxed at your marginal rate without the 15 per cent rebate.

Senator CHAPMAN—Yes, but you have also paid 15 or 30 per cent on the way in, depending on what your income level was at the time you paid it in. So you are actually paying about 63 to 64 per cent, or nearly 80 per cent, in effect, on the total.

Mr Stanhope—I do not think the numbers get that high.

Senator CHAPMAN—If you paid 15 per cent on the way in and you pay 48-point-something on the way out—

Mr Stanhope—On an excessive component? It would depend on what your tax was on the way in.

Senator CHAPMAN—Your contributions tax is at least 15 per cent, isn't it? It is now reducing somewhat with the surcharge but it has been 30 per cent.

Mr Stanhope—That is a much larger question than these regulations. These regulations simply ask: given the tax structure, should certain people be able to use a process to get around them? That is why they are called integrity measures. That is the comment made by government; it is not my comment. If these rates are right, should some people be able to use structures to get around them where other people cannot? That is a different question. Are the settings right overall? That is a wide policy question, about which we could have many debates over many bottles of red wine, but it is not the question in these regulations.

Senator SHERRY—I have one last issue. Say you have an existing corporate defined benefit fund which is guaranteeing, as much as it can, a DB benefit to a person on retirement. Those are the rules of the fund. Should these regulations stand, that fund in some cases can no longer offer that particular DB. The fund has to go to the retail provider to provide that particular product. You have touched on it but what if the retail provider cannot provide that product that has been promised within the existing structure of the DB fund?

Mr Stanhope—That question supposes that one part of a private market should make good the promises of somebody—

Senator SHERRY—No, it does not. You say that they may not be able to. What happens to that individual? The fund cannot offer it because they are forbidden by law from offering a promise that has been made in that DB fund. Therefore, the fund goes to the retail market. It says, 'We can't offer this anymore. We can't provide it. You provide it.' But there are no takers. What does it do?

Mr Stanhope—Firstly, if no change to the fund's governing rules is required then they come within the grandfathering provision in the original budget night regulations. So that problem does not arise where the governing rules of the fund are already clear and set. You have to have a situation in which the governing rules must be changed to provide a defined benefit pension. Tax's indications on that are that they will take a fairly wide view of changes to governing rules so that virtually any change will mean you cannot provide a defined benefit pension, but you will have to ask them the specifics of that. In that case, if the defined benefit fund gets to a point where it cannot meet its promises, which is what—

Senator SHERRY—In practical terms, it cannot meet the promise.

Mr Stanhope—If the defined benefit was set out fully in the governing rules, there is no problem; it is only a question of whether the assets are there to pay the income stream; otherwise, it is a policy intervention on the part of government and, as you have already discussed this morning, APRA has ways of dealing with that.

Senator CHAPMAN—I have no further questions.

CHAIR—Thank you, Mr Stanhope.

[11.50 a.m.]

WORTHINGTON, Mr deLancey, Managing Director, Senior Actuary, Actuarial Solutions Pty Ltd

CHAIR—Welcome. I invite you to make an opening statement and, if you so wish, you can comment on matters raised by other witnesses this morning.

Mr Worthington—I run a small actuarial practice here in Melbourne, so I thank you for coming to Melbourne and saving me an airfare. In my business, primarily I provide actuarial certificates for people who are paid pensions from self-managed funds. In the paper I have presented I have tried to stick to this inquiry's terms of reference, which really look at where there has been abuse or loss to the tax system from the operation of defined benefit pensions. I find that really this potential abuse could arise only with a very small number of pensioners. They are people who, through the amount of assets they have accumulated in the fund, are in excess of the pension RBL. Those who have accumulated a smaller amount in the fund to purchase their pensions are actually contributing more through the tax system than those who have gone down an alternative route of purchasing an allocated pension or going into the new 'growth' pension.

The reason for this is that a defined benefit pension has to guarantee its payments, so it holds taxable solvency reserves against poor performance and longevity risk. From statistics based on all the pensions I have ever written, those reserves on average are about 20 per cent of the assets of the fund, and the tax on the investment earnings of those assets contributes to the tax system; whereas an allocated pension or a growth pension is fully tax exempt. It is only the tax on the actual pension payment that makes any contribution to the tax system. For those who have a pension of $26,000 or less where there is no undeducted purchase price, the rebate is more than the tax they would have to pay and they get a refund of tax which they can credit against other income. So people who take out allocated pensions and growth pensions are a drain on the tax system. It is only people with defined benefit pensions with a purchase price of less than $1 million who contribute to the economy through the tax system.

So it is really those with allocated pensions with a purchase price of over $1 million that are the issue—those who have the ability to do other things. With the pension valuation formula, they can make use of the RBL compression. They can also add undeducted contributions into their superannuation fund at retirement because they have other resources. Through the use of the formula, it is possible to wipe out completely an RBL excess or come up with a zero RBL value. From my statistics, it works out that the average RBL value is about 57 per cent of the purchase price. A fair amount of pension is purchased for that price; it is competitive with an annuity from a life office. If you add an extra dollar of undeducted contribution to that pension, using the RBL formula, it counts as 57 cents in the dollar for the extra amount of pension that you purchase. But you then deduct the dollar off at the end of the formula so that, in effect, the dollar of undeducted contributions that gets added actually has a minus 43c effect on your RBL value.

So if you add enough undeducted contributions to a situation, you can get rid of an RBL problem or completely get rid of the RBL assessment and have a zero RBL value and get the full rebate. So someone who has enough resources can abuse the system. Of the cases that I have seen, that has been very rare. Of the group of pensions that I have done—and there have been 900-odd defined benefits pensions—only five per cent of those people are in a situation where they could actually make use of those undeducted contributions to get rid of an RBL situation, and I am not aware of any that have done it to any great extent. It is only the pensions that I have done myself that I can say that for.

Also, when I set up a defined benefit pension, I am aware that we have to satisfy the sole purpose test. When someone reaches retirement, they are supposed to spend the accumulated amount in purchasing a retirement income stream. It is not supposed to be for any other purpose. When I am setting the amount of pension that I am willing to sign off on, I say that there must be at least a small probability that the assets will expire before the pensioner dies so that we cannot say with certainty that there is any other purpose behind the set-up of the net income stream.

As for the pension valuation formula, I have worked out that if we used the current life expectancy tables that came out about a month ago then effectively you would need a 13.4 per cent rate of return after expenses to be able to come up with those pension valuation factors. If those pension valuation factors were recalculated using the latest life tables and a rate of return of about nine per cent, then on average pension valuation factors would increase by 37 per cent and therefore the RBL value of the pensions would increase by 37 per cent and on average for the group of pensions that I looked at, the 900, the average RBL value would have increased

from 57 per cent of the purchase price to 78 per cent of the purchase price. Also, when I did the initial valuations for each of these pensions that I set up, I calculated on average that there would be 20 per cent of the assets in actual reserves against poor performance or people living too long. Therefore, the 78 per cent of RBL value compares well to the 80 per cent of assets required on a best-estimate basis. So if the pension valuation factors were updated, it would go a long way towards eliminating the abuse.

Another alternative would be to change it to a purchase price basis. That is the methodology that is used for growth pensions, allocated pensions and defined benefit term pensions. It is also the method that is used for life office annuities. So it would bring consistency across the board. It would also remove the ability for people to compress their RBL. It would also remove the ability to add undeducted contributions to remove an RBL problem. But, again, it is only a very small proportion of those people that are retiring that actually have the ability to make use of that, because the amount that they are retiring with does not put them in a position to be able to achieve anything by doing it. They are within their RBL anyway, so why do they need to RBL-compress? They are not gaining any advantage from it, so they are not doing it.

It is only the five per cent of people who are potentially in that situation that you need to look at, and if you change the RBL formula to purchase price then you will eliminate that problem and you will not be affecting the other 95 per cent of people who are within their RBL anyway. In fact, you will be advantaging them. At the moment, because the amount of pension that they purchase results in an RBL value of only 57c in the dollar, to satisfy the so-called 50-50 rule to meet their pension RBL they may have to commit two-thirds of their retirement money to purchasing a lifetime pension and then only one-third goes into the allocated pension. It is not a 50-50 split of assets; it is a 50-50 split by RBL value. If we changed it to purchase price, those people could do a 50-50 split by the amount of money that they are retiring with and they could actually have more money in the allocated pension where they have access to the capital. They would be happier.

There are a few comments that I did not make in my paper which I would like to make now. I refer to the annuities that are provided through a retail provider. The life offices purchase a bundle of debt securities that provide an income stream as close as possible to the anticipated payments out of the annuities. This is a buy and hold strategy to minimise the reinvestment risk. The amount of annuity is therefore based on the interest rates in the market on the day the person retires and purchases that annuity. The retiree cannot defer taking their retirement income as it is a requirement under the SIS legislation that they take their retirement income as soon as possible after they reach retirement; therefore, the amount of retirement income that those people can receive is at the mercy of interest rates. Interest rates are used by the Reserve Bank to control the economy. This will result in a conflict of interest for the Reserve Bank and the government: do they support the economy or do they support retirees? Current interest rates are at a historic low. It is possible to obtain a high return on imputed dividends on shares in fundamentally sound companies. You can also expect growth in that income as the value of the shares increases. A retiree would therefore prefer to maximise their retirement income by taking it through a defined benefit pension rather than being forced to take it through a life office with its low rates of annuity.

There are three pieces of legislation involved. Two sets apply in most situations but there is another set that applies in some situations and covers these defined benefit pensions. There is the SIS legislation, which is worried about the security of members' benefits, and, as far as the SIS legislation is concerned, the more reserves the better. Then there is the tax legislation. It is worried about the fair allocation of tax concessions and the collection of tax revenue. It requires the actuary to calculate the liability on a best-estimate basis. You can think of that as being roughly a 50 per cent probability level. It is the amount that on average is required to meet the pension payments. However, the SIS legislation, which is worried about the security of members' benefits, says there has to be a minimum of a 70 per cent probability that the assets will be sufficient. So the difference between the 70 per cent level and the 50 per cent level results in reserves, and the tax legislation says those reserves are taxable at 15 per cent on their investment earnings. This situation does not arise for allocated pensions and growth pensions. It arises only for defined benefit pensions.

The last bit of legislation which applies in some cases is the Social Security Act and veteran affairs legislation. In the social security legislation there is a requirement that the amount of pension should repay the purchase price over the term of the pension, so that you must return the capital over the term of the pension. For a lifetime pension, that is taken to be the life expectancy of the longest life, so I believe another thing that should change is in the SIS legislation. That requirement in the Social Security Act should also be in the SIS legislation, so that there is a minimum level of pension that must be provided in a defined benefit pension arrangement. You do not leave it open to abuse so that people retiring on $1 million take a $1,000 pension. If you put that requirement in, it will remove the ability to abuse the system in that way.

From a risk management point of view, if you remove the ability of all these self-managed funds to provide defined benefit pensions, you are concentrating risk in a few organisations. If one self-managed fund fails, who is affected? Just the members of that defined benefit fund. They understood that risk at the time they went into it and they were happy to take on that risk. What happens, for example, if there are major breakthroughs in longevity because we have solved all these medical problems so that people do not get cancer anymore, people do not die of heart attacks and you do not start getting the effects of your body breaking down until you are 120? The life offices are also going to have problems. It would be a worldwide problem and the life offices would be affected. It would hit life offices just as much as it would hit self-managed funds, and they cannot really insure against that type of longevity risk. They can insure against an individual's longevity risk, but, if the average age of the population improves dramatically, then everybody has the problem. I will leave that open to questions.

ACTING CHAIR—Would you like to comment on any other matters that have been raised by other witnesses this morning?

Mr Worthington—I noticed that the previous witness did not seem to understand that there are capital gains tax implications when someone transfers money from one legal entity to another. A lot of these self-managed funds are structured around a block type of asset, like a property that a business is using, and it is generating a good income. It is generating an income a lot higher than they could get if they went out and bought some fixed interest securities. But they will be forced to sell that asset, because it is so blocky, when someone retires and it will have consequences not only for the person who is retiring but also for the remaining members. They are losing that asset and are not able to use it within the fund, and also there will be the capital gains tax on the asset at the time it is sold.

ACTING CHAIR—One witness suggested that the enormous growth of funds with fewer than five members since 1995 effectively brings the SMF schemes back to the average. Would you like to comment?

Mr Worthington—Back to the average in what way?

ACTING CHAIR—Average returns of all funds, which include the retailers.

Mr Worthington—You still have the ability to choose how you invest the assets prior to retirement. It is only post retirement that there is an issue. You are removing the choice—or part of the choice—that people had post retirement. If they want a real lifetime income stream, they will not be able to provide that from their self-managed fund. I have shown that, even if they take the longest term possible from a growth pension, there is still a 30 to 40 per cent probability that they will still be alive but holding no assets at the end of the term of that growth pension. So, if you really want to provide for yourself long-term, you need to take out a lifetime product, either an annuity or a pension—and the pension will no longer be available. There are consequences: they will be brought back to the market post retirement.

ACTING CHAIR—Senator Sherry?

Senator SHERRY—Thanks for your detailed submission. It is the sort of submission that I would have expected from Treasury. At least you have attempted to give us an estimate of the number of people who are engaging in these dodgy practices.

Mr Worthington—Potentially.

Senator SHERRY—Potentially, yes—up to five per cent. Never mind the other 95 per cent who get whacked on the way through. Let's take practical examples of an individual who can no longer purchase a DB within the fund when they get to retirement. It is true, is it not, that they can stay in the fund, and then the fund can purchase the DB from a retail provider?

Mr Worthington—Yes, and, following on from comments you made earlier, there is a doubling up of expenses. It is inefficient.

Senator SHERRY—So, for the people you have actuarially signed off, that would be the only way they could go about it if the new regulations stand?

Mr Worthington—Yes.

Senator SHERRY—You say a doubling-up of costs. Why is there a doubling-up of costs?

Mr Worthington—The superannuation fund has a regulatory regime and a taxation regime that it has to satisfy each year. So does the life office. They are independent. So there is reporting that has to occur, and it takes time to do that.

Senator SHERRY—So the existing charges and fees and what have you within the small super fund are added to by having to go and purchase the product from the retail provider?

Mr Worthington—Yes.

Senator SHERRY—Okay. And this would be the case not just with up to five per cent—which is what you claim the figure is—of people who are abusing the system, but with all of the people whom you actuarially sign off to?

Mr Worthington—Yes.

Senator SHERRY—So is that why you have come to the conclusion that other solutions need to be found to the abuse that is occurring within the structures of small super funds?

Mr Worthington—Yes.

Senator SHERRY—Thank you for the advice and for the suggestions. I was interested in your claim—I am not questioning it; I am just interested because I had not heard this before—that if the changes are made there will be a reduction in tax income, rather than an increase in tax—

Mr Worthington—Yes. You will notice that there are a lot of graphs in here.

Senator SHERRY—I did notice that, yes.

Mr Worthington—I am an actuary—numbers are my thing.

Senator SHERRY—I put on my new glasses in order to read some of them.

Mr Worthington—Turning to page 14, I am looking at the amount of tax generated from three types of pension. One is an allocated pension. I am assuming someone is trying to get a lifetime income stream. They are going for the longest term possible. The allocated pension is taken at the minimum to make the pension last as long as it can last. The growth pension is taken at the female's life expectancy, assuming they are five years younger. So that is the longest term that you could have on a growth pension. The lifetime pension has been taken at a rate that is competitive if they went out and purchased an annuity from a life office today. So that lifetime pension I am expecting to last for 40 years, on average. But the allocated pension is only going to last for thirty years and in the later years the income is very small—it is not really worth talking about. The growth pension is going to go for about 25 years.

Over the 40-year period the lifetime pension, if all the purchase price is undeducted, generates a positive outcome to the tax system in every year, but the other two pensions for all of their life are actually a drain on the system because the rebate is more than the tax they have to pay. If all the purchase price is not undeducted, the lifetime pension generates a positive outcome in almost every year except for the first two—and it is quite considerable in later years—but the allocated pension and the growth pension are negative in quite a number of years and they never get to the level that the lifetime pension is producing.

If we turn to the next page, which goes to the $500,000 purchase price, the story is similar but the growth pension and allocated pension are moving up towards the level of tax that the lifetime pension is generating, because they are getting over the $26,000 level and are making a positive contribution to the tax system. I am not saying people should not have their rebate. They deserve it. But, as far as ongoing is concerned, the government is handing them back the contributions tax that they paid originally.

