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The Secretary
Senate Economics Legislation Committee
Room SG.64
Parliament House
CANBERRA ACT 2600

14 July 2004

Dear Sir/Madam

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

Thank you for the opportunity to make a submission in relation to the above amending Regulations.

In particular, we wish to comment on the specific requirement contained in these Regulations for funds commencing defined benefit pensions to have at least 50 members. The Regulations effectively ban do-it-yourself (DIY) superannuation funds (and small corporate funds with less than 50 members) from providing income streams payable for life or a fixed term in retirement. For the overwhelming majority of Australians, this means that they will be unable to use their superannuation to access a pension payable for the rest of their life unless they are willing to hand over their retirement savings to a life office and purchase a traditional annuity, which the majority are reluctant to do for a variety of reasons.

Abuse of pre-12 May 2004 rules

We are not aware of any evidence that suggests widespread abuse of the pre-12 May 2004 rules in relation to the provision of life-time or fixed term pensions. If abuse of the rules does exist, then this should be addressed by fixing the rules, not applying a blanket ban for all. We believe that the overwhelming majority of mums and dads legitimately use their DIY funds to provide an income stream in retirement, and in some cases, an income for their spouse and/or children on their death.

Reasonable Benefit Limits

The Government has stated reasonable benefit limit (RBL) avoidance as one of the abuses targeted by the new Regulations. We believe that the problem here lies not with avoidance of RBLs, but with the actual formula used by the ATO for calculating the value of a pension for RBL purposes.

When assessing a life-time pension for RBL purposes, the ATO uses a series of valuation factors set out in Schedule 1B of the Superannuation Industry (Supervision) [SIS] Regulation 1994 to calculate the value of the pension. In many cases, these factors considerably understate the true value of the pension, giving rise to an RBL value which is often lower than the actual purchase price of the pension. The problem is not people abusing the rules, but the actual rules themselves. People are simply applying the rules as they currently exist.

Applying a blanket ban to DIY funds because the government's own RBL formulae gives unrealistic valuations is both unreasonable and unfair. A simpler, fairer and more reasonable approach would be to amend the formula used by the government for RBL assessment. More appropriate solutions could include:

- Updating the SIS Schedule 1B factors to better reflect the true value of a life-time pension; or
- Amending the assessment of a life-time pension so that the full purchase price is counted for RBL purposes, in much the same manner as applies to a purchased fixed term pension.

Other solutions could also be considered.

Banning DIY funds from providing life-time pensions does not resolve the issue. In fact, under the new Regulations, if a retiree is willing to purchase a life office annuity through their DIY fund, and use the proceeds to provide a life-time pension from the fund, they would still achieve the same low RBL valuation as explained above, since the new Regulations do nothing to change how a life-time pension is assessed for RBL purposes.

Access to Centrelink entitlements

The government has also asserted that the recent changes have been designed in part to stop wealthy individuals from accessing Centrelink entitlements via an asset-test exempt defined benefit

pension in their DIY fund. We do not have any evidence to support or dispute this assertion, so we are unable to comment on whether there is widespread abuse of this in practice or just a small number of isolated incidents. We do, however, acknowledge that the existing rules provide the opportunity for wealthy individuals to access the social security system.

However, we would note that the asset-test and income rules for social security are effectively the same for DIY funds and for life office annuities. Thus the same outcomes can be achieved either through a DIY fund or by purchasing a life office annuity, so banning life-time and fixed term income streams from DIY funds simply moves the problem from one area to another. Banning these income streams from DIY funds delivers life offices a competitive advantage in this regard.

Prior to these Regulations changes, the government already moved to tighten up the ability for people to access the social security system by changing the asset-test exemption from 100% to 50% for complying pensions commencing on or after 20 September 2004. This change in itself should minimise or remove the ability of wealthy individuals to access the social security system via these pensions, removing any perceived need for a blanket ban on DIY funds.

If the government believes that the change in the asset-test exemption will still not adequately resolve the issue, additional measures could be considered, such as capping the amount that qualifies for the asset-test exemption.

We would note here that pensions from DIY funds are already assessed more strictly for social security purposes than life office annuities via the deprivation test. In many instances, the deprivation test results in part of a DIY funds assets being subject to the means test, even though a retiree is paying an income stream that meets the asset-test exempt rules. The deprivation test does not apply to life office annuities.

Estate planning

The government has also referred to estate planning as being a driver for the ban applied to defined benefit pensions from DIY funds. With a life office, any assets left over on death (outside of any guarantee period, if offered) are kept by the life office. In a DIY fund, any assets left over on death remain within the fund and can be distributed to the dependants. This does not represent an abuse of the system – it is just one of the attractions of using a DIY fund to pay a pension in retirement.

Life office annuities do have their place. However, they do not suit everyone, and many retirees who have saved all their working life are unwilling to simply give the remaining capital on their death to a large institution, rather than being paid to their dependants. Annuities are also not perceived to offer value for money. Given the need to charge high risk premiums to protect the life office against both investment and mortality risk, pricing is perceived to be very unfavourable to the average retiree.

