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ASFA Research and Resource Centre

POST-RETIREMENT DISCUSSION PAPER

Tax and regulatory settings

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Introduction

Much of the recent focus on superannuation policy outcomes and settings has related to the accumulation phase. Considerable work remains to be done regarding the post-retirement phase.

Already around 30 per cent of superannuation assets (over $400 billion) relate to the post-retirement market. Projections indicate that the proportion will exceed 40 per cent in 15 years' time to reach over $1.4 trillion. This growth in assets will reflect both a maturing compulsory superannuation system and also many baby boomers moving from paid work to retirement. There are economic, financial and demographic imperatives to get the policy settings right for this strongly growing post-retirement market. This is important for individuals, funds and governments.

ASFA is undertaking considerable research and policy development work into appropriate tax, *Superannuation Industry (Supervision) Act Regulations*, social security and other policy settings which would provide better support for the post-retirement phase.

The ASFA Board is developing broad policy principles for a comprehensive ASFA policy position on the issue of post-retirement income. Further work is being undertaken to refine and develop these broad principles. This work will take into consideration input from the Retirement Outcomes Policy Sub-committee and the ASFA Policy and Research teams.

Among other things, the post-retirement income policy will encompass:

- current and future post-retirement products;
- transitional issues;
- treatment of benefits on death;
- self-managed superannuation funds (SMSFs) and retirement incomes;
- investment issues, including 'whole of life' and 'target date' investing;
- incentives to encourage later participation in the workforce;
- member engagement;
- financial advice immediately before, during and after retirement; and
- disclosure requirements.

The proposed policy principles have as their basis the following propositions:

- The main focus of superannuation should be on income streams in retirement, as opposed to lump sums or estate planning.
- Tax and social security incentives and default arrangements should be used to support the take-up of income streams. Mandating the take-up of income streams should only be considered if voluntary arrangements lead to substantial problems in post-retirement outcomes.
- Funds should offer as a default a post-retirement product that is account based although not necessarily having the same rules as currently apply.
- Deferred annuities should be an important part of the post-retirement landscape.
- Continuing access to a lump sum for at least part of the retirement benefit is important. For those with smaller amounts of retirement savings the whole amount should be accessible as a lump sum.
- The system of income streams in retirement should be sector neutral and as uniform in its application to different types of funds as possible.

This work is not yet complete and the policy principles are not yet finalised. Any substantial reforms would likely take some time to implement.

However, in the meantime there are a number of shorter term measures that could be introduced which would remove some current legislative impediments to the development of a market in Australia for deferred annuities and other longevity financial products. Adoption of each of these measures is justified in its own right. They also would facilitate more substantive changes being made to policy settings down the track.

This paper discusses the proposed measures and contains a number of recommendations to Government.

Background

According to the Treasury *Intergenerational Report*, over the next 40 years the number of Australians aged 85 and over is projected to more than quadruple, from around 400,000 in 2010 to 1.8 million by 2050.

The ageing of our population is largely in response to improvements in life expectancy. In 1983 an Australian female reaching the age of 65 could expect to live, on average, for another 18 years, while an Australian male could expect to live for a further 14 years. By 2002 these figures had risen to 21 years for females and 18 years for males.

Most Australian retirees take lump sums or make use of account-based income streams. Currently, sales of life annuities and deferred annuities are minimal although term annuities are becoming more popular due to the uncertain investment climate.

However, annuity demand has been low in Australia and is now considerably lower than it was a decade ago. For instance, while annuity sales were $3.04 billion in 2004, they had decreased to $0.82 billion by 2007. More recently there has been an increase in sales of term annuities, with one major provider of such annuities recording sales of over $1 billion in the second half of 2011. Currently most annuities sold in Australia are term certain annuities, with life annuities accounting for less than one per cent of annuity sales.

The decline in annuity demand was partly due to changes in taxation and regulation in 2004 and 2007, when the Australian Government reduced the assets test exemption for complying income streams and made superannuation benefits tax free for those aged 60 or over. More recently sales of term annuities have increased in response to investor concerns about the level of investment returns from equity investments and the volatility of such returns. However, the predominant type of superannuation product in retirement remains the account-based income stream (commonly known as an allocated pension).

In terms of aggregate amounts in retirement products or retirement phase (in the case of SMSFs), as at June 2011 there was around $400 billion with around half of that in SMSFs. SMSFs generally make use of account-based pensions although some are structured to provide complying pensions akin to long-term annuities in order to access social security concessions which are no longer available to newly taken out pension products. However, as the trustees of a number of SMSFs have discovered, it can be challenging, if not impossible, to provide a complying pension with a pool of only one person and fluctuating equity returns. Unless investment returns are high, the income will eventually decline in real terms and may not be sufficient to cover the liability of the fund in regard to the complying pension.

Around $45 billion of retirement benefit related assets is in corporate and public sector funds, with much of this linked to defined benefit liabilities. A number of public sector schemes have significant levels of unfunded pension liabilities which are largely paid out of general taxation revenue when benefits become payable. Many if not all of these funds are closed to new entrants, as the cost of providing these benefits is both high and increasing due to factors such as improvements in the longevity of pensioners.