On the next page, where we look at the $1 million purchase price, it is only then that the allocated pension and the growth pension have a tax income that exceeds the lifetime pension. But they stop and the lifetime pension keeps going, so over the full life of the lifetime pension I expect that you would get more tax revenue.

Senator SHERRY—That begs the question: why do people do this?

Mr Worthington—Why do people do this? I have a graph here.

Senator SHERRY—Do they know that they are going to end up paying more tax over the period?

Mr Worthington—I give people a quote before they take out a pension so that they know that, if they select this, this is what is likely to happen in the future. It shows that in every future year there is this expected amount of taxable solvency reserves and that they will be paying tax on those reserves. They are aware, before they sign on the dotted line and I do the actuarial certificate, that there are taxable reserves. If you go to page 11 and look at the graph, you will see why they do it.

Senator SHERRY—I was hoping you were not going to take us to the graph on page 12, which I would need my glasses for!

Mr Worthington—I will not go to that unless you want me to. On page 11 I have plotted the average amount of pension that is expected to be paid from a lifetime pension, a growth pension and an allocated pension, assuming they are invested 70 per cent in growth assets, and how long it is expected that those pensions will last. I have also plotted on the same graph the probability of survival of a pair of people—a male and a female—retiring at age 65. I have looked at what the probability is that they will still be around to receive that income. The bold line that runs across, at $24,000 per annum in real terms, is the amount of lifetime pension. It does not fluctuate and it just keeps going, so they have certainty of income in retirement. The only thing that is uncertain is how long it will last.

Senator CHAPMAN—Is that an indexed $24,000?

Mr Worthington—Yes, it is an indexed $24,000. The heading begins with 'Real gross pension'. It has had inflation taken out of it; otherwise, you would see these things going up and you would not get a good impression.

Senator SHERRY—So it is certainty? They want the certainty.

Mr Worthington—It is certainty. People like certainty in retirement.

Senator SHERRY—Some people like certainty.

Mr Worthington—Okay, some people like certainty in retirement. Those people that do like certainty in retirement have gone for a lifetime pension. They know that the money is going to be there year after year and it is going to be there much longer than the allocated pension. In real terms, the allocated pension is good for only 15 years; then it starts dying away. But the lifetime pension keeps ticking away.

Senator SHERRY—Thanks. If we adopt your recommendations, we crack down on the up to five per cent who are ripping off the system. I do not know whether that is accurate; I will accept your word for it. The tax office have not given us anything on that, so you have done one better than them. If we adopt your solution, we will actually be increasing taxable income by ensuring that those people who wish to go into a DB can continue to do so.

Mr Worthington—Yes.

Senator SHERRY—I think you have the ideal solution, and I thank you for that.

Mr Worthington—Thank you.

Senator CHAPMAN—You have spoken about the effect of undeducted contributions as opposed to deducted contributions—and your graphs show this effect. From what you have said, can you confirm whether my conclusion is correct. Assuming the RBL is about $1.2 million, are you saying that if you then had an additional $1 million of undeducted contributions in there, you in effect raise the RBL to about $1.36 million? Is that the effect of what you are saying?

Mr Worthington—If you had $1.2 million of assets—which is pre and post money, not undeducted—and you add $1 million of undeducted, then you could structure a lifetime pension which has a pension rate competitive with the annuity rate you could get if you went to a life office that has an RBL value of zero.

Senator CHAPMAN—You have not exceeded the RBL in any case, have you?

Mr Worthington—Let us say you had $2 million in there.

Senator CHAPMAN—The impression I got from what you said is that you can actually exceed the RBL by using your undeducted component.

Mr Worthington—Yes.

Senator CHAPMAN—If you only have $1.2 million, you have not actually exceeded the RBL in any case.

Mr Worthington—Yes. You could have $5 million and you have standard RBLs. You could put $2½ million of undeducteds in there and drag it back down to a standard RBL. It is only those people who have resources that can do that sort of thing. People who have those sorts of resources tend to have large accumulation balances in their self-managed funds; they are not the people with the balances of $500,000.

Senator CHAPMAN—Okay.

ACTING CHAIR—As an actuary, how do you view the 50-member rule?

Mr Worthington—I do not like it. It will put me out of business, so I have a vested interest that it does not go ahead. On page 6, I have shown—this is where you will need your glasses—a lifetime pension that provides a rate of pension that is competitive with a life office annuity rate, and I have tried to show the range

of possibilities and what is going to happen with those assets. I have gone back and looked at investment performance since 1928 in each of the asset classes, the inflation over that period and how much assets we would have at the end of each year into the future. The triangles show the average amount of assets—and this is the thing that the tax office get upset about because the average assets are actually rising and they just keep on rising except way into the future. The median, which is the middle of the range—50 per cent of cases are above that and 50 per cent are below it—is shown by the circles. The squares are the 70 per cent. I have to ensure with a 70 per cent probability that this amount is going to last a reasonable length of time. The 70 per cent level goes out 35 years, and that is well past your life expectancy point. Just investing 70 per cent in growth assets, I am easily meeting the 70 per cent probability requirement that there are enough assets there to pay the pension for the person's lifetime—and on average it is going to go through the roof. That is one of the things that the tax office do not like. In this document I also talk about what happens to the assets of someone who dies, because there are tax consequences involved in that case. There is tax revenue to the tax office when you do things with the assets of someone who dies. It is not like it is a free handover to the next generation.

Anyway, this is a combination of looking at the volatility of assets risk and at the longevity risk. I believe a self-managed fund can structure a pension which is competitive with a life office annuity and still provide a lifetime income stream, because there is a very high probability that it has enough assets to do that. So this 50-member rule is pooling the longevity risk, but in a way it will also reduce the amount of volatility that people will accept. It is the lowest common denominator. You have to offer something to the public that the public is willing to accept. Everybody who goes into that particular pool has to be happy with the asset allocation that the pool is taking on, so that pool would tend to be more risk averse than an individual who is paying their own pension. You would find that the potential outcomes would not achieve as much in a 50-member fund as they would in a self-managed fund because that person is willing to take on the risk themselves whereas the pool will not take on as much risk.

Senator CHAPMAN—Just coming back to this issue of high-wealth individuals being able to get back to their RBL through the use of undeducted contributions: is that understandable given that, in effect, once they exceed their RBL they are going to be paying about 78 per cent tax rates?

Mr Worthington—These people have investments outside superannuation. They just roll those investments into the super fund at retirement as an undeducted contribution and then when that money comes out of the fund as a pension the return of those undeducted contributions is not taxed. It is a return of capital. They take the amount of undeducted contributions divided by the person's life expectancy and then that amount each year of the pension payment does not suffer any tax. By putting in the undeducted contributions, they are not paying 78c in the dollar; they are paying no tax because they are getting it back again.

Senator CHAPMAN—I understand that, but it is avoiding a 78 per cent tax rate on their deducted contributions.

Mr Worthington—Yes, it is.

Senator CHAPMAN—If they had not put any of that money into superannuation, they would be paying only 48c in the dollar.

Mr Worthington—Yes. I am happy to say this, because it is only five per cent of my potential market that is affected, not 95 per cent, if you make that change.

Senator CHAPMAN—But that punitive tax rate removes the incentive for people to put money into superannuation.

Mr Worthington—Yes. But if you make the change to the RBL rule then they will not have that ability. I think that RBL formula is the whole crux of the problem.

Senator CHAPMAN—We are getting onto a different issue. We need to change the tax rates in relation to superannuation so that people do not cop a 78 per cent penalty rate.

Mr Worthington—You will have to talk to Treasury about whether they can afford it, and they will say no.

Senator CHAPMAN—Isn't it a matter of what is a fair rate? Is 78 per cent a fair rate of tax?

Mr Worthington—No. For example, I have a family to support. The amount of salary I draw from my company means that I am at a level where every dollar of contribution that I pay suffers a surcharge. The amount that I have accumulated in superannuation means that when I retire, unless something miraculous happens, I am going to be well below my pension RBL but I will have paid surcharges—if I am one of these

mega-rich people—all the way along. I will not get any refund of surcharge at the end, but I have to draw this amount of salary so that I can pay a mortgage and pay for my family.

Senator CHAPMAN—So you are going to pay a penalty tax rate too of about 63 per cent rather than 48 per cent?

Mr Worthington—Yes.

ACTING CHAIR—Thank you very much, Mr Worthington, for an interesting presentation.

[12.30 p.m.]

HEFFRON, Mr Martin John, Member, Superannuation Committee, Institute of Chartered Accountants

ORCHARD, Mrs Susan Janet, Superannuation Technical Adviser, Institute of Chartered Accountants

DAVISON, Mr Michael, Superannuation Policy Adviser, CPA Australia

KELLEHER, Ms Noelle, Member, Financial Advisory Services Centre of Excellence, CPA Australia

ACTING CHAIR—Welcome to the committee. I invite you to make an opening statement.

Mr Davison—I would like to make a brief statement on behalf of both organisations. On behalf of CPA Australia and the Institute of Chartered Accountants and my colleagues, I thank the committee for the opportunity to appear before it today. Superannuation is an important pillar in the Australian retirement system and it is imperative that the integrity of the system is maintained. For this reason the accounting professions will always welcome any move that will maintain or improve the integrity of the system. However, due to the timing and lack of consultation, the introduction of these measures on budget night has not only not addressed the wrongdoings they set out to address but also it has created, and will continue to create, significant problems for many other superannuation funds.

The blanket approach of banning self-managed funds from providing defined benefit pensions has disrupted the long-term retirement plans of many Australians and has reduced their options at a time when we have been promoting the benefits of choice and flexibility in superannuation. The targeting of specific shortcomings in the system would have been much more effective and much less disruptive.

In our submissions we have highlighted some alternative approaches, as we have discussed this morning, modifying the calculation of the pension RBL and updating the factors used in this calculation. Both of these would negate the need for a blanket ban. We have also highlighted various shortcomings in the regulations. Two examples are the vesting requirements and the minimum 50 member requirements and the impact these requirements have on employer sponsored funds. We are happy to go into more detail on these issues if the committee wishes and answer any questions you may have.

ACTING CHAIR—Can you outline some of the simple solutions that you are offering. Can you give us a thumbnail sketch of them.

Mr Davison—The most immediate thing is to address the pension RBL calculation.

ACTING CHAIR—Do you believe that a dollar of tax payment should equal a dollar of RBL?

Mr Davison—We do, and where you can identify the asset that is supporting the pension—and in most cases with a self-managed fund you can—you should be using that asset value to calculate your RBL.

ACTING CHAIR—And a thumbnail sketch of your solutions?

Mr Davison—One of the difficulties we had when these measures were first announced—and I notice that Senator Sherry talked to it a bit—was in understanding what the problems were and the scale of the problems, to the point where these measures were introduced on budget night and we did not have alternatives, such as the growth pensions, available. We were pretty much flying blind in working out what the problems were. We recognise there is evidence out there that there are various schemes or ways that people will use the system, but there was no concrete evidence. We looked at the most obvious things, and the first one was to ask: how did you use the calculation of your pension RBL? If you used an actual dollar amount for the capital value of your pension and updated the factors, we believe that the problem of the pension RBL would largely go away.

On the other side of that, there was the potential for abuse of social security by people using these structures to have assets test exempt pensions and hence access the age pension. We also believe that that problem went away as soon as we introduced 50 per cent reduction in the assets test exemption. Between those two approaches, we believe most of the issues that we thought were out there were addressed.

Mrs Orchard—The other issue that was seemingly being addressed by this was the use of reserves. We felt that if you are dealing with Centrelink there is some application by the government actuary that says, ‘If you have got this much money, this is how much pension it should relate to,’ and that perhaps there was an alternative way, such as using better actuarial factors or applying similar rules as would apply if you were approaching Centrelink across the board that may lead to the dollars flowing out in a practical manner across a lifetime without leaving significant reserves behind and helping address those measures. So we looked at the whole package and said, ‘Given that those are the things that people seem to be trying to address, what

alternative ways can you do that while still aiming for those people who wish to have the certainty of a fixed type income stream in their retirement to be able to continue to do that without necessarily having to change their current plans?' given that people have been planning this for a period of time.

Senator SHERRY—I think you were here when the previous witness, Mr Worthington, was giving evidence. Do you agree with his view that a person who takes a defined benefit pension pays more tax than if they take the other forms of retirement income stream that he was referring to, such as the allocated pension?

Mr Heffron—We had not done the work that deLancey had obviously done in coming up with his submission. However, having read his submission, it certainly made sense to me. On the basis of the assumptions that deLancey used, it would seem that he is correct; yes.

Senator SHERRY—If these regulations stand, it seems to me that there is a risk that people would be discouraged from taking a DB pension, wouldn't they?

Mr Heffron—In my view and in our practice, certainly we come across a reasonable number of people who are looking for the certainty of a defined benefit lifetime pension.

Senator SHERRY—The point I am getting at is this: the regulations require that the small super fund could no longer offer the DB. That is your understanding, isn't it?

Mr Heffron—Yes.

Senator SHERRY—And if the individual remains in the small super fund they would have to go to the retail company to provide that. Now, there is an additional cost for that, isn't there?

Mr Heffron—Yes.

Senator SHERRY—Secondly, they would have a bit of a problem, apparently, finding product like this.

Mr Heffron—There is the problem in that you may not be able to find a match for the benefit design of the super fund itself with the life office. My understanding is that there are only four providers of these types of product in Australia anyway.

Senator SHERRY—Is there?

Mr Heffron—I am not sure about that, but I think there are only four. So there is not much competition in the marketplace in any case at the moment, which is one of the reasons—there are several other reasons—why they look relatively expensive compared to taking your DB lifetime pension from your own fund.

Senator SHERRY—Nevertheless, some people prefer it because of the certainty.

Mr Heffron—There are certainly some people who prefer certainty. But you can achieve that certainty, either by using a life office product or by getting the involvement of an actuary in your SMSF to give you some comfort that the type of pension that you are taking, coupled with the investment strategy you have got, is also giving you an element of certainty.

Senator SHERRY—Take an individual in a small super fund. There is a DB that will be paid to them at whatever date they retire. Why should the trustees of that fund be forced to go and purchase that DB from a retail provider?

Mr Heffron—I do not know. That is one aspect of the measure that I do not really understand. Because we do not have information from the Australian Taxation Office or from Treasury for the basis for doing something as arguably draconian as that, it is difficult to know what the driver is from their point of view. Given that I do not understand what the driver is, it is not a measure that I agree with.

Senator SHERRY—There are two scenarios. Scenario 1 is that the individual cannot get the DB from their current fund and the fund may purchase it if they can find it from a retail fund. That adds to costs. That is scenario 1, isn't it?

Mr Heffron—Yes.

Senator SHERRY—Scenario 2 is that the individual leaves the small super fund. It has been raised this morning that if they do that there is a practical issue of asset break-up, if you like.

Mr Heffron—Capital gains tax.

Senator SHERRY—And there is a practical issue with capital gains tax. Would you agree with that?

Mr Heffron—Yes.

Senator SHERRY—That would be a disadvantage if the individual was allowed to leave the fund?

Mr Heffron—In my view, yes.

Ms Kelleher—In theory you have got the CGT asset problem even if they go and purchase the pension within the super fund, because you have got to get the cash to the life company somehow. If you sell the asset before you have actually started your pension, you do not have any tax-free income per se. You have got a layer of CGT at that point in time as well. Whichever way you go, you have got CGT considerations that you have got to think about.

Senator SHERRY—It seems to me that at the end of the day very few people are going to do it.

Ms Kelleher—Even just in terms of cost, that would be a big thing that people would look at. Talking to people about taking lifetime, life expectancy pensions, they are not concerned about additional tax costs if they have tax to pay within their small funds and things of that nature. If they die and there is money left in the fund, they are happy if that money gets allocated to other members in the fund. They are happy that there is surcharge on that and they are happy that that is creating RBL issues for the other people within the fund. They just do not want to see their pool of money potentially being lost within the life companies. Nobody that they know is going to benefit. If anyone is going to benefit, it is the life companies at the end of the day.

