

# Changes to regulatory settings for financial products dealing with longevity

**Ross Clare**  
Director of Research

October 2013

ASFA

Level 6  
66 Clarence Street  
Sydney NSW 2000

PO Box 1485  
Sydney NSW 1005  
T: +61 2 9264 9300  
F: +61 2 9264 8824 or 1300 926 484  
W: [www.superannuation.asn.au](http://www.superannuation.asn.au)

Outside Sydney  
1800 812 798

The Association of Superannuation Funds of Australia Limited ABN 29 002 786 290 ACN 002 786 290

This material is copyright. Apart from any fair dealing for the purpose of private study, research, criticism or review as permitted under the Copyright Act, no part of this publication may be reproduced, stored in a retrieval system, or transmitted in any form or by any means, electronic, mechanical, photocopying, recording or otherwise without prior written permission.

Enquiries to be made to The Association of Superannuation Funds of Australia Ltd.

© ASFA 2013

## Relevant types of financial products

A variety of financial products can be used to deliver an income stream in retirement, but the focus of this paper is on those that involve some sort of guarantee in terms of income-stream payments for individuals who reach an advanced age.

There are a number of financial products which explicitly deal with the financial consequences of longevity. These include deferred annuities and variable annuities.

### *Deferred annuities*

A deferred annuity is a type of annuity contract that delays payments of income, instalments or a lump sum until the investor elects to receive them.

For instance, an investor might, at age 65, invest a sum with a life insurance company (or other permitted provider) in return for a promise from the life insurance company to pay a specified amount of income to the investor from age 85, for example. An alternative product design might be for the deferred annuity to be purchased through a series of annual payments during the accumulation stage, or over the course of the drawdown stage of retirement income.

### *Variable annuities*

A variable annuity is purchased with either a lump sum or over time, with the premiums paid allocated among the various separate account funds 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 guarantees, the higher the fees paid.

Both variable and deferred annuities have been popular overseas, including in the United States, 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.

While a lack of demand for annuity products (with the recent exception of term annuities) has been partly responsible for this, regulatory and tax settings also have contributed to this outcome. The remainder of this paper addresses the change to these settings which would remove current impediments to the provision of such products.

## Current impediments and suggested solutions

### **1. Amend SIS regulations**

Current Superannuation Industry (Supervision) (SIS) regulations are very focused on post-retirement products that are currently in the market, and severely limit the scope for innovation and new products. New supportive regulations should set out general requirements which are not linked to specific products, such that it is a principles based framework.

The regulation of income streams have, to date, remained dependent on individual product characterisation (for example, account based, lifetime, residual capital value) rather than one set of acceptable principles for income streams (that is, regular drawdown regardless of whether payments commence immediately or at a future point of time). Such product-based characterisations drives legislative difficulty in arriving at a consistent view and treatment of different types of income streams. This issue is clearly demonstrated through the classification (or lack thereof) of deferred and variable annuities in the context of SIS legislation and regulations and the tax law.

Deferred annuities are one example of an innovative product solution, but there are many other potential products and solutions.

Accordingly, any regulatory barriers which impede product innovation and the development of longevity risk solutions to consumers should be removed.

In particular, the regulations should permit products which offer a deferred benefit, by ensuring that deferred annuities and like products are:

- eligible for the benefits tax exemption for persons over aged 60 years and over
- not subject to undue restrictions, such as those requiring an individual, over a specific age, to satisfy a work test before they are able to purchase such a product with non-superannuation monies
- unambiguous exemption from the minimum drawdown rules during the deferral period.

Regulations should also contemplate products which have all, or some, of the following characteristics:

- mitigate longevity risk, but aren't necessarily lifetime guarantees
- are paid for incrementally
- are reversible to the extent that any remaining assets are available, but the 'longevity premiums' paid to date are not
- are linked to an allocated pension and form a back-to-back contract for the investor, thereby providing a single income stream.

