ASFA Submission to the Department of Social Services on the Means Test Rules for Lifetime Retirement Income Streams

February 2018

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About ASFA

ASFA is a non-profit, non-political national organisation whose mission is to continuously improve the superannuation system, so all Australians can enjoy a comfortable and dignified retirement. We focus on the issues that affect the entire Australian superannuation system and its $2.5 trillion in retirement savings. Our membership is across all parts of the industry, including corporate, public sector, industry and retail superannuation funds, and associated service providers, representing over 90 per cent of the 14.8 million Australians with superannuation.

ASFA welcomes the opportunity to provide a submission in response to the policy paper that was sent to key peak bodies and stakeholders on 16 January 2018. ASFA agrees that the social security means test treatment of retirement income streams and longevity products is an important issue. Fair treatment and clarity of treatment are required for both existing and any new retirement income products.

Given that for a number of decades most retirees will continue to rely on the Age Pension to some degree it is crucial that means testing for social security purposes does not unduly impede the development of innovative retirement income products or their takeup by consumers. Preferably the development of such products should be supported by equitable and administratively feasible means test arrangements.

New superannuation regulations took effect from 1 July 2017 but in essence no new innovative longevity products have been marketed to the public. However, a number of providers have been actively considering the development and offering of products with the delay in the setting of means test treatment of longevity products preventing the finalisation of such products and their launch in the retirement incomes market.

As a result the introduction of a suite of new MyRetirement product offerings, as foreshadowed by the Government at various times, has stalled. Clearly there is a need for certainty and clarity in regard to means test treatment of longevity products before such new products will be offered. The option paper also addresses the ongoing suitability of the current rules for annuities and like longevity products.

If the policy intent is that people should spend their savings during retirement (for the benefit of the economy as well as supporting a better standard of living) rather than using it as a tax concessional bequest, then it is important to make sure that the products providing people with the confidence to spend are not impeded by policy. Indeed they may even need to be slightly favoured to encourage their use given the risks involved (for example, receiving relatively few benefits and no return of capital if the product holder passes away before average life expectancy).

ASFA agrees that the principles used to assess means test settings should be:

- Neutrality between equivalent products
- Equity, treating people with similar means in a consistent way
- Resilience, in being able to apply appropriately to new and innovative products
- Integrity, with rules designed to stop gaming of the system in order to obtain the Age Pension
- Fiscal sustainability, with settings not leading to undue ongoing public expenditures
- Simplicity, with the rules easy to understand and to administer

ASFA does not necessarily accept that the existing rules have concessional elements. The analysis in the discussion paper released last year focused on individuals who were outliers in the sense of substantially outliving average life expectancy. The options paper notes that a number of submissions argued that it is important to adequately recognise the lifetime nature of longevity products and the pooling of savings involved. For each individual who outlives the average life expectancy there will be another person who dies before the average life expectancy age. This point is not recognised at page 9 of the policy paper when again emphasis is placed on individuals who live beyond average life expectancy without taking into account the fact that the individuals who died before average life expectancy were unable to full claim the capital value of the longevity product they purchased. ASFA considers that it is misleading to focus on individual cases rather than group outcomes.

ASFA also considers that care should be taken in considering issues of fiscal sustainability. Reducing Age Pension expenditures should not be a dominant goal in revising means test settings, particularly when means test settings for innovative longevity products are being considered.

Projections, including those in the Inter-generational Report and in OECD international comparisons, show that expenditure on the Age Pension in Australia is fairly static in terms of a share of GDP. As well, government support in Australia for incomes of the aged (both Age Pension expenditure and tax concessions for superannuation) as a percentage of GDP is at one of the lowest levels, if not the lowest level, amongst both developed and developing countries. Fiscal sustainability is not necessarily a compelling argument for any further tightening of the means test for lifetime or term annuities. Takeup rates for new longevity products may be modest, depending on CIPR requirements. Such an outcome would further act to constrain the fiscal impact of any increased Age Pension payments.

Fiscal sustainability also essentially is a long-term issue. Policy measures which might lead to slightly higher Age Pension expenditures in the near future but through facilitating substantial privately funded incomes in the future have a number of advantages. They lead to lower Age Pension expenditures in the decades ahead, when there will be increased pressures from an ageing population structure, and can be seen as being more fiscally sustainable than policies aimed solely at reducing expenditures over the current Forward Estimates period.