Senator SHERRY—So if the rules are tight enough to minimise—I do not think it will eliminate it altogether—abuse in terms of the transfer of those assets within the small fund, and so long as it is actuarially sound and the reserve that is there is sufficient to meet the defined benefit, you do not see anything wrong with that?

Ms Kelleher—People would not have a problem with that. They would say, ‘That is fair enough.’ If they are able to use something they want to use and they or somebody has got to pay tax at the end of the day, people are happy with that as long as they see it as being fair and reasonable and that they are actually able to plan that into whatever it is that they are trying to do. Given that we are in an environment where we are looking at adequacy of retirement benefits and we are looking at choice within superannuation et cetera, if we are actually denying parts of the superannuation industry the ability to do what other players are doing et cetera then we are actually causing problems for people and they just will not trust super and will not look at it as being an option for them.

Senator SHERRY—A person has been in a small fund for some time and there is a defined benefit that is promised. What will that person’s reaction be if, at the end of the day, they get to retirement and they are told, ‘No, you can’t have it’?

Ms Kelleher—It will not be good. If you were talking to someone now about putting money into super and they were in a small fund, be it a self-managed fund, a small APRA fund or a small corporate fund, and you start talking to them about what they will be able to do when they retire in 40 years time—’You will not be able to take a lifetime life expectancy fund in the fund of your choice’—I would suggest that most people will not necessarily fund for the pension RBL; they will look at the lump sum RBL as being their target benefit. At the end of the day, is that what we want people to be doing?

Senator SHERRY—Let us assume there is a level of abuse going on. We have not had it quantified. We have not got any detail at all from the tax office or Treasury so far. I have asked on a previous occasion for them to provide some analytical data. Let us assume there is a level of abuse going on. Do you believe that the regulations are the appropriate way to solve that abuse?

Ms Kelleher—Personally, no. I think what we have is a blanket ban on small funds. We have not addressed the cause of the problem and we have not looked at the framework that is causing the issue. The small funds are not actually the problem—it is the legislative requirements around how you set up or what you are required to do with your defined benefit pensions. I suggest that, if we have abuse at one end of the market in terms of the RBL issues, we have abuse at the other end of the market to do with social security et cetera. You cannot address one in isolation from the other, and a blanket ban does not address the problem.

Mr Heffron—It does not seem to solve the problem anyway, because under the current change to the rules if an SMSF purchase is an annuity off a life office and then commences a pension itself, it still uses the same method of RBL calculation as it has always done. It has just purchased the annuity it is paying from elsewhere, so it does not seem to solve the problem.

Senator SHERRY—Except the individual is paying more, because there is another add-on cost because there is another provider added to the package.

Mr Heffron—Yes, so it has not solved the problem in any way, but, as you say, it is the cost.

ACTING CHAIR—Do you have any concluding comments?

Mr Davidson—I think we have pretty much covered it. To be fair, one thing that has not really been covered so far but I believe will be covered this afternoon is that we feel that a blanket ban is inappropriate. As Noelle has said, to address the system would have made more sense than to disrupt the retirement plans of many people approaching retirement who had quite often funded for many years towards using a particular structure in their self-managed fund to move into retirement. To be fair, the new growth pensions and market-linked income streams will provide people access to the pension RBL and to social security, so those options are available in the future. But we believe there is clearly a need for defined benefit type pensions within your self-managed funds—one, the more term-certain type products and, two, products for those who are after a smoother type of income stream throughout the life of their retirement. If we actually address the system instead of putting on a blanket ban, we should be able to continue to operate those sorts of structures without detrimentally affecting the system as a whole.

ACTING CHAIR—Do you think the regulations should be disallowed?

Mr Davidson—My concern about disallowing the regulations is that we are flagging an issue and creating an environment where people are aware that the government wants to crack down on it, and we may end up with open slather until it is fixed. I think there are some simple solutions which would address the problem first, such as addressing the pension RBL calculation. If we address those systemic issues first, then there are no reasons for these regulations to exist.

Senator SHERRY—But, at the end of the day, if the government does not withdraw the regulations we have no option but to move for their disallowance.

Mr Heffron—My personal view is that the regulations should be withdrawn and we should start again and address in the cool light of day the specific issues that have apparently been identified by Treasury and the ATO rather do what has been done, which appears to me at least to be a knee-jerk reaction that does not seem to solve any problems. I also make the point that the subsequent regulations—the ones that have given SMSF members who retire before 30 June 2005 the opportunity to continue taking defined benefit—is not entirely a solution either, because there are people out there who were planning for their retirement by using an SMSF that they have not yet established. They know that they are going to get a certain benefit from their corporate fund or their master trust down the track, and their intention was to set up a DIY fund in order to run their retirement, but now they are not being given the opportunity to do so and take a DB pension, which may have been the plan that was in place all along. So I do not think that the postponement of some of the items in SR84 has actually solved the problem for everyone.

Senator SHERRY—A politician would suggest that that is to go past the election—to get the heat off and wait and see what happens. Do you have a view on that?

Mr Heffron—I do not know. I do not move in those circles. It does seem odd that the review has been postponed until April, but I do not know.

Mr Davison—The regulations are causing more trouble than we believe they are solving. To disallow the regulations would make those problems go away, but it is imperative that we put proper solutions in place very quickly to make sure that if there is any wrongdoing out there—we have all recognised we cannot quantify it yet—we address that pretty quickly.

Ms Kelleher—In the Ernst and Young budget barometer that was conducted this year, superannuation was an area that was addressed—the feedback from corporate Australia in terms of the importance of super. I would suggest that the important thing is to get the regulations right and get them done ASAP, because super is out there as an issue that everybody is aware of, regardless of what hats they are wearing. The important thing is to get it fixed, get it right and keep people confident in super.

ACTING CHAIR—Has either the institute or the CPA been invited by Treasury to make a submission? Have they been involved in discussions in relation to the fewer-than-50-member rules?

Mr Davison—We had discussions with the minister's office and Treasury when the regulations came out. We have not had any discussions since a review was first announced or directly in relation to the 50 member issues.

ACTING CHAIR—So since the announcement by Treasury to look at and evaluate this 50-member rule, you have not been consulted?

Mr Davison—No.

ACTING CHAIR—The institute has not been consulted. Do you know of anybody who has been consulted?

Mr Davison—Not that we have heard. At the time the announcement about the transitional arrangements and review was made, we were in discussions. We are certainly of the expectation that we will be involved in the process but we have not heard to date.

Senator SHERRY—The meeting you are referring to was the meeting called after the budget in Canberra where you were given a lecture about not questioning the underlying thrust of the regulations but were asked to provide a view within that limitation.

Ms Kelleher—The whole problem with this set of regulations is that it is meant to be addressing a set of rorts or whatever that is happening out there in the system. But no-one has been able to say, 'These are the specific examples that we are looking at,' so that as an industry we can then sit back and ask, 'What's going to fix the problem?' An example in the regulations where there is still a problem with what is being suggested is to do with surcharge avoidance—having contributions allocated within 28 days of the contributions going into the fund and having them vest 100 per cent in the person concerned. The problem with that is that it does not actually say that the contributions have to be allocated to the person they are meant for. I can still allocate them to the spouse or whoever it is I want to allocate them to and avoid the surcharge in that way. All it has done is change when I am allocating it. It is not changing who I am allocating it to and it is not keeping those contributions in the members' hands that they were actually being made for. The easy or better solution to that would have been to change some of the tax rules to deny the deductibility if the contributions are not given to the right person. So even just in terms of that simple change, what is in the regulations is not enough to get us over the hurdle of solving the surcharge issue.

Mrs Orchard—In addition to that, what is in the regulations gives an arbitrage issue where people can reduce the surcharge that they are paying through using the new rule, as we pointed out in our submission. In fact, we have introduced something different. As well as not addressing the problem, we have now introduced something different that can occur.

Senator SHERRY—If these are integrity measures, as is claimed, there are identified areas of malpractice—the RBL compression and estate planning—and the tax office and Treasury have knowledge of this, wouldn't it be reasonable to expect them to be able to provide us with some details about the level of malpractice in each of these categories—revenue at risk and those sorts of details?

Ms Kelleher—How can you fix something if you cannot describe it? That is the basic question.

Senator SHERRY—That is very well put.

Ms Kelleher—Both the tax office and Treasury should be able to give specific examples of what they are looking at trying to fix up.

CHAIR—We look forward to getting those after 3 o'clock. Thank you very much for giving evidence.

Proceedings suspended from 12.55 p.m. to 1.54 p.m.

BLOORE, Mr Andrew, Managing Director, Smartsuper Pty Ltd

DAVIES, Mr William, Marketing, Smartsuper Pty Ltd

ACTING CHAIR—Welcome. Are there any comments you wish to make about the capacity in which you appear today?

Mr Davies—I am also the representative to SILG on behalf of Smartsuper.

Mr Bloore—The predominant role of our business is as administrator for self-managed super funds. We are here making a submission in relation to that.

ACTING CHAIR—I invite you to make an opening statement.

Mr Bloore—One of the key things I want to do is to give some insight from the clients' point of view as to what we are seeing and what is being asked of us as an administrator and perhaps to reflect on some of the issues that the changes have made for them. Supporting that are some proposals which may alleviate some of the issues and to give you some of that information from that point of view. I think the key thing that our clients have indicated to us on the way that they use defined benefit pensions—and a significant proportion of our clients use defined benefit pensions—is looking at it not as a pension on its own but part of a tier of pensions that they use for different purposes.

We have found that our clients set up self-managed super funds predominantly for the reason of taking control over their assets. They diligently wish to build those assets over their lifetime, which they do, and some of our clients have quite significant sums in superannuation funds. Then over the course of their retirement those provide some flexibility in the way they pay that income stream to themselves to ensure both that they are looked after and their spouse is looked after on their demise, and also that there are assets which are passed on to the children on their demise—should assets be there after their death, that they are passed within the family. The predominant reason why people use self-managed funds are those two stages: the accumulation stage, where they are looking to take control of their own process and the manner in which they accumulate assets; and then applying that same investment strategy facility and the way that they manage their assets into retirement and ultimately through their estate.

The loss of defined benefit pensions has two significant impacts for our clients. We tend to find that clients do not use just an allocated pension or just a complying pension or just a term certain pension; they use them in conjunction with each other. So they build part of their retirement income stream in an allocated pension, which gives them the flexibility to change, adapt and take different sums out. They then use residual capital value or term certain pensions to maintain an asset which on their death would pass to the spouse or children, whichever they so choose. There are also lifetime pensions to ensure that there is longevity of the money to look after their spouse. Using the pensions in conjunction with each other gives a natural result to the way people are building their assets, leaving aside superannuation, for their own retirement. They are saying, 'We have worked over our career to build up an amount of assets, to live on the income stream and make sure that the spouse is looked after in death, and so on and so forth.' The predominant concern that clients have is the loss of control of those assets where under this proposal they are now being asked to put those with life companies or institutions to provide that for them, when through their career of running self-managed super funds they have looked after those assets for themselves. As has been stated this morning, there are issues of capital gains tax. The requirement to unwind the assets that they have diligently chosen to have and to give that investment over to an institution to run on their behalf is not something which they choose to do.

Additionally, in relation to whether clients are prudently making those investments, clearly many of them have prudently made investments. We have seen that from the way that self-managed super funds have performed in the last 10 years and from the costs reduction they have been able to generate from using those vehicles. Furthermore, they are saying, 'If we've been prudent enough to build up those assets, why now are we no longer allowed to do this?' In addition to the independence of an auditor and an administrator, whether that is an accountant or a firm such as ours, we now have a third tier of overseeing the fund—that is, an actuary. So they are saying: 'From our point of view, we've grown the assets and have got them to this point. We're very happy with the make-up of those assets.' With the additional services, they should be paid out in accordance with the legislation.

Certainly we have seen some significant concerns from clients, who have been saying, 'We're no longer allowed to do this purely because of the size and number of the members in the fund.' Clearly, they have not been happy with that, given that the whole reason they have been building up the money was to do this. It has

often been said to me that the predominant reason for using superannuation is to get to a point where, when you retire, you can take all your money out. What we are seeing is a significant change to that in terms of lump sum withdrawals. Clients are looking for certainty of payments and a process of taking pensions and income streams, rather than simply saying, 'I want access to capital, so I can take my lump sum out.'

At the same time, clients do not want to be in a position where they are told: 'The only vehicle you can use that in under the new legislation is the growth pension in a non-commutable form.' We have gone from a process of having allocated pensions, residual capital value pensions, term certain pensions and lifetime pensions to having allocated pensions and growth pensions. It has taken away the biggest area of flexibility in the way that payments are made to 'pensioners'—and I use that word from a superannuation point of view. I think that is the core part of the overall concern from a client point of view.

In recognising the issues that relate to the potential abuses that are in the system, I think that predominantly, as we have heard this morning, the abuses have come from the structure of the formula itself rather than from the funds. These changes seem to simply say, 'We've moved the place at which the abuse is going to occur from a self-managed super fund to an institution.' If you go through the same process, you get the same result. Simply, the fact that there are not 50 members in a fund does not mean that it has changed the actual construction of the pension or the formula or the way that the RBL is contrived. Unlike others, I do not have an issue with a change in the formula back to something which is RBL assessed for each dollar of taxed money. In many circumstances, pensions create a greater amount of assessed RBL. For example, if you use all undeducted money in a pension and you have 100 per cent residual capital value, it will report an RBL, even though it is all undeducted money. So there are circumstances where the RBL works in reverse. It actually creates a payable RBL, by comparison to one where the abuse is suppressing or reducing the amount of RBL. The formula itself is the issue in relation to RBL.

If we apply the same practice from a Centrelink point of view, having pensions constructed which have an actuarial bias not in a table form, not by a process that says there is a clear definition of the way that formula is calculated, we are always going to get a result which can be manipulated. From my point of view, I certainly do not argue that. As an administrator, we use a table of factors which is used exactly the same way for every single client. The end result is known, because it is one figure divided by the other figure and you will always know what the end result of that is.

If you are looking for some certainty, perhaps we need to build a process where we use a set of tables which produce a known end result that everyone is comfortable with rather than to simply say that actuarially the pension meets its 70 per cent high degree of probability rule and therefore it is an allowable pension. We can look at different ways to provide the same solution of continued defined benefits payments to clients. Very clearly, our clients are looking for the certainty of lifetime pensions and to pay them in a known form rather than an allocated pension where the older you are the more it forces money to you, so you are required to use it more when you are older. Those issues are the predominant concerns that I laid out in my letter.

ACTING CHAIR—Would you like to comment on matters raised by other witnesses this morning?

Mr Bloore—A few questions were raised, particularly in relation to the 50-member rule. My concern about the 50-member rule is how to ensure that funds meet the requirement to ensure that payments are made. I do not believe that a fund of more than 50 members will do that any better than a fund with fewer than 50 members if the process is right, and that is a key issue. In relation to whether the payment of pensions should be through institutions: if 50 per cent of all net money went into a DIY fund, we have to ask ourselves why clients are setting up DIY funds. If they are doing it because they are not happy with what is out there, forcing them into using the other things that are out there will drive them away from superannuation.

ACTING CHAIR—Some people would say they are doing it to defer taxation. Would that be a correct reading?

Mr Bloore—I do not think that is the case. In the accumulation stage, contributing to superannuation clearly provides a more beneficial tax environment than having an asset in your own name. I do not believe that the transfer out of money afterwards is, as was pointed out this morning in the tax calculations. More importantly, if you think about the growth of an asset in a superannuation fund that has been paid out, and let us presume it is paid with the 15 per cent rebate, then you end up with 33.5 per cent if you are on the top marginal rate—48½ per cent less the 15 per cent—also presuming you have paid tax along the way. But if that same asset were in your own hands, capital gains tax on that asset would be 24.25 per cent, so you pay more tax on paying growth assets out as an income stream than you do if you hold a growth asset in your own name. Clearly, tax is a beneficial issue in the way we accumulate assets, but it is less of a concern in the way that we

pay it out. To the other extreme: if you have an excess benefit pension you do not get a 15 per cent rebate and if you had the same income in your own hands you would not get a 15 per cent rebate. So it does not create as big a concern in terms of people being in excess of their RBLs because they are paying the same rate of tax as they would be paying if it was in their own hands on the income stream.

ACTING CHAIR—So it is only in the accumulation stage?

Mr Bloore—In the accumulation stage it does not and, obviously, in the pension stage it does.