In APRA's superannuation statistics, currently around $40 billion is in "balance of statutory funds". This item consists of annuity obligations of life companies together with certain reserves held by life companies for superannuation purposes.

Clearly tax, social security and other policy settings are likely to have played an important role in generating this outcome of very limited use of market-based longevity products. As a result, the attendant longevity risks and demands largely fall upon the Government-provided Age Pension. Otherwise there are no attractive products which provide longevity protection to Australians – although this protection seems in our community's interests.

The Organisation for Economic Cooperation and Development (OECD) suggests that a high degree of annuitisation protects public finances. It also increases the sophistication of the country's financial services markets, which would help promote Australia as a financial services centre.

Innovation in post-retirement products

There is a small but growing number of products where investment and longevity risks are shared between the customer and the product issuer. However, product issuers require a fee or the like to take on such risks. For instance, some products offer (for a price) market-linked returns plus an income and/or capital guarantee and some also protect investors against longevity risk. Many financial planners and potential purchasers in the past have considered that these charges are too high for the extent of the guarantees provided. The majority of such products also generally lock the purchaser into the product for a considerable period of time which is another factor impacting on their popularity.

Most longevity risk products are annuities – either life, term, variable or deferred. Each type of annuity deals with different types of risk and has different types of characteristics.

Deferred annuity

A deferred annuity is a type of annuity contract that delays payments of income, instalments or a lump sum until an agreed future date, decided at the start of the contract. For instance, an investor might at age 65 invest a sum with a life insurance company in return for a promise from the life insurance company to pay a specified amount of income to the investor from, say, age 85.

Variable annuity

A variable annuity is purchased with either a lump sum or over time, eg by accumulating contributions within a superannuation fund, with the premiums paid allocated among the various separate account funds or investment options offered in the annuity contract. The investment return and income paid by the variable annuity fluctuates with the performance of the underlying investments. However, in return for a fee, the provider of such products may guarantee a minimum payment, either for a set period or for life. The more the guarantee, the higher the fees paid and also, the more conservative the actuary to the life insurance company must be, to ensure that it doesn't become insolvent by providing benefits which cannot be supported by the assets. This conservatism is required by actuarial standards and the *Life Act*, to ensure that existing policy owners receive the benefits promised to them. Unfortunately, the more and/or stronger the guarantees, the more the conservatism and the less attractive the product becomes to the consumer.

Both variable and deferred annuities have been popular overseas, including in the US, Asia and Europe. However, in Australia there have been only one or two providers of variable annuities. Deferred annuities have not really been on offer in Australia or purchased to any marked extent. One provider did offer such a product but only a few sales were made. The accumulation prior to the income starting at the end of the deferred period was taxed at superannuation rates, which made it unattractive compared to the tax-free income earned under account-based pensions. It also was a product not well understood by planners or consumers in the Australian market.

Furthermore, people in general tend to be unwilling to convert their lump sum superannuation benefit into the promise of future income by a life insurance company or superannuation fund. This psychological resistance is a major barrier to be overcome, even if regulatory settings were supportive.

While a lack of demand for annuity products (with the recent exception of term annuities) has been partly responsible for few sales being made of such products, regulatory and tax settings also have contributed to this outcome. They are a significant barrier to the development of a viable lifetime income stream market.

Recommendation 1: SIS Regulations

A number of *Superannuation Industry (Supervision) Act Regulations* (SIS Regulations), including Regulation 1.06 (2), are major impediments to the development of products which provide longevity protection, such as the deferred annuity or lifetime pension (life insurance companies provide annuities and superannuation funds provide pensions).

In essence, in order to meet the requirements of the Regulations and thereby receive the benefit of the investment income backing the annuity being tax free, an annuity must be paid at least annually throughout the life of the primary beneficiary and throughout the life of an eligible reversionary beneficiary. Regulation 1.06 also limits the amount by which the annuity payment can vary from year to year. The income may increase by up to five per cent a year, but it can never decrease. This adds to the financial risk for the provider.

More generally the SIS Regulations have tended to focus on the characteristics of specific products rather than provide a generic framework which permits the development of new products which meet certain broad standards. There also are regulations specific to life companies and to superannuation funds, which have the potential to lead to an un-level playing field between the two types of provider. For instance, a greater range of products can be provided by life companies compared to superannuation funds.

The SIS Regulations should also allow insurance companies and superannuation funds to purchase reinsurance from a regulated entity in order to manage the financial risks attached to issuing products providing protection against the financial risks of longevity.