However, ASFA does not object to the development of new, simpler rules provided that they are equitable and appropriately take into account the pooled nature of longevity products and the different outcomes different holders of such products will achieve. Current rules relating to the assessment of annuities and other longevity products are relatively complicated and difficult for both consumers and advisers to understand. Simpler means testing rules might assist sales of both existing and proposed types of longevity products.

Should the new rules apply to existing holders of longevity products?

ASFA agrees that where retirees have already purchased lifetime products prior to implementation of the new rules, there is a strong case for grandfathering these investments so that the current rules continue to apply.

Given that existing purchasers will have already had their Age Pension entitlements set in the past by the existing rules it would be very challenging to develop transitional arrangements to deal with a change in the rules for such persons. As well, such existing product holders generally will not be able to commute the product and there was a reasonable expectation on the part of the holders of such products that the basic structure of the means test rules would continue over the term of the longevity products concerned.

Allowing existing product holders to choose to opt into the new rules would also open up opportunities to game the system in order to achieve more favourable outcomes with inconsistent means test treatment over the life of the product.

The proposed means test rules for pooled lifetime income streams

The policy paper puts forward proposed new means test rules with relatively little discussion. The case for their adoption appears to depend on the net present value calculations in the Attachment to the document. These values were amended on 12 February by DSS to take into account an error in the calculation of the value of death benefits in the position paper circulated on 16 January.

Both the original and revised calculations consistently show that in a range of cases under the proposed new means test rules Account Based Income Streams would deliver the highest net present value taking into account product income, death benefits and the Age Pension received. In other cases there may be a higher net present value of income and capital access from use of a mix of retirement products but the difference from the amount for Account Based Income Streams is not large.

It also should be noted that Account Based Income Steams are attractive to retirees in that there is access to capital if needed for health care expenses, home repairs, or capital payments for aged care, amongst other things.

Individuals put a value on access to capital. They do not solely evaluate retirement income products based on a life expectancy weighted discounted value of projected future payments. Individuals also do not uniformly restrict drawdowns from Account Based Income Streams to the minimum age related percentage. Around half of Account Based Income Stream recipients draw down at more than the minimum rate. Individuals with relatively high account balances are the most likely to take payments at the minimum rate. Therefore the assumption of minimum drawdowns does not represent a realistic benchmark for many retirees. In this context, going forward the new rules in regard to transfer balances will cap the amount that can be held in an Account Based Income Stream.

ASFA suggests that the analysis in the position paper would be more meaningful if it took into account the value placed by individuals on access to capital. There are analytical methods for doing that, including the Member's Default Utility Function developed by David Bell and colleagues that is described in detail on the ASFA website.

It also would be helpful if the analysis demonstrated the sensitivity of the results to different assumptions about discount rates, investment earnings rates, inflation and wages growth, and the like.

The analysis in the Attachment also does not take into account assets and income held by individuals outside of superannuation products. Most individuals currently subject to the Age Pension means test are impacted by the income test rather than the asset test. Around 620,000 persons are paid a reduced Age Pension due to the operation of the income test with around 320,000 having their payment reduced due to the asset test.

The proposed inclusion of a fixed 70 per cent of payments as income arguably overestimates the average investment return component of longevity products and this would have a substantial impact on those already affected by the operation of the income test.

A further issue is that the proposed factors are independent of the age at which products are purchased. Even if the factors proposed were appropriate for a person aged 65, they may not be appropriate for a product purchaser aged, say, 85 or more who of course has a shorter life expectancy on average. ASFA understands that currently most purchasers of annuities are aged 70 and over. It would be desirable if modelling were undertaken on the impact of the proposed means test settings when a retirement product is purchased at age 85 or older.

The position paper notes at page 12 that pooled lifetime products can be held as an investment inside an Account Based Income Stream and that where this occurs the value of the lifetime product would continue to be assessed as account balance. ASFA considers that to the extent possible the means test treatment of lifetime products should be the same regardless of how they are held by the consumer.

What would be appropriate factors in the asset test and the income test for the means testing of longevity products?

Actuarial analysis undertaken by Nick Callil of Willis Towers Watson indicates that the proposed new rules are punitive relative to current rules. The analysis indicates that the reduction in the Age Pension value generally increases with retirement balance. One of the reasons for this is that the benefits from the proposed new rules in terms of a discounted capital value of the product for Age Pension purposes are lost when an individual only becomes eligible for the Age Pension after a number of years as their other assets are run down.