Senator SHERRY—I would like to come back to the issue of your clients. Let us assume for the sake of argument that the current regulations stand and the client wants to have a defined benefit pension. Let us take two scenarios. Scenario 1 is that they remain within the small super funds structure, and effectively the trustees are forced to purchase it for them from a retail provider. That is my understanding. Is that correct?

Mr Bloore—Yes, that is correct.

Senator SHERRY—If they follow this scenario, their costs would go up; presumably they would have to pay.

Mr Bloore—Yes.

Senator SHERRY—Why would their costs go up?

Mr Bloore—The underlying superannuation fund itself will have the same amount of costs whether you are administering in the pension phase or otherwise, leaving aside the actuarial requirements. They are then taking an asset which they already own within the fund, triggering a potential capital gain—presuming he has made a gain—and then having to buy an institutional product. That institutional product has an inherent management cost. The key reason why people fund self-managed superannuation funds is they want to manage their own assets. If you look at the statistics from the ATO, you see that only a very small percentage of the assets in DIY funds actually then ultimately end up in managed funds, and that is somewhere around 24 per cent.

Senator SHERRY—So if their current trust structure remains and they want the DB, there are add-ons in terms of cost: obviously the administrative cost and probably some commission, I suspect, from the retail provider.

Mr Bloore—Those are a significant deterrent to people using them.

Senator SHERRY—We have had evidence that, if they do not choose to go that way and actually leave the trust structure, there are practical issues as to selling the assets, releasing the asset values, and the capital gains tax issue.

Mr Bloore—Yes.

Senator SHERRY—Thank you for confirming that. I notice you actually say in your submission—and you have said this to us verbally—that they have an asset which on death they can pass as a lump sum to their children. Let us explore this issue for a moment. I think the discussion really is about what is an appropriate level of asset that would be left to their children or other beneficiaries. Let us assume the actuary—and it is an independent actuary who is signing off on this—establishes a reserve of some sort. If we as legislators were unhappy about the level of reserve that ultimately might flow—it is not guaranteed, but it may flow—to the other beneficiaries, presumably we could change the formula.

Mr Bloore—Yes.

Senator SHERRY—Is that an option?

Mr Bloore—I think that is a clear option as to the way that you find a resolution of this. Our clients are not looking at this as a method of avoiding the process. It is more a case of having it, which provides a lifetime payment of some certainty.

Senator SHERRY—And if there is money left over it flows to the beneficiary?

Mr Bloore—It does. The difficult question with what we have been dealing with this morning is longevity. If you outlive your life expectancy, we have to deal with that within the reserves and the fund has to have the capacity to do that. But, at the other extreme, what happens if you die earlier? The very clear reality of clients is that just as many people die before their life expectancy age as die after—that is statistically the fact—so we have to be able to at least say, ‘If you do die early, we want to make sure that assets can pass or continue or continue to pay an income stream,’ and have the facilities to be able to do that.

Senator SHERRY—It is interesting to note that a previous submission from Mr deLancey Worthington pointed out to us that if you purchase a defined benefit pension you are actually paying more tax in retirement than if you purchase another form of income stream. Are you aware of that?

Mr Bloore—Certainly that is a possibility. If you build reserves and reserves are not drawn on because of continued positive performance, that is going to be the case.

Senator SHERRY—It seems to me we run the risk that if the regulations stand and we are cracking down on these alleged abuses, which are yet to be identified in any submission, we will be discouraging, and we will see a drop-off in, the take-up of defined benefit pensions—wouldn't we?

Mr Bloore—Yes, absolutely. There is no doubt about that from our clients' point of view.

Senator SHERRY—Regarding the alleged abuses, a number have been mentioned and there has been the odd anecdotal case given to us by the tax office and Treasury of RBL compression, estate planning and tax minimisation. If these practices are unreasonable and excessive in some areas, would it be reasonable to see an outline from Treasury and the tax office about the level of abuse, identified abuse, tax revenue loss and those sorts of things?

Mr Bloore—I think it would be more than reasonable; it should be something we would require before making any final decision as to whether pensions should be removed. Clearly, cases of abuse are not what anyone wants to see in any superannuation system—or any system. However, in our experience, there has been no evidence of that in terms of abuse of the process, predominantly because we use a standard practice through all of our defined pensions. You use the same factors for the same thing each time and they are as defined by our actuary. Abuse is something we need to ensure does not happen, but there is certainly no evidence of that from what I have seen as an administrator—we are not seeing these things occur. So, if we use the figures which were quoted before, you are ending up with 95 per cent of people being disadvantaged as a result of the changes. If those 95 per cent of people are doing the right thing, then that is a significant disadvantage.

Senator SHERRY—So your argument is that, if the regulations stand, it is unfair to disadvantage the 95 per cent and totally disrupt their planned retirement choice, which is a DB fund. It is totally unfair to disrupt them in the cause of cracking down on the maybe up to five per cent who are abusing it.

Mr Bloore—Absolutely. Unfortunately, there may be some circumstances where this has occurred. It is not something that I have seen, but it may be the case. But is that something which is common practice? No. And to therefore say that the whole industry is no longer able to do that, or that people who have set their superannuation funds up with the design to do this are no longer allowed to do it, is a negative position.

Senator SHERRY—I do not want to deal with issues that are commercial-in-confidence, but what sort of client base do you have in terms of numbers? Also, are the people in this area that we are dealing with all up near the RBL—the $1.2 million? Where do people predominantly lie in terms of the assets in their fund?

Mr Bloore—We have people at both ends of the spectrum and quite a reasonable number of funds. At the moment we are 10 years on from the transitional RBL arrangements so, logically, you are going to see people who are retiring now with transitional RBLs worth a significant amount. Those people are clearly using defined benefit pensions as a method of paying income streams to themselves. The reality is that people who retire with $300,000 or $400,000 in their superannuation funds are not going to use defined benefit pensions to anywhere near the extent of the larger asset holders. So it certainly is more for people who are looking for continued, ongoing income streams to be paid out to them and to their spouses.

From an abuse point of view at the other end of the scale, regarding the Centrelink issues which are put up, one of the key things that is a huge deterrent for people to run Centrelink abuse, if it does occur, in a self-managed super fund is the issue of deprivation. If you use an insurance company to provide you with a complying pension, then you do not have deprivation. If you run it through a self-managed super fund, about 20 per cent of the assets are deprived. That is a disincentive for people to use a self-managed superannuation fund as an abuse. Again, I would like to actually see how many cases have gone to Centrelink where Centrelink have said, 'Yes, including your deprivation you still get the pension payments,' and clients have been happy with that. It is certainly not my experience.

Senator SHERRY—And, as a matter of law, there has to be a sign-off by the actuary and also the auditor?

Mr Bloore—Yes, and the tax agent for the fund who is preparing the return.

Senator SHERRY—Have the tax office been examining these arrangements? Have they checked the arrangements with your firm, for example?

Mr Bloore—They have done no audits on any of our clients to date. In our involvement with the SILG committee we have been actively pushing the need for more activity in relation to compliance to make sure that funds meet their obligations. Clearly the statements made by the commissioner last Wednesday indicate that. The number of funds that they are now auditing is twice the number in the previous year. They have a beefed-up audit team, a new process and new guidelines for auditors to ensure that funds meet those obligations. From that point of view there is certainly increased regulation on superannuation funds. We have a number of professionals looking at these, making sure that funds do what they should be doing.

Senator SHERRY—Presumably the regulations that we now have—they are law, unless they are disallowed—have to be based on something. They have to be based on some observation, some analysis. I read the commissioner's statement last week which, whilst it relates to small super funds and DIY, has a different set of issues. Currently, we are dealing with issues in the regulations where some identifiable level of abuse must have occurred.

Mr Bloore—If it is, I have not seen it. I have not been asked to participate in any process of determining whether it is or is not.

Senator SHERRY—Did these changes come as a surprise?

Mr Bloore—A total surprise.

Senator CHAPMAN—I do not have any other questions. What we heard this morning and what you have said cover my issues.

ACTING CHAIR—On a point of clarification, is a fixed term pension defined as a defined benefit pension?

Mr Bloore—Yes. The only types which are not are growth pensions and allocated pensions. So you cannot provide a fixed term pension. Take an example: a husband and a wife die and they have minor children, and written into the defined benefit document now is that a child is not to receive that asset as a lump sum until they are aged 35. The only way you could do that is to pay an allocated pension to them. Under the rules for a defined benefit you could pay a term certain pension to that age, with a known end value. So it can have a residual capital value at 100 per cent of its value, so you pay the income stream amount out and give the asset to the child. That is one of the key things that have been taken away. From a family planning point of view, people are not just looking at saying, 'What if I can make this last a little bit longer beyond my life expectancy, and I can rort the tax system for this bit.' It is not to do with that. It is about saying, 'I want to ensure that I have the flexibility to pay myself and have assets for my family, and in my demise I know this asset is going to go to the people I built up the asset for.' That is the key thing that has been removed.

Senator CHAPMAN—So that has been removed?

Mr Bloore—Yes.

Senator SHERRY—If the government does not withdraw these regulations—and we have had a number of different advices about dealing with the alleged abuses—should they be disallowed?

Mr Bloore—Should the current regulations be disallowed?

Senator SHERRY—Yes, if the government does not withdraw them.

Mr Bloore—Yes, I believe so.

ACTING CHAIR—Thank you very much, Mr Bloore and Mr Davies. That was very enlightening. And thank you for your submission.

[2.25 p.m.]

WATSON, Mr Cohen John, Director, Retirement Incomes and Asset Consulting, PricewaterhouseCoopers

ACTING CHAIR—Welcome, Mr Watson. Would you like to comment on matters raised today by other witnesses?

Mr Watson—Yes, thank you. I do not know that I am necessarily going say anything new to the committee. I hope I do not disappoint the committee—no disrespect to Mr Worthington, but I do not have any fancy or complicated graphs to show you today. I do want to say that we are very concerned with the recent regulation changes; specifically, their impact on lifetime and fixed term pensions from funds with less than 50 members. The overwhelming majority of Australians are now unable to access their superannuation via a pension payable for life unless they are willing to hand over their retirement savings to a life office and purchase a traditional annuity, which the majority of people are reluctant to do for a number of reasons. In my opinion, a blanket ban is severe, it is unfair and it is unreasonable. In fact, for the integrity and the good of the social security system and of the superannuation system the government should be encouraging people to take their savings in the form of an income stream rather than as a lump sum and then falling back onto social security at some future point. Reducing the number of choices for retirees from four to one, or five to two—or however you want to measure it—certainly does not do that.

ACTING CHAIR—Where has it gone from five to two?

Mr Watson—If we count growth pensions, for instance. If we say we have an allocated pension and a growth pension in a few months time, and we have a complying lifetime, a complying fixed term and a more flexible lifetime or fixed term that does not meet either RBL or Centrelink rules, the last three are treated as defined benefit pensions and are now disallowed. So retirees only have allocated pensions and growth pensions in a few months time, effectively, unless they want to give their money to a life office.

Picking up on Senator Sherry's comment earlier about using a sledgehammer to crack a nut, I put it to you that that is precisely what these regulations have done. In fact, over the past few days we have examined our own pension client base, looking at the numbers. I do not want to state the exact number in *Hansard* for reasons of confidentiality, but I would be happy to give the senators the numbers afterwards. But out of the hundreds of pensions that we certify each year—we are talking about an annual certification of people paying themselves defined benefit pensions—less than two per cent had balances of more than $1 million. That means that out of 500 pensions we are talking less than 10 people. If we are talking 1,000 pensions, we are talking less than 20 people. More than 93 per cent of every person on our books who has a defined benefit pension had assets of less than $500,000.

I think Mr Stanhope asserted earlier that only people with assets higher than the pension RBL want defined benefit pensions. With more than 93 per cent of people having less than $500,000 I cannot see any basis for that assertion, for starters. Mr Stanhope also said earlier that people only want defined benefit pensions for tax arrangements. If less than two per cent of defined benefit pension people on our books have more than $1 million, it is very difficult to see how those comments stack up, to be honest.

I do not have any evidence of widespread abuse, even among the two per cent of people who supposedly have the resources to abuse the system. I want to be frank with you. Does opportunity for abuse exist? If you know the system then, yes, the opportunity is there to abuse the system. Do people actually take advantage of it? In my experience there have been very, very few. Again, being frank, in my 10 years of practising experience I have seen two cases of people with substantial assets who are accessing social security entitlements as well. That is a potential maximisation of the system. I am talking of balances greater than $500,000. It is not that these people have specifically structured their pensions in such a way as to abuse the system; it arises out of the current 100 per cent assets test exemption that applies for Centrelink purposes. The change to a 50 per cent exemption will fix that up immediately. If the government still is not satisfied that that will fix the system then put a cap on it or do something to that effect.

So there are probably one or two isolated cases, and I suspect that Treasury and the ATO will probably quote those today. But again, with less than two per cent of people having assets of more than a million dollars using these, we are talking very small numbers. Widespread abuse? Definitely not. Why penalise all retirees for the sake of one or two isolated cases? If people are abusing the rules then I would put to you that the rules should be fixed to address those instances. In the submission that I put forward I put some specific suggestions

on the various areas that the government seems to be asserting that abuses are occurring. We have talked about RBL compression today—and I do not want to go over the same issues again. But if RBL compression is an issue, fix the formula. It is the government's formula. Either make it the purchase price or revalue the factors that the government uses so they are more representative of what a pension is actually worth today.

As for the Centrelink side of things, if the government is concerned that wealthy people are accessing the social security system via pensions, then fix that side of things. They have already made moves to do that. The 100 per cent assets test exemption down to 50 per cent should resolve that. The access to social security is an income test and an assets test. It is the greater of the two. You cannot just say that you put all your assets into a pension and that is the end of it. There is an income test that applies as well. If estate planning is the issue—and, again, there has been talk about that today—then, depending on what the issue actually is, put some additional measures in place. I have put some suggestions in my paper. They are not the perfect suggestions; they are just some ways that the government really does need to look at to address the issues.

I also want to say that there seems to be a real hang-up in some circles—and Mr Stanhope mentioned it today—about the issue of guaranteeing the pensions. I would like to let everybody in on a little secret. There are no guarantees in life. Ask Ansett employees whether there are any guarantees. Ask the customers of HIH whether there are any guarantees. There are no guarantees in life. A life office also carries risk. Risk comes with the risk that at some point there may be a failure. Life office risks are managed actuarially; so are small funds. Every small fund paying a defined benefit pension has to have independent actuarial involvement. People in small funds are aware of the risk they carry. They are aware that there is a chance—be it 20 per cent, be it five per cent, whatever the actuary has calculated—that the assets may not go the distance. They are willing to take the risk over giving their assets to a life office and paying the cost of doing so.

Life offices themselves are having difficulties with reserving for improvements in mortality. Experience from overseas—and I do not purport to be an expert in this, but in the actuarial circles in which I mix it is discussed—where there are bigger markets for annuities is that life offices are having difficulties on the mortality risk side of things. People just do not perceive value in life office annuities, partly because of the large reserves they have to carry for investment risk and the large reserves they have to carry for mortality risk. In that sense it would be a huge shame if the outcome of these regulations is that people either are forced to take annuities—and they simply will not, in which case people will be reducing their choices—or are forced back to one of two pensions, which will suit some people but will not suit everybody, or a lump sum.

My view is that the regulations should be disallowed as they are, but that the Treasury review process—which I understand will commence shortly and will be reporting in April next year—should be used to consult with industry, to clearly identify any actual or perceived problems or any opportunities for abuse that may or may not be there and to achieve specific targeted measures that actually deal with those, rather than penalising the 98 per cent of people—if you exclude people with more than a million dollars—who are simply using a defined benefit pension for certainty of income and for control over their superannuation. People have spent a lifetime building up their superannuation and they are simply not going to give that away.

ACTING CHAIR—What will your advice be in the meantime—between now and April next year, when Treasury give their report?

Mr Watson—My advice to whom?

ACTING CHAIR—Your clients.

Senator SHERRY—The regulations are in force.

Mr Watson—If the regulations are not disallowed, clients who were members of DIY funds as at 11 May have the ability to start a pension but any new clients who were not members as at 11 May are shut out—they have no opportunity.

Senator CHAPMAN—So your recommendation to us would be to disallow the regulations?