We assume that the government's concern over estate planning arises from a belief that some retirees are deferring capital in retirement by drawing a lower pension than what can be supported by their assets and building up large reserves over time. We believe that the attraction to do this is limited somewhat by the fact that the exemption from tax on the investment income from the assets is limited to a "best estimate" value of the assets required to pay the pension. Any income arising from surplus or reserve assets is taxed at normal superannuation tax rates.

We also note that the asset-test exempt requirements force people to take a lower (rather than a higher) pension in order to meet the high degree of probability requirement each year. If a high degree of probability test was not required, a higher pension could be paid.

If the government is concerned about deferral of income, then rather than applying a blanket ban to all, a number of alternative solutions could be explored, such as:

- Placing a lower bound on the amount of pension that must be drawn – eg require a pension to be commenced at no greater than a certain level of probability, ensuring a certain level of income is drawn from the asset;
- Putting limits on the reversionary beneficiaries that can be included in a pension (which will help to increase the amount of pension paid to the primary beneficiary);
- Limiting the amount of reserves backing the pension by requiring the pension drawing to be increased if reserves exceed a certain level (eg due to good investment performance). On the flip side, some allowance would also be required to allow the pension to be reduced if assets subsequently fall;
- Limiting the ability to structure residual capital values past retirement age.

Other solutions may also be appropriate for managing reserve levels and estate planning opportunities.

Growth pensions

We welcome the introduction of the new growth pensions from 20 September 2004. These new pensions provide additional choice for people in retirement. The more income stream options available to retirees, the more likely that the choices available will meet the needs of individual retirees and thereby encourage retirement savings to be taken in the form of an income stream, rather than a lump sum.

However, the government appears to be of the belief that the new growth pensions (available from 20 September 2004) will remove the need for people to take life-time or fixed term pensions. While the new growth pensions will be attractive to some, they will not be suitable for all:

- Growth pensions may not be suitable for retirees who wish to live off their retirement savings for the rest of their life. A growth pension will cease after a set number of years, with retirees potentially falling back onto the social security system after that time;
- Growth pensions may not be suitable for retirees who seek a stable level of income during retirement, since the income level will move up and down each year depending on the remaining account balance (there is no flexibility in the government's prescribed pension drawing factors).

We believe that life-time pensions still fill a valuable role in the retirement plans of many retirees.

50 member minimum requirement for defined benefit funds

As an actuary, I also feel it would be remiss of us if we did not comment on the ban applied to defined benefit funds from admitting new defined benefit members if they have less than 50 defined benefit members.

With respect to these funds where members are usually entitled to a multiple of final salary or average salary based on length of membership, the financial soundness of a fund is determined primarily by:

(a) the capacity and willingness of the employer sponsor to meet ongoing funding requirements; and
(b) the investment performance of the fund.

The SIS Regulations also impose a number of additional standards and actuarial controls on such funds to ensure that the financial position is regularly reviewed and managed appropriately.

The number of members is irrelevant to whether a defined benefit fund can operate effectively or not. If the employer-sponsor has the capacity and willingness to fund the promised defined benefits, then members' entitlements will be secure and the financial position will be sound.

It is also difficult to see how these arrangements are engaging in abuse or avoidance:

- The same RBL limits apply on benefits received from both defined benefit and defined contribution funds;
- An employer's total maximum deductible contribution limit for a defined benefit fund is the sum of the individual maximum deductible contribution limits for each defined benefit member. Consequently, the same total limit applies to the employer regardless of whether their employees are members of a defined benefit and defined contribution fund;
- Surcharge assessments apply to both the notional cost of the defined benefit, as well as any additional distributions made to members from surplus or reserve asset that might arise from time to time.

Consequently, it is difficult to see the need for such an onerous restriction. The ban on such arrangements with less than 50 defined benefit members adversely impacts both large companies who may have a small defined benefit section within their fund and small businesses who may not have the required 50 employees.

50 member defined pension funds

The Regulations also require a fund to have 50 members in order to start paying a defined benefit pension. It is difficult to see how this adds to the financial soundness of a fund. For example, a fund with 49 members in accumulation mode (whose assets are segregated to support their accumulating benefits) and one defined benefit pension member provides no more certainty than a fund with only one defined benefit pension member. The fund needs to undertake the same amount of reserving in either case.

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The Secretary
14 July 2004

The number "50" just seems to be a way of stopping DIY funds from paying life-time or fixed term pensions.

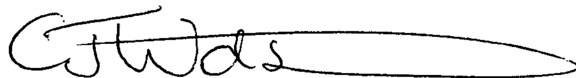
Summary

The overwhelming majority of mums and dads legitimately used DIY funds to provide an income stream in retirement. People are being actively encouraged by the government to save for their own retirement and take control of their superannuation, and for many people, a DIY fund is seen as their preferred retirement savings vehicle. Those abusing the system should be dealt with by fixing the rules, not applying a blanket ban that unfairly penalises all.

There are much better ways to solve the issues that the government is trying to address than penalise the overwhelming majority. We would encourage the government to give serious consideration to a range of alternatives and work with industry to achieve the government's desired outcomes in a much fairer and practical manner.

If you would like to discuss the above further, please do not hesitate to contact me on telephone 08 9238 5259.

Yours sincerely,



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