Portfolio Planning Solutions

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6 August 2004

Senator Grant Chapman
Member of the Senate Economics Legislation Committee
Parliament House
CANBERRA ACT 2600

Dear Senator Chapman

SUPERANNUATION INDUSTRY (SUPERVISION) AMENDMENT REGULATIONS 2004 (NO. 2)

I refer to our recent discussions on this issue and I am pleased to confirm the main issues that were raised in those discussions.

Given that the Senate Economics Legislation Committee will be holding a public meeting on Monday 9 August 2004 on this issue, I confirm that this letter may be used as a tabled submission to the Committee if you wish.

1. About Portfolio Planning Solutions

Portfolio Planning Solutions Ltd is a holder of a Australia Financial Services License, and provides advice to individuals, companies, superannuation funds and government departments across a range of financial services, including:

- Personal Financial Planning,
- General Insurance Broking, and
- Actuarial Advice and Services.

We have our own superannuation master fund, with assets in excess of $200 million for some 3,000 members. Defined benefit pensions can be paid from sub-funds within the master fund.

We have a number of Self Managed Superannuation Funds for whom we provide administration and financial advisory services.

We provide actuarial advice to around 400 Self Managed Superannuation Funds ("SMSF") or Small APRA Funds ("SAF") that are paying defined benefit pensions.

We are recognised as being a major adviser in relation to the establishment and management of pensions in Self Managed Superannuation Funds, and are quoted in the national financial press on these issues.

We are making this submission from both a financial planning and an actuarial perspective.

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2. Specific Issues of Interest or Concern

We are interested in the provision of defined benefit pensions from SMSF's and SAF's, and have the view that they remain an appropriate vehicle for the payment of income streams during retirement. In this letter, we will refer to SMSF's for convenience, but the issues apply equally to SAF's.

Our reading of the Proof Committee Hansard of the meeting of the Senate Economics Legislation Committee held on 26 July 2004 raised a number of issues about which we wanted to provide comment.

We have addressed the following issues:

- Guaranteed pensions,
- Who benefits – shareholders or retirees ?
- Estate planning activities,
- Encouragement then penalty,
- Closing out of SMSF's,
- RBL and Centrelink issues,
- Consumer confidence, and
- Choice.

2.1 Guaranteed Pensions

In their evidence to the Committee, representatives of Treasury seemed to be concerned about the lack of guarantees for defined benefit pensions in SMSF's.

We agree with the industry submissions that there can be no absolute guarantees about the viability of any pool of pensioners or annuitants.

One of the means by which life office annuity pools attempt to "guarantee" future annuity payments is to price the annuity on an extremely conservative basis. It makes good sense that any financial arrangement that is very conservatively priced has a much higher chance of protecting the purchaser of the risk.

We received an example of lifetime annuity quotes that were obtained from an actuarial colleague, involving a male aged 57 and a female spouse aged 44, with initial capital of $1,400,000. The CPI indexed annuity was quoted by two major life offices, the first offering an initial annuity of $21,000 per annum and the second an initial annuity of $34,000 per annum.

I have determined the initial pension that I would certify for the same person in a SMSF, with a high growth investment portfolio. I would certify an initial pension of $70,000 per annum, also CPI indexed.

It is no surprise that the life offices (and Treasury) talk about annuities being guaranteed, when they are so conservatively priced.

The life expectancy of the 57 year old male is 24.2 using the latest Australian Life Tables 2000/02. The actuarial certification of the pension from the SMSF would involve an expected payment period of 24 years. This suggests that the least conservative of the life annuities would be expected to be paid over a term of 48 years !

This appears to involve significant undue conservatism in the pricing of the "guaranteed" annuity. The life offices would state that this relates to "longevity risk", investment risk and re-investment risk.

This simple example suggests that SMSF pensions are priced on a balanced financial equivalence basis, while the life office annuities involve a deferral of income and retention of significant reserves for the life office.

2.2 Who benefits – shareholders or retirees ?

If there is any "estate planning" that is occurring, it appears that it is in favour of the shareholders of the life offices.

The conservative pricing of annuities will result in lower pensions being paid to retirees, and any remaining capital on death (within the annuity pool) will likely pass on to shareholders of the life office through surplus funds.

If there are assets remaining after the death of a SMSF lifetime pensioner, the assets remain in the superannuation fund and can then be applied according to the requirements of the superannuation legislation. This generally means that the assets are applied in favour of other family members within the superannuation fund.

In a SMSF environment, any remaining funds are used for the benefit of the retiree's family within the SMSF. In a life office annuity pool, remaining funds are applied to reserves which ultimately pass to shareholders.

2.3 Estate Planning Activities

It has been suggested that SMSF pensions are deliberately structured so that consumption of capital is deferred, with the result that the retiree passes ownership to their children.

The anecdotal example quoted above suggests that there is undue conservatism is likely to be found with life annuities rather than SMSF pensions.

We suggest that prudential management of actuarial guidelines on the establishment and financial management of defined benefit pensions in SMSF's would be an appropriate way of addressing this issue.

We note that the legislation requires actuaries to be more conservative than they would normally be, by assuming a higher degree of probability that the assets will be sufficient to support future pension payments. For this purpose, a "high degree of probability" is 70%.

We have not seen any pensions where there is a more conservative basis used for the establishment of a defined benefit pension in a SMSF.