Mr Watson—My recommendation would be to disallow the regulations as they stand. With such a major change, I believe industry needs to be consulted. If there is a small section of the community that is abusing the current rules, or even if there is the potential for abuse, then specific targeted measures should be implemented to deal with those people. Based on quite a large sample size of our client base, we do not have any evidence that there is widespread abuse. If anything, there may be one or two isolated cases at most. Those cases were to do with people with large balances who appeared to be accessing Centrelink. The changes from 20 September will can that altogether. That change in itself will fix that issue.

Senator SHERRY—Just on the operative date issue, though, don't we face a problem in that your clients are in a twilight zone—those who retire between now when the regulations are in force and April next year, when this review may or may not change the current regulations that are in force. The twilight-zone people are going to be in a difficult position, aren't they?

Mr Watson—Correct: very difficult. Even people who are able to start a defined benefit pension up to 30 June via the transitional arrangements have a very difficult decision to make. I do not know whether you are aware, but the ATO brought out a draft determination last week which had a very strict interpretation of what could happen to people with pensions in payment following 30 June. Say I had a client who, come 1 June next year, said: 'I still haven't seen the Treasury review; I want to start my pension. I'm going to do so just to make sure I get in before the 30th.' And let's say the markets dive and in five years time I look at the client's portfolio that year and say, 'I can no longer sign off with a high degree of probability that you can continue your pension; therefore, you need to restructure it and lower your income stream.' The ATO's determination is that they might have started their income stream during the transitional arrangements but they can no longer reset it outside of that time. They would be forced out of their DIY fund into an annuity. As the regulations currently stand, those people cannot even convert their lifetime pension to a growth pension. I do not know whether that is intentional, but it has certainly been overlooked with the growth pension changes, in that there is no capacity for somebody who is being paid a lifetime pension to stop that and repurchase one of the new growth complying pensions.

Senator SHERRY—Let's say a person is in a current small fund and the fund says, 'You'll get X as a defined benefit pension when you retire.' They can no longer take it through the fund directly; the fund has to go to the retail provider. My understanding is that there are not many retail providers who offer defined benefit funds and they may not offer a defined benefit pension that would be identical or very similar to that which is on offer through a small super fund.

Mr Watson—Correct. My understanding is that there are only a very small number of providers—we are talking life offices—who are willing or able to offer an annuity here in Australia. Of those, it is very difficult now to even purchase an annuity that is linked to the CPI because the life offices are getting more worried about the risks that they are carrying, the reserving that has to be implemented. Some recent work we have done shows that it is very difficult to buy a CPI linked annuity with a life office.

Senator SHERRY—That is one of the things that drives the push for growth pensions, isn't it? They minimise the risk to themselves.

Mr Watson—Correct. My understanding is that growth pensions have all been driven from the retail providers so that they can offer a pension with no risks to themselves.

Senator SHERRY—Let us assume under scenario 1 that the person retires and, under these new regulations, the trustees have to purchase a pension product from the retail provider life company. Do their costs go up under this scenario?

Mr Watson—Outside of the DIY fund?

Senator SHERRY—They are still a member of the DIY fund. They have not left it, in terms of liquidating the assets and transferring them out. They are still a member, and the trustees have bought the product from—

Mr Watson—Inevitably, yes. If you are buying, through your DIY fund, the product from a retail provider, the retail provider has its own administration structures. Most retail providers have shareholders and therefore have to generate a profit, which a DIY fund does not need to be concerned about. The retail provider has certain regulatory reporting to APRA, actuarial controls. Then within the DIY fund, very similarly, you have got the actuary who still has to be involved, and the DIY fund still has to deal with the regulator. You have normally got an adviser involved in order to be able to get access to a retail product or an annuity.

Senator SHERRY—On commission?

Mr Watson—Correct. Or fee for service, depending on how the adviser works. But there is a whole layer of additional costs introduced.

Senator SHERRY—So costs go up. If the person can actually leave the fund—the DIY or the small super fund—and the assets have to be liquidated, I understand there are some practical issues there in liquidating assets and also capital gains tax issues, and then they shift that value out to the retail provider. That is an option, isn't it?

Mr Watson—Correct—if you are willing to liquidate your assets, willing to incur the capital gains. That is assuming some assets can be liquidated within a reasonable period of time. If you are holding a property or something of that nature, if you have reached 65 and the superannuation regulations say that as soon as practicable you have got to convert your superannuation into an income stream, you cannot exactly wait around for a couple of years for the property market to bounce back or for you to find the right buyer to do so.

Senator SHERRY—Assume the regulations stood and numbers of people decide: 'This is not worth it. We're not going to go and convert to a defined benefit pension.' Do you think it is likely that the demand for defined benefit pensions through your structures would decline?

Mr Watson—If the regulations stand?

Senator SHERRY—Yes.

Mr Watson—They pretty much will not be allowed beyond 30 June next year.

Senator SHERRY—They are not going to go to the retail providers and use their DB products, where they can find them?

Mr Watson—Some will. I think a small section of people would be willing to pay the additional costs and purchase a retail product; but for the large majority of people, no, they will not bother. They do not do it now and they are not going to be forced to do it via regulation change.

Senator SHERRY—Just on this issue, we had some interesting evidence from Mr Worthington about the tax income from a defined benefit versus other forms of income stream. It actually showed that there is a greater tax income and that people were willing to pay the greater tax levels over the period of time—however long they live—because of the certainty, even though there was a higher tax collection against other products. Is that your understanding?

Mr Watson—That would be one of the reasons why people would, yes. I do not disagree with Mr Worthington's figures at all. I have not checked them but, just looking at the overall results, they appear reasonable to me as an actuary and they are certainly explainable.

ACTING CHAIR—Is it the wish of the committee to accept the Draft Superannuation Determination 2004/D1 as an exhibit to the inquiry? There being no objection, it is so ordered. I just have a couple of questions in relation to this. Item 5 says:

> ... an SMSF cannot provide a defined benefit pension, even if its governing rules allow for the payment of defined benefit pensions, if they do not set out the terms and conditions of the defined benefit pension proposed to be paid.

Does that meet the standard off-the-shelf trust deed, or does it go beyond it?

Mr Watson—In my opinion, it goes far beyond it. My understanding of the tax office's view on this is that they would consider that the deed needs to set out the indexation rate, the person receiving it, who the reversionary is and how much the pension is going to be et cetera. For most retirees the trust deeds reflect the requirements of the existing law, which is framed in terms of the pension being indexed between certain amounts and sets out the general terms and conditions. It is not until the person actually gets to retirement that they decide the level of pension and the exact terms, and it is set at that point. As that determination stands there would be very few trust deeds that meet that, other than defined benefit corporate funds where the employee entitlements have to be prescribed in the trust deed specifically so that when the employee commences employment they know exactly what the terms and arrangements are when they cease with the employer.

ACTING CHAIR—What were the other surprises for you in this determination?

Mr Watson—I am very concerned—I do not know that I am surprised given what happened on 11 May as part of budget night; probably nothing surprises me at the moment in that respect—about how strict the interpretation is being taken.

ACTING CHAIR—Is that in regard to the definition of paying a pension in a trust deed? Are you referring to the strictness of that?

Mr Watson—The strictness of the ATO's interpretation. I do not have a copy of it in front of me, but that interpretation in my experience basically means that anybody beyond 30 June next year, regardless of whether they have had a trust deed and have been running in accumulation mode for 12 months, 10 years or for however long, will not be able to commence a defined benefit pension. It is regardless of whether they started

their fund five years ago with the view that they are coming up to retirement and that is how they want to take it.

Senator CHAPMAN—Even if they commence it prior to that, they run the danger of never being able to reduce it to counter market conditions.

Mr Watson—Correct. We have clients who have been running these things long before social security entitlements ever came in. We have some clients who have been running them since 1994-95. After next year, for instance, if they have invested in shares and the stock market crashes and we assess it and say, 'What you have now actually doesn't look like it is going to support you for the rest of your life. You actually need to restructure it,' that determination is saying, 'Tough luck, boys, you need to liquidate your assets and get out of the funds because you cannot restart your pension.' This is extremely retrospective and unfair.

Senator SHERRY—So it can affect people who have already retired who may need to restructure their defined benefit fund if something serious happens?

Mr Watson—Correct. The last example in that determination talks about somebody starting now and needing to do some sort of restructure in five years time. The ATO have left no doubt about their intentions given the wording of that last example—no doubt all.

ACTING CHAIR—Thank you very much—that was a very coherent explanation. Well done.

[2.51 p.m.]

BURT, Mr Michael Donald, Actuary, Australian Government Actuary

MARTIN, Mr Peter, Australian Government Actuary, Australian Government Actuary

HANSCOMBE, Mr Mathew, Director, Government Initiatives, Australian Taxation Office

NICHOLSON, Ms Tracey, Assistant Commissioner, Superannuation, Australian Taxation Office

COLES, Mr Tony, Manager, Superannuation, Retirement and Savings Division, Department of the Treasury

LEJINS, Ms Erica Noble, Senior Adviser, Superannuation, Retirement and Savings Division, Department of the Treasury

THOMAS, Mr Trevor John, General Manager, Superannuation, Retirement and Savings Division, Department of the Treasury

ACTING CHAIR—Welcome. We invite you to comment on matters that have been raised in the submissions or on matters raised during the proceedings today.

Senator SHERRY—Do you have a written submission?

Mr Thomas—We do not have a written submission. However, I have a statement that I would like to make to the subcommittee. I would certainly be happy to give that electronically to Hansard to assist the subcommittee.

ACTING CHAIR—That would be helpful, but we would still like your comments. We would like your prepared statement and we would also like you to comment on matters that have been raised today.

Mr Thomas—Thank you very much for the opportunity to appear before the subcommittee. In this opening statement I would like to address a number of issues—namely, how the arrangement works and how it allowed taxation, estate planning and social security benefits beyond that anticipated by parliament; policy concerns about the ability of small funds being able to pay a defined benefit pension on an ongoing basis; promotion of the arrangement, including some analysis of numbers of people participating in the arrangement and estimates of the revenue at risk; and, finally, the manner of addressing the arrangement, including how the regulations should be interpreted and my perspective on some of the other possible solutions presented by industry.

Firstly, from a layperson's perspective this is a rather complicated arrangement, as it involves the integration of taxation, superannuation and social security laws as well as actuarial valuation of a range of factors, including the assessment of investments held by the fund, future returns, pension payments and so forth. As it is not a simple arrangement, it is highly likely that a trustee of a fund would probably be required to seek, consider and then resolve to accept professional advice before the arrangement could be fully implemented. There are a number of elements to the taxation issue and pension access associated with this arrangement.

Senator CHAPMAN—Could you tell me what you mean by 'the arrangement'?

Mr Thomas—'The arrangement' is essentially the defined benefit pension that the principal regulations act in relation to. The first of these elements involves what the industry calls RBL compression—that is, compressing the amount of benefit which is counted so that it falls below the member's reasonable benefit limit. In relation to pensions, benefits below the reasonable benefit limit receive a full pension rebate. The degree to which the member's benefits exceed the RBL result in a proportionate reduction in the rebate. For example, I am aware of one instance where benefits of approximately $18 million, involving $10 million of taxable contributions, were brought under the pension reasonable benefit limit and therefore the member was entitled to the full pension rebate.

Central to the application of this arrangement is the use of the formula contained in section 140ZO of the Income Tax Assessment Act 1936. The tax purpose of the formula is to derive the capital value of the superannuation pension. The goal of the arrangement is to minimise the capital value of the pension as far as possible. This is achieved through the minimisation of the annual value of the pension and the inclusion of, in effect, undeducted contributions. To set the scene, the formula prescribes that the capital value of a superannuation pension is determined by the annual value multiplied by the pension valuation factor less the undeducted purchase price, to which is added the residual capital value.

I will take each of those elements in turn. The annual value means the sum of the pension payments to be made in the course of the first year of the pension. For the purpose of the arrangement, the annual value of the pension can, in the words of one superannuation lawyer, ‘be made to be a movable feast, depending on the design of the pension’. Matters such as whether there is a reversion, the level of risk and profitability, asset allocation and deemed earnings rates will have a big impact on the amount ascertained by the actuary to be the first year’s pension.

The pension valuation factor is determined by reference to schedule 1B as set out in the SI(S) regulations. The capital value of the pension can be reduced further, again in the words of the superannuation lawyer, ‘through the judicious use of undeducted contributions’. This can result in the capital value of the pension being zero for RBL purposes. For completeness, the residual capital value of complying pensions will always be zero, and I will explain why shortly.

The capital value of the pension is used to calculate the RBL amount of the pension, which is then used to determine whether or the degree to which the benefit is excessive. In theory, the proportion of a member’s benefit that is determined to be in excess of the RBL results in a reduction in the member’s entitlement to the pension rebate. Essentially, therefore, designers have considerable flexibility to adjust the annual value element and/or the undeducted purchase price to minimise or eliminate any excess amount and gain access to the full pension rebate. I reiterate that the inappropriate use of the arrangement has resulted in benefits in excess of $10 million of taxable contributions being brought under the pension RBL and therefore being eligible to receive the full 15 per cent rebate.

It is also presently possible that an individual with up to $2.4 million in assets wholly held within a complying superannuation pension would be eligible to obtain the aged pension benefits. I note, of course, that the government has acted to address this, and so new asset test exemption rules will apply from 20 September. While there may be some debate as to at what point a person becomes wealthy, we need to remember that average income is approximately $49,000 and median income approximately $37,000 per annum.

I now come to the other significant tax and retirement income policy issue associated with the improper use of the defined benefit pension arrangement, and that is estate planning. Often characterised as intergenerational wealth transfer, the arrangement can make use of low pension payments, plus the concessional tax treatment of pension assets, to grow and retain superannuation benefits that may never be used to fund a retirement income. I offer an example presented by an actuary to a conference. The example related to a male aged 65 with $2 million in assets inside his fund. The member elected to take a complying life pension and an allocated pension, with minimum drawdown. The actuary estimated that the projected assets of the fund, despite the drawdown of pension income, would grow from the initial $2 million to $4.9 million over 30 years. It is assumed this is in nominal terms.

Senator CHAPMAN—That is not real terms?

Mr Thomas—No, nominal terms. This is achieved through the individual’s eligibility for the full age pension rebate, plus the concessional tax treatment of assets supporting a pension. Benefits used to support a pension are generally exempt from tax on the earnings.

For a fund to obtain this exemption, an actuary needs to certify that a certain amount or a certain proportion of the fund’s assets—depending on whether or not the assets are segregated—are current pension liabilities. Where the assets are unsegregated, the ATO has produced an advisory note indicating that actuaries should use their best estimate to determine the amount of assets in the fund that are exempt from income tax. This would be expected to result in around 80 per cent of the fund’s assets being exempt from taxation. However, the best-estimate requirement still provides the actuary with some latitude as to how much of the fund’s assets should be exempt from taxation.

It has been argued in some submissions that it is not a bad thing that the use of conservative estimates by an actuary, depending on the person’s longevity, could result in a large amount of assets remaining in the fund after the member dies. After all, the money will eventually be paid out as superannuation benefits to another fund member. The problem is that this may be 30 or more years later and in the meantime it will have continued in a low-tax environment. It is hard to see how ordinary taxpayers are getting value for money for the tax forgone when the original benefit was being accumulated. Indeed, the policy intent is clearly shown by the legislative requirement that complying pensions have no residual capital value—that is, ideally there should not be any assets left once the term of the pension has been completed.

The ability for small funds to effectively provide a residual capital value is perhaps one of the central reasons why a small fund is preferred by wealthy individuals over the arms-length fund. The small fund provides the trustee member with certainty that the assets can be passed on after their death and, depending on the fund membership, left to flourish in a highly concessionally taxed regime for what could be a very long period. In arms-length arrangements, any assets remaining will be used to support the overall pool of benefits to other members—that is, the organisation has provided a guarantee that payments will be made for life, so any remaining assets will be used to ensure that the pension entitlements of the other members will be met. Of course, the owners of such organisations also need to be confident that the fund will not fail because of the promise it provides, but it must also be accepted that the pooling arrangement will provide certainty that the member's pension entitlement will be met in full even in periods of poor investment returns.