Recommendation 1: The SIS Regulations be amended to:

- *Provide equivalent treatment of post-retirement products offered by life insurance companies and by superannuation funds, preferably through development of regulations which apply to both.*
- *Set out general required characteristics for longevity products that are in the interests of our country rather than mirror the specific characteristics of existing products in the market.*
- *Allow products which efficiently provide a deferred benefit past normal retirement age to be offered.*
- *Allow product issuers to make use of reinsurance arrangements in regard to financial risks of post-retirement products.*

Recommendation 2: APRA prudential standards provisions

There is also an APRA prudential standard on minimum surrender values of deferred pension and annuity products during the deferral period. Deferred annuities do not fit into the structure of that prudential standard as it is currently worded however. Applying standard minimum surrender values to such products could make them unattractive from the point of view of a provider given that an individual might use the minimum surrender provisions if it comes apparent to them that they are not likely to reach the age at which the deferred annuity or pension is payable. This would impact on the pricing of such products and/or lead to inequities between deferred pension and annuity holders. Any minimum surrender value standard applying to deferred pension products should be consistent with their design and objectives.

Recommendation 2: The APRA prudential standard applying to minimum surrender values of pension and annuity products be amended to reflect the special characteristics of such products.

Recommendation 3: Asset test treatment of deferred annuities

Under the current means test for the Age Pension, the purchase price of a deferred annuity will generally be fully taken into account in the asset test. However the purchasers of a deferred annuity are not able to access any capital or income until the qualifying age set out in the contract for the annuity. As well, individuals who do not reach the qualifying age will not receive any income or return of capital from the annuity.

In these circumstances, and given that it would be desirable to encourage the take-up of deferred annuities, it is suggested that a deferred annuity, while in the accumulation stage, be exempt from both the asset and income tests.

Recommendation 3: The means test applied by Centrelink should be amended to exempt deferred annuities from both the asset and income tests during the period prior to payment.

Recommendation 4: Approval processes for new post-retirement products

Product providers must deal separately with the ATO, APRA, ASIC and Centrelink when developing new post-retirement products. As well, each of these bodies might treat the product in an inconsistent way, eg the taxation and social security definitions of income may differ. In addition to any such inconsistencies, the need to deal with multiple regulators complicates and delays the development of new products.

Establishing a ‘one stop shop’ for new post-retirement products which involves all the regulators would lead to a more efficient approval process and less inconsistencies in the prudential regulation, tax and social security treatment of such products.

Recommendation 4: A new administrative arrangement be put in place so that the ATO, APRA, ASIC and Centrelink undertake the assessment of new post-retirement products on a consistent and coordinated basis.

Recommendation 5: More education and advice to fund members

Better take-up of post-retirement products is also likely to occur when superannuation fund members are better educated and advised about such products. In this regard, the scaled advice model envisaged by the Future of Financial Advice reforms is intended to enable trustees (or those employed by them) to discuss issues such as adequacy of superannuation accumulation, interaction between the members' superannuation interest and Centrelink entitlements, and nomination of beneficiaries.

A smoother transition between the accumulation and drawdown phase is needed, particularly for individuals who have only a limited amount of superannuation and/or are not willing to pay for a holistic financial plan.

Government educational resources, such as the MoneySmart website, should also include material on the full range of post-retirement products.

Recommendation 5: The scaled advice operating guidelines to be developed by ASIC allow for funds to provide members with limited advice relating to retirement products.

Recommendation 6: Taxation of deferred annuities

The current provisions of the taxation legislation were not drafted with deferred annuities in mind. This leads to both ambiguities at best and adverse treatment of deferred annuities compared to other retirement products at worst.

Consideration should be given to the amendment of a number of the tax provisions so that they provide appropriate treatment of deferred annuities and any other retirement products that are developed in the future. The drafting should be in broad terms rather than linked to the characteristics of specific products.

Importantly, the investment earnings which support longevity products should be tax free. This treatment is currently provided to account-based income streams and there is no reason why it should not be extended to deferred annuities and like products. Not to do so results in a tax bias favouring products which do not provide any protection against the financial consequences of longevity. The cost to tax revenue of such an exemption would be minimal as in the absence of such an exemption, superannuation fund members would make use of existing post-retirement products such as account-based income streams which are tax exempt in regard to investment earnings.

Recommendation 6: Legislative amendments should be made to provide tax treatment for deferred annuities and other products which is comparable to that provided for existing post-retirement products. Specifically:

- *There should be clarification that benefits from deferred lifetime annuities and other longevity products purchased with superannuation monies are tax free when received at age 60 and over.*
- *The investment earnings supporting deferred annuities and other longevity products should be tax free within the superannuation fund or life company.*

Recommendation 7: Providing longevity protection for members of SMSFs

It is not easy to provide protection against the financial consequences of longevity within an SMSF, as a number of trustees have discovered when they set up complying life pensions within their SMSF. Generally, given the small pool of members in an SMSF, it is necessary to have a relatively large amount of assets and a relatively small annual drawdown amount to be able to ensure the provision of a benefit for a period of 25 years or more.

An option to facilitate the purchase of longevity products which protect the members of an SMSF would allow the trustee of an SMSF to purchase a deferred annuity or like product from another superannuation fund or from a life insurance company. Current legislative provisions in effect limit the purchase of such products to individuals in their own right.

Recommendation 7: Trustees of a self-managed superannuation fund (SMSF) should be permitted to purchase deferred annuities and like products on behalf of a member of the SMSF.