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4 August 2004

The Secretary
Senate Economics Legislation Committee
Parliament House
CANBERRA ACT 2600

Dear Dr Batchelard

**Inquiry into the Superannuation Industry (Supervision) Amendment Regulations 2004
(No 2) as in Statutory Rules No. 84**

We are writing to assist the committee in its review of the above Statutory Rules, specifically, the prohibition on defined benefit pensions from funds with fewer than 50 members. *In our view, this prohibition is unnecessary and grossly inappropriate.*

We note that the Committee held a public hearing to gather evidence in relation to these changes on 26 July 2004. As a result of evidence provided to the Committee by Treasury, the ATO and the Australian Government Actuary's office, we now have some understanding of the reasons behind their support for the ban on defined benefit pensions from small funds. Several of those reasons (for example, the process referred to throughout the hearing as "RBL compression", estate planning opportunities and the ability to access social security benefits) have been addressed in some detail in submissions prepared by other witnesses at the hearing. We have therefore not sought to address those in this letter.

We did, however, note that representatives from the office of the Australian Government Actuary (AGA) supported the ban on, inter alia, actuarial grounds. In other words, the AGA would appear be concerned that the provision of a defined benefit pension from a self managed superannuation fund is actuarially unsound. *In our view, as actuaries practising in the self managed superannuation fund arena, those concerns are without foundation.* This letter specifically considers the actuarial case for permitting or prohibiting small funds from providing defined benefit pensions.

It would appear that the AGA's primary concern is that small funds are not able to appropriately manage risk (investment or mortality) and may therefore either:

- "fail" (ie, run out of funds before the pension has ceased on, say, the death of the pensioner); or
- at the opposite extreme, provide an unreasonably low income stream (on the basis that this will at least ensure that the pension does not fail) that is significantly out of step with the income available on an arm's length basis from (say) a life insurance company.

49302199

Our interpretation of comments recorded in Hansard on 26 July is that the AGA believes:

- the inability of small funds to "pool" (ie, provide pensions to a large number of individuals and thereby minimise the chance that the mortality experience of a single individual will have a significantly detrimental impact on the financial security of the group as a whole) makes them inappropriate vehicles for pensions which involve mortality risk; and
- the fact that small funds have no external financier (eg, the coffers of a large life insurance company) means that they cannot realistically underwrite the guarantees implicit in a pension contract.

One of the undersigned (Mr Allen Truslove) has recently forwarded an extensive submission to the Committee that explores some of the flaws in this argument in detail (a copy of the submission is attached). In brief, however:

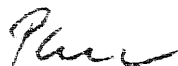
- every pension provider (small and large) is faced with the very significant issue of declining mortality (and therefore longer life expectancy). In our view, this situation is actually more readily recognised and addressed in a small superannuation fund;
- "pooling" removes only one aspect of mortality risk – the risk that an individual's experience may differ from his or her peers. It does not assist a pension provider in addressing other (very significant) mortality risks such as the trend towards declining mortality (and therefore longer life expectancies);
- effective pooling would require a far greater number of lives than 50 – the ban on funds with fewer than 50 members represents an arbitrary "cut off" that is not statistically supported;
- even the life insurance industry has recognised that pooling is not the only answer to dealing with risk (including mortality risk). Within the life insurance industry, there is a well established practice of effectively passing risk back to the annuitants by incorporating variable "bonuses" into annuity contracts;
- pooling has no impact on investment risk – one of the major risks associated with providing a defined benefit pension.

The lack of an external financier, coupled with quite stringent solvency tests already incorporated within the relevant legislation does encourage most actuaries to take a relatively conservative approach in determining the annual pension which can be provided from a given pool of assets in a self managed superannuation fund. In theory, one would expect this to result in SMSF pensions being much lower than the annual income available on a commercially obtained annuity. In our experience, however, this is simply not the case. The income streams are often comparable or even, in some cases, higher in the SMSF environment.

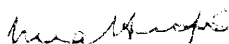
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In summary, we believe that an actuarially controlled defined benefit pension is an entirely appropriate income stream for a self managed superannuation fund. They are not inherently likely to fail, nor will they necessarily result in artificially low annual payments. The AGA's concerns are unfounded and we recommend that Statutory Rules No 84 is withdrawn in its entirety pending the outcome of the Treasury review.

Yours faithfully



Peter Crump



Meg Heffron



Warren King



Allen Truslove



deLancey Worthington

49302199

Details of signatories

Peter Crump (Bachelor of Arts, Fellow of the Institute of Actuaries of Australia, Fellow of the Taxation Institute of Australia)

Chief Executive Officer of Portfolio Planning Solutions Ltd, a South Australian financial services firm providing financial planning, insurance broking, superannuation and actuarial services. Peter has provided advice to trustees and members of small superannuation funds since 1993.

Meg Heffron (Bachelor of Economics, Fellow of the Institute of Actuaries of Australia)
Meg is a Principal of Heffron Consulting Pty Ltd, an independent firm specialising in providing advice to accountants and financial planners in relation to self managed superannuation fund issues. Prior to establishing Heffron Consulting in 1998, Meg was a Principal of William M Mercer and provided general superannuation advice to a range of corporate and industry superannuation funds.

Warren King (Fellow of the Institute of Actuaries of Australia)
Warren is a Director of Actuaries in Super and King Actuarial Consulting. He has practiced in the superannuation field (both at the large and small end) for over 30 years.

Allen Truslove (BSc PhD MBA FIA FIAA)
Allen has over 30 years' experience advising on superannuation and life insurance issues. He is currently a consulting actuary advising on life insurance as Appointed Actuary, advising on large and small superannuation funds, as well as health insurance. His past roles have included Victorian Government Actuary (supervising the life insurance operations of friendly societies as well as advising on the actuarial aspects of government superannuation funds) and Queensland State Actuary and Insurance Commissioner (advising on the actuarial aspects of government superannuation funds, setting premium rates and assessing solvency of CTP insurers, as well as supervising the life insurance operations of friendly societies).

deLancey Worthington (Bachelor of Arts, Fellow of the Institute of Actuaries of Australia)
deLancey is the Managing Director of Actuarial Solutions Pty Ltd, a firm specialising in providing advice on paying pensions from self managed funds. He has over 25 years experience in actuarial management of defined benefit superannuation funds. He has also been appointed actuary to a number of friendly societies offering life insurance products. In 1990 deLancey presented a research paper to the Institute of Actuaries of Australia that examined the ability of defined benefit superannuation funds to support their liabilities under volatile investment markets.