We suggest that prudential management of actuarial guidelines on the establishment and financial management of defined benefit pensions in SMSF's would be an appropriate way of addressing this issue.

2.4 Encouragement then Penalty

We are concerned that the proposed prohibition of SMSF's supporting defined benefit pensions involves a retrospective amendment to government policy.

In January 1999, Modification Declaration No. 23 (to the *Superannuation Industry (Supervision) Regulations 1994*) made it clear that superannuation funds, including SMSF's, were able to provide defined benefit pensions.

That announcement provided individuals with what was then perceived to be a certainty about planning for their retirement.

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Prior to that announcement, superannuation fund members were generally reluctant to accumulate or target superannuation benefits in excess of the Pension Reasonable Benefit Limit ("RBL"). Unless they were inclined to commit half of their retirement benefits to a life office annuity, any benefits in excess of the Lump Sum RBL would suffer penalty tax. (The issue of this penalty tax has been dealt with during the Committee hearing.)

As a result of that announcement, superannuation fund members were able to deliberately and specifically target retirement benefits that were well in excess of their Lump Sum RBL. This was undertaken in the belief that they would need to take half of their benefits in the form of a defined benefit pension.

As financial planners, we have assisted a number of clients over the last five years to significantly increase their superannuation balances, by way of deductible and undeducted contributions. This strategy was undertaken in a manner that was totally consistent with government policy, which actively encouraged people to fund for their retirement and to receive that entitlement by way of a pension.

As a result of the proposed amendments to the Regulations, any person who is unable to retire before 30 June 2005 has been misled by past government policy and announcements and has limited option for a tax effective retirement pension.

We suggest that the prohibition of SMSF's supporting defined benefit pensions is equivalent to a retrospective policy change. The superannuation industry is littered with "grandfathered" legislative changes, which were either progressively implemented or phased in to avoid disadvantaging existing superannuation fund members.

2.5 Closing Out of SMSF's

The Committee discussed the issue of the cost of moving out of a SMSF to a life office annuity, noting that there would be Capital Gains Tax consequences for the sale of the SMAF assets and imposition of the life office's (higher) expense structure on the individual.

However, there was no mention of the potential plight of investors in a SMSF who may have relatively illiquid assets and who had not expected to be compelled to realise them in the near future.

The legislation permits the investment of SMSF assets in direct property, including "business real property", which is a common SMSF property investment. These investments are undertaken with the intention of long term ownership of the property by the trustees.

Members of SMSF's who were approaching retirement age and were intending to take a defined benefit would have had no expectation of needing to sell that property investment at the time of retirement.

The proposed Regulations mean that, unless the individual is able to retire before 30 June 2005, they will be compelled to sell their SMSF property investment to purchase a life office annuity. That will not only trigger Capital Gains Tax, but is quite likely to result in a "forced sale", regardless of whether it was favourable market timing for the sale.

2.6 RBL and Centrelink Issues

The timing of the announced prohibition of defined benefit pensions in SMSF's appeared strange, since the suggested Social Security "rorts" would have been successfully closed off by the announced 20 September 2004 reduction in Asset Test exemption.

The RBL treatment of defined benefit pensions and lifetime annuities is a result of the schedule of factors in the *Superannuation Industry (Supervision) Regulations*, and the issue of "compression" was well discussed in the hearing.

We raise the same issue as in the previous section, however, that any change to the RBL treatment of lifetime pensions should be phased in progressively, since individuals would have made their retirement plans on the basis of the RBL treatment of lifetime pensions and annuities that ahs remained constant for 10 years.

It was interesting to note the recent finding of the Australian Taxation Office in relation to alleged Part IVA activities involving undeducted contributions and the "recontribution strategy". The finding suggests to us that the ATO has no difficulty with making undeducted contributions shortly before retirement with the intention of producing a better taxation outcome.

We therefore suggest that any concerns that Treasury may have about the use of undeducted contributions in "compression" strategies should be similarly viewed.

2.7 Consumer Confidence

We have discussed above the issues of retrospectivity of policy changes. This, together with the urgency with which the changes were implemented, has significantly damaged the confidence that the public has about superannuation.

There are already enough underlying concerns about the significantly long locked in nature of superannuation, which has the potential to discourage people from adding voluntary contributions to their retirement savings.

This round of regulatory changes, delivered quickly and then amended after industry outcry and now subject to a Senate committee has not helped the concern about "legislative risk".

As the government is about to embark on a program of public education on superannuation issues, this perception of "legislative risk" needs to be put away.

2.8 Choice

The government has finally succeeded in providing choice of superannuation fund for Australians, and is to be commended on that result.

However, the proposed prohibition of SMSF's supporting defined benefit pensions is a direct contradiction of choice. We run the risk of having the concept of choice being compromised to become:

"you can choose your superannuation fund (including a Self Managed Superannuation Fund) until retirement, but you have restricted choice when you retire".

Further, if the member had already made a choice of having their own SMSF, unless they retire before 30 June 2005 they must sell up and transfer to a lifetime annuity if they had planned to receive a lifetime pension from their SMSF after that date.

We have attempted to address what we consider to be the main issues arising from the original hearing that needed further comment. We would be pleased to amplify any of these comments if you or the Committee require.

Yours sincerely

PETER CRUMP
Chief Executive Officer and Director, Actuarial and Consulting Services

Representative of Portfolio Planning Solutions Ltd