I now want to turn from the tax and estate planning outcomes for high-wealth individuals to the other fundamental consideration of the government in deciding on these regulations. This is, of course, the inability of small funds to guarantee the payment of benefits on an ongoing basis. A defined benefit pension is, almost by definition, an entitlement to an income stream where the characteristics are established on creation and where the payment is guaranteed for the term of the pension. In relation to small superannuation funds, there are three key concerns about the ability of these funds to guarantee such pension entitlements. The first is the lack of an employer sponsor or other intermediary, the second is the lack of risk pooling and the third relates to the management of investment risks. The lack of an employer sponsor or other intermediary, such as a life company, clearly means that there is no-one who is obligated to contribute extra money if the fund experiences a period of poor investment returns to the extent that it may jeopardise member entitlements.

Even though these pensions have been provided by small funds for only a few years, the Australian Government Actuary is aware of a number of instances where the fund actuary has not been able to certify to its solvency. This has resulted in the pension having to be restructured with lower payments, throwing into question the whole basis on which it was designed in the first place. This has occurred even though investment returns have not been significantly abnormal on an historical basis. There have been no instances where this has occurred in institutional funds.

A major concern, particularly with lifetime pensions, is the lack of risk pooling, especially mortality risk. A pension for an individual may be paid for a day or far beyond their life expectancy. Consequently there is bound to be too much money in the fund or not enough. In the larger pooled arrangement, there is greater certainty that the deaths will occur in a more structured manner. This enables a closer estimation of future benefit liabilities. As identified earlier, the unused entitlements of shorter-lived members can be used to ensure the benefits of longer-lived members. The government's view, based on actuarial advice, is that at least 50 members are necessary to provide sufficient pooling to offset mortality, liquidity and investment risks. In a similar vein, a larger number of members can provide a greater diversification of investment choice to ameliorate the risks of poor returns. In small funds there have certainly been instances where there has been too great a concentration of investments into a single investment class or even a single investment itself. Even a small fund with a readily diversified investment strategy can become unviable in an extended period of poor investment returns.

While it may be possible to address these risks by maintaining high investment reserves, this is likely to result in the payment of a much lower income stream. The pension would almost certainly be less than that payable from a commercial provider for the same purchase price for the same level of guaranteed payment. It would also provide a great opportunity for significant estate planning, as I have highlighted earlier. In essence, the conceptual basis of the current policy framework provides that a small fund be allowed to pay a complying pension providing a guaranteed income for a variable period or a variable income for a guaranteed period as per the new market linked income stream. Small funds are not sufficiently equipped to provide a reasonable amount of guaranteed income for an indefinite but guaranteed period. The review announced by the government will consider whether a new conceptual framework can be designed to allow a small fund to provide a defined benefit pension in a manner that is not detrimental to the integrity of the retirement income and tax system. The decision by the government to introduce these regulations was also taken with the knowledge that the new market linked income product would be available to small funds and provide many of the benefits of defined benefit pensions without the significant tax and estate planning outcomes.

Turning to the promotion of the arrangement and the estimation of revenue at risk, this arrangement was the subject of increasing promotion in the superannuation and financial planning industry. The benefits which could be obtained were regularly included in the conference programs of lawyers, financial planners and accountants in the last few years. A simple search on the Internet using the term 'RBL strategies' or 'defined

benefit pension' provides a great number of examples of how the arrangement works. Links are made to law firms specialising in superannuation, to accounting and financial planning companies and to newspaper articles. Industry contacts were also telling us of the increasing promotion of the arrangement. I note from the recent Senate committee hearing that Senator Murray indicated the arrangement was also widespread on late-night television. Clearly the arrangement was likely to become much more popular with higher wealth individuals. In that regard I note that most small superannuation funds are currently in the accumulation stage rather than the benefit payment phase, where the cost to revenue could be expected to have been significant.

The government has acted early to stop the spread of an arrangement that was promoted to obtain benefits beyond that which the ordinary person could consider reasonable. The ATO recently undertook a survey of RBL reporting by funds and it is estimated that up to about seven per cent of self-managed superannuation funds are paying a pension. Of this seven per cent, it is estimated that approximately 40 per cent are paying a defined benefit pension. These figures have to be treated with some caution at this stage. The ATO will undertake further compliance work to obtain better results. I also understand that Centrelink has approximately 3,000 customers who are receiving a defined benefit pension from a self-managed superannuation fund and who are in receipt of age pension benefits. Their experience indicates that up to about 50 people a month with these types of benefits are seeking to become Centrelink customers. They also indicated an increasing trend in the applications to obtain age pension benefits.

While these figures only represent a small number of people, the government was concerned that the promotion of the arrangement, tied with the increase in the number of retirees and account balances, would over time create a significant risk to revenue. Of course, as I have discussed, access to the age pension is only one of the reasons this arrangement would be entered into. In relation to RBL compression, it is very difficult to estimate the number of people who have engaged in this practice. Superannuation account balances are not reported to the ATO, although some information on withdrawal benefits will become available following changes to fund reporting from the co-contribution arrangements.

In relation to tax collected, ATO data does not currently allow separate identification of, for example, the amount of tax collected from excess benefits. Consequently, no useful data can be extracted at the present time. I understand that, say, for a lifetime pension the RBL reporting to the ATO would only be after the trustee had determined the annual value of the pension. The ATO data, therefore, would only reflect post-arrangement circumstances. In the absence of account balance information, the ATO has no way of establishing the extent of RBL compression and hence the potential revenue lost. The ATO has begun a program of compliance activity in relation to self-managed superannuation funds, including the benchmarking of RBL reporting. This activity is in its early phase and no definitive results can be concluded yet.

Analysis by the Australian Government Actuary also indicates the relative Commonwealth support this arrangement, including through both tax and age pension, provides over other pension products. The analysis compares the outcomes of the arrangement with an allocated pension and a market linked income stream. The analysis indicates that the arrangement provides significant tax and age pension advantages compared to these other products, as shown by lower taxable income during the life of the pension and higher account balances in later years of the pension. For example, with an initial income stream and a purchase price of $2.5 million, the lifetime pension provides a taxable income in year 1 of $24,000, whereas allocated and market linked income streams provide an income of $38,000 and $35,000 respectively. Deferral of taxable income is reflected in the account balance size. For example, a male aged 90—in the other words, who has been in the product for 25 years—would have account balances for an allocated pension of around $168,000, a growth pension of around $235,000 and a defined benefit pension of around $815,000. That $815,000 is more than three times the amount for the growth pension and about five times the amount for the allocated pension.

Senator SHERRY—Before you go on, I would like to clarify that. Is that based on $2.5 million?

Mr Thomas—That is based on an initial account balance of $2.5 million. So the $2.5 million has gone down to $815,000 after 25 years.

Senator SHERRY—Did you do figures for $250,000, half a million dollars and a million dollars?

Mr Thomas—We did figures for $600,000. That was the lowest figure.

Mr Burt—That is wrong. That is based on $600,000.

Mr Thomas—That is based on $600,000; I am sorry.

Mr Burt—That 2.5 is a typo.

Mr Thomas—Okay. I am being corrected. That is with an initial balance of $600,000. For an allocated pension, the amount has gone down to $168,000 and for a growth pension it has gone down to $235,000. For the defined benefit pension the amount in the fund has increased to $815,000.

Senator CHAPMAN—Is that in real terms or nominal terms?

Mr Martin—In nominal terms.

Senator CHAPMAN—So it would still be a real decline.

Mr Thomas—Yes, certainly, but it is a very significant amount.

Senator CHAPMAN—We do not know. You are talking 25 years hence.

Mr Thomas—Compared to the other two products—

Senator CHAPMAN—But in real terms it may not be a significant amount in 25 years time.

Mr Thomas—What we are talking about here is the impact of this product compared to the others in terms of the benefits that can be obtained for not using the tax concessions that are being provided for the accumulation of superannuation assets during the lifetime of that person.

Mr Burt—Can I just make another minor correction?

ACTING CHAIR—Sure.

Mr Burt—There is a figure that should be '91', by the looks of things, rather than '90'. It looks like another typo, another gremlin, has got into the system.

Senator SHERRY—What does this 'typo' refer to?

Mr Coles—The age of the male.

Mr Burt—How can I express this? The projections assume the income is taken at the end of the year. So this is at the end of the male's 90th year—effectively, just before the year turns over and he becomes 91. So really it is 91 rather than 90, or I can express it as 90 years and 364 days.

Senator SHERRY—I am sure the difference would be readily apparent.

Mr Thomas—The main point of that was to indicate that the difference in the outcome was after 25 years of taking that particular product. I will turn now to how the government addressed the arrangement. As evidenced from this discussion, the government was clearly concerned that small funds were providing unintended tax, estate planning and social security benefits. The government was also clearly concerned about the likelihood of small funds meeting their pension commitments into the future. With this in mind, regulations were gazetted in May that inserted a new division in part 9 of SIS to restrict when a small superannuation fund can provide a defined benefit pension. In summary, no new small superannuation fund will be able to offer a defined benefit pension. Secondly, the regulations provided that a small superannuation fund may continue to provide such a pension, as long as it did not need to amend its governing rules to provide for the pension. As a matter of course, the responsibility for the interpretation and administration of the laws, having been implemented, falls to the regulators.

ACTING CHAIR—Do they continue to pay a defined benefit pension, even if their numbers fall under 50?

Mr Coles—Yes.

ACTING CHAIR—So long as you do not have to alter your deed?

Ms Lejins—That is correct, or so long as you do not amend other governing rules that may be outside the deed.

ACTING CHAIR—So you can continue so long as you do not amend your deed in terms of the governing rules. Is that in relation to this aspect or any other aspect?

Mr Coles—We will be coming to this explanation shortly and that might help you.

ACTING CHAIR—Thank you.

Senator SHERRY—I am glad you have extra time, because we are half an hour in and we have nothing in writing. It is making it all very difficult for us.

ACTING CHAIR—Please continue.

Mr Thomas—As explained in the explanatory statement, the new division will not prevent a defined benefit pension being paid by an existing superannuation fund where the governing rules of that fund set out

the terms and conditions of the pension prior to the commencement of these regulations. If, however, the governing rules of an existing superannuation fund are amended in relation to that pension, the new division will apply. The term 'governing rules' as defined in section 10 of the SI(S) Act, in relation to a fund, scheme or trust, means:

(a) any rules contained in a trust instrument, other document or legislation, or combination of them; or

(b) any unwritten rules;

governing the establishment or operation of the fund, scheme or trust.

A trustee could not begin to pay a pension until it has considered and made a decision about the type of pension to be provided and what would be the key desired characteristics of the pension. Until this time, the trustee has a quantum of assets under its control, with an intention to pay a pension. For example, there are generally four types of pensions that may be paid from a fund: a complying or noncomplying life pension or a complying or noncomplying term pension, including pensions such as the new market linked income stream and allocated pensions. The trustee would then need to establish the terms under which the pension would be paid, such as the relative size of the payment, as well as if and to what extent it would be indexed, when to pay it, for how long to pay the benefits and so on. Clearly, the payment of the pension establishes an obligation that governs the operation of the fund.

An alternative interpretation of the relative provisions would allow for the grandfathering of all funds in existence as at 12 May 2004. This is because the definition of 'governing rules' would include the SIS rules prescribing the rights to pay a pension. Such an interpretation, however, fails because of redundancy. Paragraph 9.04F(1)(a) already establishes that new funds cannot provide a defined benefit pension. Clearly the government intended that paragraph 9.04F(1)(b) must have some purpose. That purpose is to ensure that, where the terms and conditions were not established for the payment of a pension as at 11 May 2004, the trustee cannot begin to pay that pension.

It is important to recognise that the explanatory statement to the regulations specifically identifies that the regulators have the power to exempt or modify compliance with the regulations on an individual or class basis to deal with particular fund circumstances. Without restricting the regulator, this allows for the regulator to address the needs of superannuation fund trustees where they can show their legitimate arrangements were caught by the regulatory changes. The trustee would need to be able to provide evidence that the arrangement does not offend the policy rationale for the regulations.

I would now like to briefly comment on a number of suggestions proposed by industry. Firstly, it has been proposed that a simple amendment be made to the RBL formula so that the amount of taxable contributions made to the fund form the basis of determining the purchase price of the pension. Without prejudicing the review, I should indicate that this proposal is unlikely to resolve the issue of inappropriate estate planning, nor would it solve the fundamental concerns about the sustainability of small funds providing a guaranteed benefit. It has also been proposed that concerns about the use of defined benefit pensions could be resolved—

ACTING CHAIR—Just a minute—regarding the second part, it was not designed to do that. It was designed only to overcome the compression problem.

Mr Thomas—The second part?

ACTING CHAIR—That is my understanding of it, so it would be better if you did not try and extend the thing to something it was never intended to cover. When that view was first put forward to us, it was only designed, to my thinking, to overcome the compression problem. Now you are talking about sustainability. It had nothing to do with sustainability; it was only designed as a change to overcome compression. Am I right?

Mr Coles—Can you be a little clearer as to what you mean by the 'second part'?

Senator SHERRY—You have added a second ground—that of sustainability.

Mr Coles—I think the government was clear that there were also concerns—

Senator SHERRY—Was that in the initial press release?

Mr Coles—about the prudential arrangements. 'Prudential arrangement' means the ability to pay a fund over a set period of time to ensure the certainty of that payment. Our understanding is that it includes the certainty that that pension is going to be paid.

Senator SHERRY—Do we have a copy of the original press release?

ACTING CHAIR—I think you are adding a dimension that industry certainly was not envisaging when it was talking about changing the basis to overcome the reasonable benefit limit problem—that of compression.

Mr Coles—I do not have the original press release here.

Mr Thomas—I will take that on notice and come back to you on that. I am happy to do it.

Senator SHERRY—I am sure we can check.

ACTING CHAIR—Please continue.

Mr Thomas—It has also been proposed that concerns about the use of defined benefit pensions could be resolved by updating the pension valuation factors. While I acknowledge that these factors are somewhat dated, I note that they are also used to value lifetime pensions provided by large public sector and corporate funds. A change to these factors could have a significant impact on a much wider range of people than the membership of smaller funds. This issue would need to be carefully considered before any amendment could be made.

In summary, the government has acted to address a range of concerns that have the potential to undermine the integrity of the retirement income system. It has acted before the proliferation of the arrangements would have given rise to significant revenue risks. The government has clearly indicated that it will work constructively with interested parties to provide viable pension choices to retirees in a manner that meets their needs while addressing the concerns which have been highlighted. Clearly this will involve an examination of the conceptual basis underpinning the policy framework for the provision of pensions by small superannuation funds.

ACTING CHAIR—Could you give us the income profile—

Senator SHERRY—Chair, may I deal with a couple of preliminarily matters before we get to the detail. Mr Thomas, I note you took about 40 minutes for your address. I respect the right of a witness, particularly the tax office, to respond to submissions we heard earlier in the day, and I accept that that can only be done in the form you have just used, but I am concerned that the bulk of your submission could have been given to us in writing—as much as it contains new information—so we could have had it in front of us in order to ask a questions. I am not a fool; I have been around this game a while, and I know that if you have documents in front of you you can work out a few questions before witnesses give evidence. If we cannot ask questions based on what you have said because we do not have the documentation, we will ask them on another day. That is the reality of the place.

Mr Thomas—I am perfectly happy if you ask questions.

Senator SHERRY—On another day?

Mr Thomas—Any time you like.

Senator SHERRY—Good. I am glad we got that out of the way. It is not a very satisfactory process that we have just been through. The other issue is for Mr Hanscombe. What is ‘Director, Government Initiatives’? Is this a new position? I have not seen the description before.

Mrs Nicholson—Mathew works in the tax office for me, looking after the implementation of our new measures. His role is looking after newly enacted government legislation.

Senator SHERRY—Is it a new position? There is always new government legislation.

Mrs Nicholson—I think we have just changed the name recently.

Mr Hanscombe—I think used to be called ‘new measures’.

Senator SHERRY—I am just trying to ascertain where you slot into the picture. Thank you.

ACTING CHAIR—Mr Thomas, could you give us the income profiles of defined benefits pensioners accessing Centrelink benefits? You gave some quite significant numbers, but that does not necessarily mean they are all high-wealth income earners; they might be people in receipt of defined benefit pensions of $2,000 or $5,000. Unless we have the income profiles, I do not think your numbers have helped me. Can you give us the income profiles of those people who are on defined benefit pension accessing Centrelink benefits—we need to have a classification. You can take it on notice.