Income streams could be broadly defined as follows (irrespective of whether provided by a superannuation fund or a life insurance company annuity provider):

| Accessible income streams  | Non-accessible income streams   | Deferred income streams (retirement longevity insurance)  |
|--|---|---|
| <ul style="list-style-type: none"> <li>• Minimum drawdown required on at least an annual basis.</li> <li>• Ability to commute to lump sum.</li> <li>• Centrelink friendly for income test.</li> <li>• Tax free.</li> </ul> | <ul style="list-style-type: none"> <li>• Calculated drawdown made on at least annual basis.</li> <li>• No ability to commute to lump sum unless on death or hardship.</li> <li>• Centrelink friendly for both income and assets test.</li> <li>• Tax free.</li> </ul> | <ul style="list-style-type: none"> <li>• Portion of superannuation balance used to fund payments.</li> <li>• Fixed payment commences at future point in time.</li> <li>• May or may not have a surrender value.</li> <li>• Tax free.</li> </ul> |

## 2. Amend the APRA prudential standard on minimum surrender values of longevity products

An APRA prudential standard requires surrender values to be provided when a policy holder wants to terminate a pension or annuity product. While this standard is relatively technical in nature, the bottom line is that it makes it more expensive to offer such products, and hence makes their pricing in the market less attractive to consumers.

The prudential standard sets out the requirements for determining termination values, minimum surrender values and minimum paid-up values. The key requirements of this prudential standard are:

- a life company must calculate the termination values of policies using the methods prescribed in this standard
- termination values cannot be less than the minimum termination values prescribed in this standard
- termination values are used in determining the capital base of a life company and its statutory funds (refer to Attachment H to *Prudential Standard LPS 112 Capital Adequacy: Measurement of Capital*)

- section 207 of the *Life Insurance Act* requires a life company to pay a surrender value to a policy owner in some circumstances
- this prudential standard specifies the minimum surrender value that must be paid
- section 209 of the *Life Insurance Act* requires a life company to vary a policy in some circumstances if the policy owner requests that no further premiums be paid
- this prudential standard specifies the minimum amount of a paid-up policy.

Deferred annuities do not fit into the structure of that prudential standard as it is currently worded. Applying standard minimum surrender values to such products could make them unattractive from a provider point of view, given that an individual might use the minimum surrender provisions if it becomes apparent 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.

Accordingly, in the case of deferred annuities and other longevity products, it does not make commercial sense for product manufacturers to be required to give the holder of such a product the right to a substantial payment prior to reaching the age at which they are entitled to the contracted payment. To do so would reduce the effectiveness of products which pool longevity risk.

As such, flexibility in APRA prudential standards on minimum surrender values is necessary to allow different types of longevity products to be offered during the deferral phase, such as pooling or not pooling longevity risk. This is reasonable when the product design is reliant on there not being a surrender value and the lack of any surrender value is clearly communicated when the relevant longevity product is being sold.

*APRA Prudential Standard LPS 360 Termination Values, Minimum Surrender Values and Paid-up Values*, issued in January 2013, now allows there to be no minimum surrender value where “the policy documentation and promotional material clearly discloses the non-availability of a surrender entitlement”. However, this applies in only very limited circumstances, chiefly in regard to certain policies issued prior to 1995, and is not of assistance in regard to new business.

Any other provisions in the prudential standards which may unreasonably inhibit the offering of deferred annuities should also be reviewed.

### **3. Means test treatment for longevity products**

The design of the means test for the Age Pension can have a substantial impact on the type of post-retirement products that retirees will hold. As well, it is not fair to treat a financial asset where there may be no access to funds for a decade or longer the same way as, for example, a bank account at call. A full or partial exemption from the asset test of certain longevity products would substantially increase their attractiveness. Specifically, this may involve full or partial exemption of deferred lifetime annuities and like products from social security and aged-care assets tests during the deferral period, or during the period benefits are paid.