Individuals with relatively low retirement savings balances might be less likely to buy a longevity product as the Age Pension will provide much of the protection against the financial consequences of longevity that they need. Access to capital might also be important for such individuals.

Another concern is that the assumed proportion of payments attributable to investment income is relatively high. What the paper fails to recognise is that the rules should take into account the experience of the overall group, not just the experience of the minority that outlive the average life expectancy for somebody of their age.

In a relatively low interest rate environment a significant proportion of the payments from life annuities is return of capital, higher than the 30 per cent on average over the life of the product assumed in the position paper.

Actuarial calculations suggest that someone who purchases a life annuity at age 65 would under the proposed rules need to live to 107 to receive full recognition for the return of capital. It is unlikely that many people will achieve that, even with increasing longevity.

As well, the paper places considerable emphasis on the need for equivalence in treatment between longevity products and other retirement income products, such as Account Based Income Streams. For individuals with an Account Based Income Stream drawing down 5 per cent or more of their account balance (which will be the case for the great bulk of the holders of such products) the income test deeming rules result in an assessed income for the means test of less than 70 per cent of the payment received. When the product holder draws down 10 per cent or more of their balance the assessed amount is less than 35 per cent of the amount received by the individual.

ASFA analysis suggests that a 60 per cent/30 per cent structure for the assets test and an assumed 60 per cent of payments as income would give a better "fit" to the existing rules than the structure proposed in the position paper. It would also be closer to what would be the actuarial values for investment income and return of capital associated with longevity products.

Accordingly, ASFA recommends that:

- The income test apply a fixed percentage of product payments as income at the rate of 60 per cent of payments
- The asset test apply a consistent value of 60 per cent of nominal purchase price until life expectancy at purchase and half that amount (30 per cent) from then on
- Lower percentages (to be calculated) be considered when the product purchaser is aged, say, 85 or over

What approach to income and assets testing income streams during the deferral period for deferred annuities and like products would best meet the policy principles of neutrality, equity, resilience, integrity, fiscal sustainability and simplicity?

An approach which would balance the various policy principles is suggested below.

Asset test treatment

If an income stream product has a period during which income is deferred the capital value for means test purposes should be the upper of the commutation value offered or death benefit. If, like a defined benefit life pension, there is no ability to access the capital behind the product, then that amount of capital should not be assessed in the means test. The product holder is not able to draw on the capital. One of the stated goals by the Government for the asset test is that it is designed to encourage individuals to draw down on their capital when it is above a specified amount. This principle should be applied as uniformly as possible. This means that where access to capital is not possible the product should not fall within the net of the asset test.

By definition, if capital cannot be accessed by commutation or by a death benefit then the product's capital is not being used for estate planning purposes.

The asset test treatment suggested in the policy paper is likely to be regarded as relatively unattractive by potential purchasers of deferred annuities. It could severely limit the potential market for such products, which might mean that the proposed MyRetirement products incorporating a deferred annuity component may never actually be offered or taken up in the market to any significant degree.

ASFA suggests that a better approach would be for deferred annuities and the like to be asset test exempt during the deferral period or at very least have only a small proportion of the purchase price included in the asset test assessment. ASFA considers that a deferred product should be treated more as an insurance product than a wealth management product, with the purchase price akin to payment of an insurance premium. If the qualifying event (achievement of a specified age) is achieved then a significant income stream might become payable. However, if the product holder dies before the specified age the product delivers no payment to the product holder or their estate.

If the deferral age is life expectancy or beyond, only a minority of product holders will receive a monetary payment. A means test treatment which led to the majority of the holders of deferred annuities or like products having a significant reduction in Age Pension although never receiving any payment from the product is unlikely to be seen by potential purchasers as being equitable. It does not look right, and ASFA does not consider it would be right.

As well, for the minority of product holders who receive a benefit, it would be better to include the real value of that benefit at the time of payment. In essence, ASFA is suggesting that individuals be assessed on the value of payments they actually receive.

When and if the deferred annuity starts to be paid an actuarial assessment could be made of its then capital value. The payment stream could then be treated in the asset test in the same way as an immediate annuity with equivalent purchase price.

In order to avoid any “gaming” of the rules, asset test exemption could be made only available when a deferral period of at least life expectancy of the purchaser is chosen.

Income test treatment

During the deferral period by definition no income stream is being received by the product holder. ASFA agrees with the proposed income test treatment in the policy paper proposed in regard to the deferral period and the payment period.