Mrs Nicholson—We wonder whether somebody from Family and Community Services might be able to help with that question.

ACTING CHAIR—Is there somebody from Family and Community Services here?

Mr Coles—There is a representative from the Department of Family and Community Services here.

ACTING CHAIR—Are they able to give us that breakdown?

Mr Coles—Not at the moment.

ACTING CHAIR—Could you take it on notice?

Senator SHERRY—Is this data we are referring to at the moment—there is some other data as well—new? Has it been given to industry organisations prior to today's hearing?

Mr Thomas—I am not aware of it being so given.

ACTING CHAIR—Can you take it on notice? What is the rationale for treating, say, a five-year fixed term pension in a manner identical to a lifetime defined benefit pension?

Mr Coles—By that, do you mean: why is it receiving a pension rebate?

ACTING CHAIR—No, my question is: why do you treat a five-year fixed term pension in an identical manner to a lifetime defined benefit pension?

Mr Coles—It will have a different RBL treatment depending on the life expectancy of the individual at the time. If they are turning 65, or 60 perhaps, that treatment would be as for a non-complying pension and would therefore be treated against the lower RBL and would be included in the concessional asset test treatment for the age pension. A life pension is paid for the lifetime of that member and is therefore treated differently in the sense that it will have the more concessional treatment for the pension RBL and also provide for the higher social security benefits.

Ms Lejins—Could I also add that the five-year, fixed term pension is valued using a different methodology to the lifetime pension for RBL purposes.

ACTING CHAIR—It uses different methodology? Why exclude them both? I have some sympathy in relation to the defined benefit pension—I accept that, as such—but I have trouble identifying that in terms of its treatment or exclusion from, say, a fixed term pension or annuity for five years. You might like to take that on notice.

Mr Coles—I hope I understand you.

Mr Burt—I am nonplussed, I would have to say. I am not quite certain of the point of your question. From looking around the table, I would say that everyone is looking rather flummoxed as well.

Senator CHAPMAN—Far be it from me to try and interpret what Senator Watson was saying, but I suspect that he was saying that one of the arguments you have put up against the defined benefit pension is the prudential argument—in other words, how you assess the long-term capacity of a do-it-yourself fund to pay that pension—

ACTING CHAIR—True.

Senator CHAPMAN—and yet you are treating a five-year, fixed term pension in exactly the same way. Surely a do-it-yourself pension would have no problems with prudential requirements in relation to a five-year, fixed rate pension, and yet, as Senator Watson says, you treat them in exactly the same way.

Mr Burt—Not necessarily, Senator—you are all senators—

Senator SHERRY—What do you mean by that?

Mr Burt—'Not necessarily.' If you are superannuation fund and you say, 'I will pay the only member of the fund $10,000 per year,' that would be fine. If you went along to a bank and they said, 'We can give you a whole series of term deposits—one for five years, one for four years, one for three years, one for two years and one for one year—each paying $10,000, you virtually have 100 per cent certainty that that five-year term pension will be paid. But if you buy, say, $50,000 worth of equities, you may or may not be able to pay those five years worth of $10,000 payments because you might go out and buy $50,000 worth of equities and the market might halve tomorrow and not recover by the end of the five years. That is why I am saying that five—

Senator CHAPMAN—This is getting a bit granny-state-ish isn't it?

Mr Burt—No. It is true.

Senator CHAPMAN—Surely people have to take some responsibility for their own investments and the management of them, if they choose to do so.

Mr Burt—That is precisely the point.

Senator CHAPMAN—You are not letting them have that option. You just want them to go into some big, managed fund and have that responsibility taken away from them, even if they choose to have that responsibility themselves.

ACTING CHAIR—Let me put my question in another way. Where is the merit in excluding fixed term pensions where there is no RBL compression?

Mr Coles—What we are talking about there is that these arrangements do provide significant—

ACTING CHAIR—No, that does not answer my question.

Mr Coles—I have not got to your question.

Senator SHERRY—He is anticipating you well! I am thinking the same thing that Senator Watson is thinking, before he has said it and before you have said it, too.

Mr Coles—I might just think then!

Senator SHERRY—That is not recorded in *Hansard*, unfortunately. I would love to read what you are thinking in *Hansard*. It would be very interesting.

ACTING CHAIR—Where is the merit in excluding fixed term pensions where there is no RBL compression?

Mr Coles—A fixed term pension provides a great opportunity for providing residual capital value. That means that the assets have been used to provide an income. Also, the concessional tax treatment associated with payment of the pension—in that about 80 per cent of them put it aside tax free, because they are supporting the pension, and that is going to be dependent upon how the actuary values those assets—provides an opportunity for wealth accumulation and intergenerational fund transfer so that benefits are not being fully utilised to pay the pension of the retiree. The assets can be there and can be used to provide benefits and intergenerational wealth transfer to children and so forth.

Senator SHERRY—We are against intergenerational wealth transfer, are we? Even the Labor Party would not be that adventurous, but you are.

Mr Coles—I actually think that it was the Labor Party that helped develop these rules in first place.

Senator SHERRY—I was going to get to that. You say that there is great opportunity. If you die early—let us say that you die after five years—and the defined benefit is worked out actuarially to run for 30 years, obviously there is going to be a residual value. But you would hardly describe a person dying early as a ‘great opportunity’, would you? Is that what you are seriously suggesting?

Mr Thomas—What we are saying is that this product provides a disproportionate benefit compared to alternative products.

Senator SHERRY—How do you get around a person dying early? Actuarially you can work out an average but if a person drops dead the money is there and it stays in the trust. Is that unreasonable?

Mr Thomas—A balance has to be struck between the use that is being made of the taxation concessions that are made available for the accumulation of superannuation assets and the purpose of those concessions, which is for the expectation that they will be used to provide income for the person in retirement. Clearly, if the person dies early then that is not going to happen. The whole basis of a lifetime pension arrangement is that nobody is going to die on exactly the average. People are going to die before or they are going to die after.

Mr Coles—We can also make the point that under the present rules, depending on the arrangement for the pension structure, if the person dies they could get back the money under the 10-year guarantee period. That guarantee period has now been increased to life expectancy, so they are able to get back the moneys.

Senator SHERRY—This person is dead but they can get their money back—

Mr Coles—Their estate or their dependants can.

Senator SHERRY—Yes. So that is 15 years now, is it?

Mr Coles—It is up to the life expectancy—

Senator SHERRY—What is that at the moment?

Mr Coles—It depends on the person at the time.

Senator CHAPMAN—You are making a lot of your claim of the tax concessions in relation to accumulating superannuation. If there is a tax mischief being perpetrated through these schemes, it is in

relation to people who really have not had a big concession. To accumulate the sorts of amounts you are talking about at least for the last seven or eight years these people are going to have been paying the surcharge so they have been paying 30 per cent on the way in. If they stay at the RBL they will pay over 33 per cent on the way out so they are already paying over 63 per cent in tax on these funds compared with a normal marginal tax rate of about 48 per cent. If they go over the RBL, they are going to be paying something in the order of 78 per cent on the corpus of the fund compared with the marginal tax rate. It is not much of a concession. It may be that they perceive it as an unfair tax situation and that is leading to some of this mischief if it is occurring.

Ms Lejins—A payment of a death benefit ETP lump sum is tax free to a dependant up to the deceased’s reported RBLs, so it is not taxed.

Mr Coles—I cannot quite work out your numbers on this, Senator. I do not think that it is possible to start adding up the tax arrangements at 15 per cent, 15 per cent, plus 38 per cent and so forth. The system does not quite work that way.

Senator CHAPMAN—Thirty per cent comes out at the beginning when you put the money in.

Mr Coles—I do not think that is correct.

Mr Thomas—There is a nominal 30 per cent, but it is less than that because it is based on fund taxation which is also reduced by credits and that sort of thing. It would be an absolute maximum of 30 per cent if they were subject to the surcharge. It is less now because the surcharge is going down to 10 per cent—

Senator CHAPMAN—It was up until recently.

Mr Thomas—If they have paid that upfront, then the rebate is available at the end. So that offsets half of that tax upfront. There is concessionality right through the system. The degree of benefit that people can extract out of this arrangement also depends on the extent to which they use undeducted contributions. That could come from other sources, not through wage and salary earnings. It could be through bequests or other things as well. So there are all sorts of opportunities to increase the concessionality—

Senator CHAPMAN—The second issue you raise was estate planning, where I assume from what you were saying people seek to take a lower rate of pension, and therefore a lower income, to leave a larger capital sum. It seems to me that that is a pretty complicated arrangement. You would be far better off to leave your funds outside of superannuation and just borrow against them. You would be far better off in capital terms at the end of that than you would be by doing it through a superannuation structure.

Mr Coles—I do not think so—

Senator CHAPMAN—I think you would be.

Mr Coles—Essentially you are paying tax at the marginal rate outside the superannuation system.

Senator CHAPMAN—Not if you borrow. You are getting a deduction for your borrowings. So if that is the mischief you wanted to achieve, it would be far better to do it outside super—borrow and reduce your income that way, and you have a far larger corpus which is increasing in value.

ACTING CHAIR—You might like to ponder that one. Not all members of a fund have to be in pension mode in terms of the 50 numbers. Is that right?

Ms Lejins—Are you talking about the numbers for the defined benefit fund rule or the pension rules?

ACTING CHAIR—The new 50-member rule. Not all of them have to be in pension mode.

Ms Lejins—In terms of the 50-member limit for the defined benefit fund rules, you must have 50 defined benefit members. For the pension rules, you must have 50 members, and they do not necessarily need to be in the pension mode.

ACTING CHAIR—They do not have to be in pension mode.

Ms Lejins—Not for the pension members.

ACTING CHAIR—But they have to have the option of being able to take a pension.

Mr Coles—That is correct.

ACTING CHAIR—So you have to have 50 people who have an entitlement, if they wish, to take a pension but who may not be in pension mode at the moment.

Mr Coles—They have to have 50 members in the fund. Very few funds—I would be very surprised if it were any funds—would prescribe against the payment of pensions, and if you consider the governing rules of

the fund and the definition of 'governing rules' they include other legislative rights, so, in effect, all members of the fund are able to take a pension.

ACTING CHAIR—That is exactly what I said. My question is: how is a fund any more secure if it has 49 members in accumulation mode and one in pension mode? Perhaps you might like to take that on notice.

Ms Lejins—In terms of the restrictions on defined benefit funds, the 50-member rule for that restriction imposes a threshold of 50 defined benefit members. They are the funds that provide a guaranteed benefit, a defined benefit. But for the pension funds, it is possible to have 45 accumulation members. However, you obviously have a greater pooling of your risk with that fund, because you have a greater number of members.

ACTING CHAIR—What about 49 members who have only been there six months? There wouldn't be much pooling there.

Mr Coles—One of the reasons why we have come to choose the 50-member limit is that it generally does provide that there is greater certainty of the payment of pensions. Generally, most 50-member funds would have—

ACTING CHAIR—You talk about generalities now. I am saying that we have a situation where you have an old, established person who is getting a pension and you have 49 relatively new members. How can you convince us, without talking about generality, that in that situation it is more secure? Take it on notice.

Mr Coles—No, I think that—

Senator SHERRY—I am waiting to be convinced.

Mr Burt—The situation is fairly complicated and would obviously depend on the terms of the trust deed concerned.

Senator SHERRY—Let us say it does say that.

Mr Burt—Okay. Let us assume we have 45 accumulation members—

ACTING CHAIR—Please stick to the example I have given.

Mr Burt—You said 45 accumulation members and five pensioners.

ACTING CHAIR—No, 49 and one.

Mr Burt—Okay, that is fine. Suppose the employer or the sponsor of the fund winds up and suppose that the trust deed says that any assets are divided equitably amongst all the members. Then effectively everybody gets their fair share. It could be that the reason the fund has got into trouble is because of the guarantee to the defined benefit member, the one pensioner. I know this is a very extreme example, but bear with me. What it means in that situation is that the pensioner does not suffer too badly. We will take an extreme example, that the stock market crashes by 90 per cent. It is very unrealistic again, but bear with me.

ACTING CHAIR—People are shaking their heads at the back of the room.

Mr Burt—I know they are shaking their heads, and I am being deliberately extreme here to illustrate a point. In that situation everybody loses equally but there is some chance that the pensioner will be protected. I am not arguing this very well at all. I will start again. Effectively if the pensioners suffer different experience from expected then in a winding-up situation the damage is less to those pensioners. That is actually why a 50-member fund is better than a one-member fund. In a one-member fund if something goes wrong the pensioner is 100 per cent affected. If you have 49 accumulation members and one pensioner, all 50 get affected but by a lesser proportion. You can argue whether that is fair or not but that is the rationale, I think. But it does depend on the terms of the trust deed.

ACTING CHAIR—I would be more convinced if you took it on notice. The next question is this. We were told this morning that under the regulation that we are looking at amounts have to be allocated to a member within 28 days. A witness said to us you can drive a horse and chariot through that one because you can nominate any number of people, such as spouses, within that 28 days. It does not cover the problem. So here we have a regulation through which we can drive a horse and chariot because it is not specific enough, it is not focused enough. All you say is that it has got to be allocated within 28 days.

Ms Lejins—The intention is that the person to whom—

ACTING CHAIR—I know what the intention might be, but the terms of the wording do not seem to have covered the defect that we are trying to remedy.

Mr Coles—That is the first time I have heard in my consultation with industry that anyone could drive a bus through the 28-day—

ACTING CHAIR—It was told to us in open forum today.

Senator SHERRY—A horse and chariot, not a bus.

ACTING CHAIR—Were you here when it was said?

Mr Coles—I was not, but there were representatives of Treasury and I understand—

ACTING CHAIR—It would help if representatives of the Treasury did sit through the presentations.

Mr Coles—Erica was here.

Ms Lejins—The person who is allocated the contribution is the person for whom a tax deduction must be claimed. I think the ATO actually confirmed that being the case.

Mr Hanscombe—We think that is effective. We have also heard people argue that the deductibility rules are ineffective for exactly the same reason, but we disagree with them and we are willing for them to challenge us in court.

ACTING CHAIR—Maybe that might be a matter that you might have to re-examine.

Mr Hanscombe—Whenever we raise it with people and we find real, live examples, they back down and will not take the matter on in court.

Senator SHERRY—Who have you been raising it with?

Mr Hanscombe—When we have found employers and funds and the employer argues that they do not have to claim deductions in relation to particular individual members and we have disputed that with them, they have always backed down. And it is exactly the same argument, only it is in a superannuation environment rather than a tax deduction provision environment.

ACTING CHAIR—I will have to hand over to Senator Sherry in a minute because of time constraints. How far have—

Senator SHERRY—I do not think that we should be constrained by time, Chair, in the sense that we—

ACTING CHAIR—I just want to give you a fair go, that is all.

Senator SHERRY—I have quite a lot of questions, and I think it is unfair to try and compress them into the limited time we have. I foreshadow perhaps another hearing. There are quite a few questions that you have put on notice, and I do not think that is a satisfactory way to proceed, particularly given the previous concerns I have expressed.

ACTING CHAIR—I will have one question, then I will move on to you. How far has the Treasury review of the defined benefit rules proceeded, particularly in relation to the 50-member rule?

Mr Coles—The government is still to finalise the terms of reference for the review, so I am not sure that I can comment on that to a great extent. The government has not identified the terms of that review. But clearly the review will take place; we will be consulting with a whole range of stakeholders and we will be responding to government by April. I cannot really go beyond that in respect of how far we have gone down the track. The government has not decided the terms of reference.

ACTING CHAIR—Okay.

Senator SHERRY—But this presents us with a major difficulty, because we have regulations that have the force of law, and we have this review that you have mentioned which is to report by 1 April next year—goodness knows what the terms of reference are; we will probably see them after the election, depending on who is in government. So what are people to do? The regulations are in force and the regulations may change next year, subject to this review that is reporting in April. What are they to do in this interim period?

Mr Coles—The law is in place—

Senator SHERRY—Yes, exactly.

Mr Coles—and the law will continue to be in place until and unless we disallow the law or the government—of whatever denomination—changes the law, so the only thing that we can say is that people should act in a law-abiding manner. I cannot answer your question beyond that.