The means test should recognise that a product that is not commutable and pools individual mortality, is equivalent to an insurance premium. This ‘insurance premium’ is used by the manufacturer to fund higher income streams through the later years of a person’s retirement, provided that the individual survives past the contracted age for payment. In both cases the reliance on the Age Pension may be reduced.

While the current Age Pension means test arrangements reduce the attractiveness of managing longevity risk through deferred annuities or longevity products, a more mature and equitable retirement income system would provide appropriate support for individuals who mitigate risks such as longevity and sequence

risks. However, any changes clearly need to be sustainable within the context of the Australian government budget and should not be capable of 'gaming' the system in order to extract Age Pension benefits in circumstances where those benefits were not intended to be provided.

This will necessarily involve a trade-off between tax exemptions, budgetary restraint, and Age Pension impacts.

Facilitating the take-up of deferred annuities and other longevity products would also lead to lower Age Pension expenditures in the long term, as older retirees would have more private income than without such products.

#### *A possible means test treatment of longevity products*

In assessing possible approaches to the means test treatment, it is helpful to set out what the basic characteristics of deferred annuities are.

Specifically, it is reasonable to assume that deferred annuities will be structured with the following characteristics:

- during deferral period, the deferred annuity will have nil surrender value
- during deferral period, the deferred annuity will have nil value on death of the policy owner
- income will only become payable where the policy owner survives to an agreed age
- once the deferred annuity commences paying an income stream, there will be nil surrender or value on death other than income payments that have become payable
- deferred annuities will have a known and agreed level of income payable at a future date. This could (and arguably should) include an observable indexation of the income payment.

One option for providing an appropriate means test treatment of deferred annuities would be:

- specifying that, like an insurance premium paid by an individual, a deferred annuity would have nil value for the purposes of the assets test during the deferral period
- specifying that during the deferral period, the deferred annuity would be assessed as providing nil income for the purposes of the income test
- when payments under a deferred annuity become payable, they are included as income for the purposes of the income test, but the product falls outside the scope of the assets test.

An alternative approach would be to include a deemed amount of income during the deferral period but to exclude any income from the Income test during the deferred payment period.

In designing the means test treatment, it will be important to not open up technical strategies that have the primary intention of deferring or minimising tax, or transferring wealth in a tax advantaged way.

Deferred annuities do provide a mechanism of deferring assets that might otherwise be required to be drawn down in an account-based pension or reduce access to the Age Pension. However, they do so though an uncertain payoff based on survival, and it is difficult to see how this aspect of the trade-off would lead to deferred annuities being used as a tax strategy. However, any relaxation to the assumption of a nil value on death or surrender would open up potential for tax strategies.

#### *Are there policy issues related to the assets test at the time the deferred annuity commences payments?*

There are arguments in favour of supporting the incentives during the deferral phase, but how the deferred annuity would be treated once it transitions into making a payment also needs to be considered.

If the purchase price was the original lump-sum deferred, then this would lead to a situation where the investor would face a low-asset value for the purpose of the assets test, but would receive an equivalently low deductible amount for the purposes of the income test (relative to the size of the income stream that benefits from earnings during deferral and mortality credits).

If the purchase price is some indexed amount, or even the equivalent purchase price for a lifetime annuity paying the same level of income at the point of deferral, then this could create unintended consequences for the investor, but would at least leave them equivalent to an investor that converted their account-based pension to a lifetime annuity at life expectancy.

#### **4. Reform of approval processes for longevity products**

Currently, providers need to navigate a maze of red tape with separate, and sometimes inconsistent, approval processes from the ATO, APRA, ASIC and Centrelink. A one-stop shop offering a prompt and consistent approval process is needed. There should be a clear statement of policy intent in terms of having an appropriately flexible retirement income choices to guide regulators. As such, it may be appropriate to set up a forum or body, on which all the relevant regulators, along with the policy departments, are represented. This would allow regulatory issues to be considered in a wider context, rather than through the lens of each regulator and government department. As far as reasonably practicable, this should provide a one-stop shop for considering innovative retirement income options, and ensure a consistent approach.

Support the need for longevity products to be developed with a 'principles' basis to reduce any potential inconsistencies amongst the regulators.

Such an approach would be consistent with the stated intention of the Coalition Government to eliminate any unnecessary red tape for businesses. It would also mean that new products and options could be offered to consumers. Costs would be reduced through use of a one-stop shop approval process, leading to more competitive pricing for consumers. It would also facilitate the entrance of new providers of longevity products.

#### **5. Facilitating provision of advice on post-retirement products**

Increased take up of longevity products will occur when fund members are better advised and educated about such products. The scaled advice operating guidelines being developed by ASIC should be drafted in such a way as to allow funds to provide all members with advice relating to retirement products.

The impact and cost of longevity needs to be illustrated to consumers (and not merely using life tables and average life expectancy as the goal), as this will enable them to understand the implications of their life stage, lifestyle and financial position.

Product providers need to take the lead in illustrating this impact to consumers by modelling a range of returns, volatility and life expectancies, focussing on retirement related risks such as longevity, sequence, timing and inflation. This can take the form of calculators, seminars, advertising and research.

#### **6. Taxation of deferred annuities and other longevity products**

Current tax provisions exempting the investment earnings supporting traditional post-retirement income streams do not apply to deferred annuities and like products. Specifically, there is a need to clarify:

- earnings tax treatment of non-commutable deferred annuities and like products during the deferral period, to explicitly recognise that they are risk products
- accruals tax treatment of non-commutable deferred annuities and like products to ensure that they can be bought, either by an individual, or by the trustee of a superannuation fund.

As such, there is inequity in taxation outcomes for investors in these products, compared to those who have superannuation pensions. The government has announced that they will seek to close this gap. It is not clear whether such a change will be limited to deferred lifetime annuities at this stage, or apply more generally to longevity products. It would be desirable on a number of grounds for such an exemption to apply to all longevity products, meeting set generic requirements for such products.

In light of public policy objectives around the future of the superannuation system and, its ability to adequately support an aging population, an appropriate approach to reform may be to more broadly review the provisions surrounding the taxation of annuities and life policies so as to facilitate an efficient market and innovative design across all types of retirement products (not limited to deferred annuities). This review would need to be sufficiently comprehensive to ensure that all facets of the taxation implications of these types of products, for investors and providers, alike are adequately clarified in the taxation law.

Accordingly, the taxation provisions need to be amended to remove this discrimination with at least as wide an exemption as proposed by the current Government, but not yet reflected in legislation.

### **7. Allowing SMSFs to purchase deferred annuities and like products**

Current SIS provisions only allow individuals to purchase annuities and like products. Self-managed super funds (SMSFs) should be permitted to purchase such products as well.

There should be consistency, such that SMSFs can invest in deferred annuities and like products and receive the same tax treatment. An individual should be able to manage their retirement income needs through a single vehicle, which is a single superannuation fund (employer, industry or SMSF). In order to achieve this, a fund would need to be able to enter into a variety of contracts on behalf of its members. For example, a fund (including an SMSF) should be able to purchase a deferred annuity and have the same tax and social security treatment for its clients (as would have occurred if it had been purchased directly).

### **8. Allowing MySuper products to pay benefits as pensions**

While not strictly an impediment to the provision of longevity products, under the current rules for MySuper products, benefits can only be paid as a lump-sum in retirement. To enable funds to transfer workplace default members to income streams by default, it will be necessary to amend the legislation that prevents MySuper products from paying benefits as a pension. Such a change would allow work-place default funds to transfer accumulated savings to income stream products that boost the retirement income for members approaching retirement, as opposed to paying out benefits as a lump-sum.

Finally, as early purchase of post-retirement benefits can result in better economic outcomes for individuals (for example, purchasing a deferred annuity or like product at 55, pre-retirement), this fiduciary responsibility should not preclude purchase of a longevity product while still in accumulation.