Senator SHERRY—How is it satisfactory? You are complying with these regulations that may or may not be disallowed—I do not know—but you have a review to report back in April next year, which may change

aspects of the existing regulations. So if you happen to retire in the year, approximately, between the time when the regs were promulgated back in April or May, whenever it was, and this review in April next year, you may in fact be retiring under a different set of rules than that which may be in place from April next year. That is a possibility, isn't it?

Mr Coles—Under the current regulations, if you retire and you are a member of the fund as at 12 May, then you have a right to take a defined benefit pension. So those people will have the same opportunities as people had prior to the introduction of the regulations. The fact that the law may change will be based on consultation with a wide range of stakeholders—

Senator SHERRY—Yes, I understand that. That is the usual jargon; I would say the same if I were you: consultation et cetera. But the problem is that we have new law in place and it may change as a result of the consultative government and the review that is occurring.

Mr Thomas—There is always a legislative risk that anybody faces.

Senator SHERRY—So it is 'legislative risk'?

Mr Thomas—There is a legislative risk that anybody faces. There are transitional regulations in place that provide people who retire between now and 30 June with a right to take that type of pension. People can retire and take that type of pension. That is the certainty that the transitional regulations provide.

Senator SHERRY—This is not your fault; I do not blame Treasury per se or you as individuals. The fact is there is a new law and regulations, and five or six weeks later the government issues a press release saying, 'We'll review aspects of this.' That is where we are at, is it not?

Mr Thomas—Yes.

Senator SHERRY—And the regulations may change depending on the review and who is in government.

Mr Thomas—It might lead to new types of pension products being available—anything like that.

Senator SHERRY—There are a whole range of new possibilities.

Mr Thomas—Yes.

Senator SHERRY—So why would anybody retire?

Mr Thomas—You might have just had enough and decide it is time to retire.

Senator SHERRY—I am not surprised you have had enough with all this change going on. It is time to get out.

Mr Thomas—You basically make your choices from the options that are available to you at any point in time.

Senator SHERRY—Senator Watson has correctly directed me to ask questions. I want to touch on the fact that there are these regulations, we have a review and there is the possibility of more change to the advantage or disadvantage of people. That is a problem.

Mr Thomas—It is a problem that people face at any point in time. The law may change and there may be different rules.

Senator SHERRY—Are you suggesting this happens all the time—that there is an announcement, a crackdown and then the possibility the law may change a year later?

Mr Thomas—I could decide to work more this year and be paying higher income tax because tax cuts are going to be cut on 1 July next year.

Senator SHERRY—Are you seriously suggesting that, in a world where we would like a little certainty, it is good practice that the average punter is confronted with a change to the tax law which has gone through the parliament—it is now law; it is a regulation—and it possibly all changing again in April next year? Are you suggesting that is a good practice?

Mr Thomas—What I am saying is that, if somebody retires between now and 30 June, they know what their options are. They are the same options they had before budget night. It is no different for somebody retiring between now and 30 June next year than for somebody retiring before budget night. They had the same range of pension options available to them as the other person.

Senator SHERRY—I disagree with your argument. It was not one of the major points I was going to make, it was just one point. In the very limited time available, I want to sort out one of the arguments about sustainability. How long have we had small self-managed funds or DIY in this form?

Mr Thomas—Are you referring to the structure of a self-managed superannuation fund?

Senator SHERRY—In terms of them being able to offer a defined benefit, for example, how long has that existed? Just the approximate time; I am not going to hold you to any date.

Mr Coles—In 1998 modification declaration 23 was introduced which provided certain rules for the payment of defined benefit pensions and so forth. As you know, the superannuation industry supervision regulations allow for the creation of excluded superannuation funds. They are pretty much under the same guise as what is now known as self-managed superannuation funds. If you go back to 1993-94—and I would take advice from the actuaries on this as well—the view was perhaps that small funds would not be able to provide a defined benefit pension until the promotion of the arrangements following modification declaration 23.

Mr Burt—This has a lot of history attached to it. The history is so ancient that it even predates my time in Australia, so it was a long time ago.

Senator SHERRY—You are right on that, it would be a long time ago.

Mr Burt—I understand that some small funds were providing defined benefits and this relates to an old dodge which was basically along the lines that if you paid one pension payment and then commuted the amount—maybe the tax office can help me on this—you avoided paying what little tax you had to pay at that time. This is going back pre-1983—it is really ancient. Effectively, by paying one pension payment and then commuting the pension, you avoided paying any further tax. As a result, small funds did set their structures up as defined benefits to be able to take advantage of this anomaly in the taxation system.

Senator SHERRY—I want to be clear on this. I thought it was the early 1990s.Whether it was a dodge or not, legally could a small super fund, whatever they were called back in the early 1980s or before that, offer a defined benefit fund type?

Mr Burt—I have seen them set up in that way.

Senator SHERRY—We are now looking at a period of 20-plus years. There has been no question about their sustainability until recently.

Mr Burt—I think I need to qualify my answer in that case.

Senator SHERRY—Oh, do you?

Mr Burt—They were set up that way but they never actually paid pensions. It is so ancient but I think the majority never paid pensions and the ones that did probably purchased them from a life insurance company. The trouble with this is that we are talking ancient history. I am sure that if you really wanted to know some of this stuff the tax office might be able to delve into the archives and blow dust off a lot of files and find something for you.

Senator SHERRY—In the context of the issue of sustainability, how long have what are known as small super funds been able to offer and have been offering defined benefit type arrangements?

Mr Burt—In terms of numbers, my impression is that they were starting to take off around the mid-1990s.

Senator SHERRY—That is your impression; do you have any data on that?

Ms Nicholson—We have some very rough numbers, Senator. I am not sure how accurate they are. The numbers that were requested up until 1998 were in the tens, which is very limited so I do not think the argument or even the risk of sustainability would have been something that would have crossed anybody's mind because the numbers were too small. In 1999 they were in the hundreds. From 2000 up until now it has been in the thousands and it seems to be on an increasing trend.

Senator SHERRY—We have an increasing number. I am glad we are getting some numbers out on the table at last. It would have been nice to have had them earlier. You are saying that there has been a significant increase in the growth. How are they not sustainable? This is what I am interested to find out. I want to deal with this issue of sustainability. Put aside the other issues of tax minimisation, RBL compression and estate planning, which I am going to get to. How many of these things have fallen over?

Mr Burt—Not that many so far. You would expect that they should not have fallen over to date given that they are only relatively recent vehicles. If they are falling over within five years, that is bad news.

Senator SHERRY—How many? You say not that many so far. How many have fallen over?

Mr Burt—It depends what you call ‘falling over’. I ought to explain something. We do work for Centrelink on assisting them in the small fund area. I cannot say how many we have seen but we certainly have noticed a number of restructures in the cases we have been asked to review. Quite how many I cannot tell you because we do not keep that information specifically. Centrelink probably have a better handle on that than we have.

Senator SHERRY—Who at Centrelink has got the better handle on this? You are being fingered for fingering them so I would like to know who is the expert in this area.

Mr Burt—They may have better information.

Senator SHERRY—Oh, they may.

Mr Burt—They may or they may not.

Senator SHERRY—Who is the expert in this area in Centrelink whom you believe may have better information?

Mr Burt—I am reluctant to say that they will.

Senator SHERRY—I am accepting that it could be ‘may’. I am just after the name of the person who may have better information.

Mr Burt—I think I would rather talk to FaCS about this before I give you a name.

Senator SHERRY—There is no-one at the table from FaCS.

Mr Burt—There is someone siting in the room from FaCS.

Senator SHERRY—Don’t worry; we will find out. We will get to the bottom of this.

Mr Burt—Can I take this on notice?

Senator SHERRY—Mr Thomas, you said in your opening address something about the government actuary and the number of instances that throws into question the original estimates in respect of the—

Mr Thomas—This is restructuring.

Senator SHERRY—This is restructuring. This is not the sustainability issue.

Mr Thomas—That is an indicator of sustainability. If they have to restructure it means the pension as originally designed is not working.

Senator SHERRY—Mr Thomas, you talked about the government actuary, who is helpfully here. You referred to a number of instances. I ask about the instances and for a bit of detail and profiles—what exactly went wrong. Just because in a number of instances they fall over for whatever reason does not mean the whole sector is at risk, does it?

Mr Burt—Yes, it does unfortunately.

Senator SHERRY—That is a pretty bold statement.

Mr Burt—Yes. I want to step aside and give a bit more background. A small super fund is a great investment vehicle. It is not a good risk vehicle. What I mean by risk is guaranteeing benefits. Essentially, a small super fund is able to do two out of the three following things: provide a reasonable level of income, guarantee paying that income for life and pay that income on guaranteed terms. It cannot do three out of three. You can pay a tiny pension that will definitely be payable for life and on guaranteed terms. You can pay a reasonable income and guarantee that it is payable for life, but you cannot guarantee the amounts. Alternatively, you can pay a reasonable income on set terms, but you cannot guarantee it is payable for life. That is what it comes down to. You can do two out of three but not three out of three.

Mr Coles—There is no pooling that is able to support the pension in times of crisis.

Senator SHERRY—I understand the pooling issue.

Mr Coles—That is one of the fundamentals of this issue, in the sense that a defined benefit pension is the crystallisation at the start of the pension to pay a benefit for either a period of time or a lifetime, for example. If it cannot meet that, then it is not meeting its terms.

Senator SHERRY—If we logically progress this argument about the sustainability, how is any small superannuation fund, or DIY for that matter, sustainable given the sole persons test? You seem to be mounting an argument against small super funds full stop.

Mr Coles—Certainly not. They are an important and valuable part of the market, but—

Senator SHERRY—Of course you would say that, but the logic of your argument is that there is a lack of sustainability in respect of small super funds.

Mr Burt—It depends on the product they are paying.

Senator SHERRY—If they are sustainable pre retirement in the accumulation stage and the assets continue to grow, they meet the sole purpose test—and let us get rid of the jewellery, the holiday homes and the art collections, which I am interested to get some facts on and see how many of them there are, but that is for another time—and they have a balanced portfolio, how are they not sustainable post retirement?

Mr Burt—There is no difference between pre and post retirement provided they stick to their knitting—and their knitting is that they are investment vehicles. That is, pre retirement they are accumulation. If you use an SMSF to pay an allocated pension, that is an investment vehicle. That is fine. If you use an SMSF to pay a growth pension, that is another investment vehicle. That is fine. The difference is that an SMSF—and I call them pretend lifetime pensions—involves guarantees and risk. That is the difference. You are changing it from an accumulation investment vehicle only to something that involves guarantees.

Senator SHERRY—There is no guarantee in life, and you know that. We talk about levels of risk and guarantees and promises. Let us not argue about that yet. It is an investment vehicle, but why can an investment vehicle not pay out a defined benefit?

Mr Coles—I think the important thing here—and it is what Mr Burt was talking about—is that it can provide it for a lifetime but it is going to produce a minimal amount of income. There is going to be a major reserve. The whole purpose for the government is to balance the concessionality provided for these vehicles to provide a benefit.

Senator SHERRY—I understand we have to be careful of the concessionality and the estate planning but, if an individual is willing to choose a DB which, given the investment and the asset backing, may in fact be a lower payment but in their eyes involves less risk over time, why should we stop them?

Mr Thomas—It is that balance that the government has taken on board: the balance in the overall revenue between what it provides to the person and the needs of society. The government has decided that there is an appropriate level of support for these individuals in a benefit. What it needs to do then is balance that against the needs of the rest of the community and the tax that these people are paying. In that balance, it is weighing that up and it needs to make a judgment as to what is appropriate. The government has said that the risk for these small funds in providing this benefit is not worth it.

Senator SHERRY—The difficulty I have is that many of your compatriots in the actuarial community who have given evidence to the inquiry this morning—and there are many who have written to me and have spoken to me about this—disagree with you quite fundamentally on this central point that we have been discussing for the last 10 minutes.

Mr Burt—We are talking about the actuarial profession here, aren't we?

Senator SHERRY—Yes.

Mr Burt—It is quite interesting because—I am not saying that the actuarial profession is split down the middle, but the split is probably not far from the middle—there is one group, and I have to admit I belong to this particular group, who think this is nonsense and say, 'How can a one-person fund properly pay a lifetime pension?' There is a second group, from whom you heard this morning, who basically say, 'The intention is to try to pay an income for life'—and I emphasise the word 'intention'—'therefore, that is probably a good thing; therefore, we are happy for it to happen.'

Senator SHERRY—Including the Institute of Actuaries of which you are a member. It is the professional organisation.

Mr Burt—I do not think the institute went that far; in fact, I am pretty certain they did not—

Senator SHERRY—I do not think they are not supporting that small super funds should not be allowed to offer DBs.

Mr Burt—I think the institute's views properly reflected the fact that the membership has two quite strongly divergent views. I would not necessarily accuse them of sitting on the fence, but I think they have difficulties—

Senator SHERRY—They are not supporting these regulations.

Mr Burt—Supporting the regulations may not be the same thing as supporting this particular issue. The regulations contain other issues as well.

Senator SHERRY—Your difficulty is that there are a significant number of actuaries who do not agree with you from whom we have heard already.

Mr Burt—And there are a significant number of actuaries who agree with me as well.

Senator SHERRY—That is right. Shall we take the poll? How do we determine all of this?

Mr Burt—I am not certain where that is going to get us.

Senator SHERRY—That is exactly right.

Mr Coles—The government of the day based its decision on advice from the Australian Government Actuary as to what is an appropriate outcome.

Senator SHERRY—I ask you to take this on notice. You gave us an example of the RBL compression, Mr Thomas. I think I have heard about it before. I think this has been public for some time. You gave us an example of estate planning. I would like to know how widespread this is. What analysis have you done? How many people are doing this? What are the numbers? I am not going to hold you to it and say, 'Look, you said it was 10 people last year.' I am not going to be that tough on you. But we do want a better data set than what you have provided.

ACTING CHAIR—We do need the income profiles with it. I am just worried that, in my term as the chair of various superannuation committees, I have never seen a set of regulations or legislation with such a social engineering impact. At one end of the spectrum we are concerned about people making too much money out of superannuation. Because of their investment performance and because they are prepared to take higher risks, you want to bring them back to the fold. At the other end, you are worried whether people have an ability to pay a pension. Be that as it may, Mr Burt, a query was raised that certain matters had not been referred to you before. Have you read the submissions before today?

Mr Burt—Which matters are you referring to?

ACTING CHAIR—The matter which I referred to in terms of the vesting of contributions. You have not read the submissions, have you?

Mr Burt—I have read some of them. Whether I have read the relevant one is another matter.

ACTING CHAIR—Obviously the CPA one must not matter. I will just refer to it.

Mr Burt—Oddly enough, I do not think—

ACTING CHAIR—I am establishing my credentials, because you said that it had never been referred to and you were not aware of such a situation. Under the heading 'Full vesting of contributions' the CPA submission says:

> We understand the requirement for all contributions to fully vest in the member is aimed at addressing superannuation surcharge avoidance and deductions claimed inappropriately for contributions. However, these issues do not generally arise through vesting, but in the way contributions are allocated within a fund. We believe the provisions in the amended SIS Regulations will not fully address these issues and are unworkable.
>
> Firstly, Division 7.2 of the amended SIS Regulations requires a contribution received in a month to be allocated to a member within 28 days of the end of the month. However, it does not require the contribution to be allocated to the member for whom it was intended or for whom a tax deduction was claimed. That is, an employer will still able to claim a deduction for a contribution made for a particular member but then have it allocated to another member possibly avoiding a surcharge liability or excessive benefit.

And it goes on. I just wanted to put that on the record. We look forward to seeing you either next week or the week after.

Ms Lejins—I would like to clarify that point because it is a point that the ATO has already clarified. The ATO has already clarified that this is not an issue. The person to whom the contribution is allocated must be the person for whom the tax deduction is claimed. There is no opportunity to allocate to a member other than the member for whom the deduction is claimed.

ACTING CHAIR—I think you had better go back and readdress that because more than one person at the back of the room is shaking their head. We are in a difficult position when you are asserting one thing and the industry is asserting another. We are quoting from the submissions. I think we would like a full clarification when next we meet. The secretary will be in touch in relation to a new meeting because we do have a lot of other matters to cover. I thank all the witnesses for appearing before us today.

Committee adjourned at 4.16 p.m.