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Review of retirement income stream regulation

September 2014

Association of Superannuation Funds of Australia (ASFA)

Summary of ASFA responses

Question 1: What types of income stream products would enable retirees to better manage risk in the retirement phase (in particular, longevity risk and investment risk)?	In order to manage longevity and investment risk, ASFA consider legislative change is required to establish 'MyPension' arrangements. These changes should be consistent with regulatory and governance arrangements for 'MySuper'. Setting the rules is difficult however the regulatory framework should as a minimum require the provider of the MyPension arrangement to consider whether to include longevity risk protection as part of the offer to members. If longevity risk protection is not provided then there should be justification for this provided in the form of "if not, why not" documentation which would be subject to review by APRA. As a maximum, the regulatory framework should require a default MyPension arrangements, to have a standard form of longevity protection, but with a requirement for opt-out being to be offered. ASFA does not support the mandatory provision of longevity insurance with no opt out availability to members.
Question 2: Do the annuity and pension rules constitute an impediment to the development of new products and if so, what features of the rules are of most concern from a product innovation perspective?	Yes, ASFA consider that there are five key regulatory impediments. 1. The SIS regulations for a product to qualify to be a superannuation pension (and therefore be eligible for a tax exemption) are dependent on the specific features of the product. ASFA consider that regulations should be principle based and this would encourage innovation. 2. The SIS regulations minimum drawdown requirements do not cater for deferred lifetime annuities (DLAs). 3. There is no tax exemption in the deferral period for DLAs. 4. The requirement for a minimum surrender value for DLAs makes their pricing uneconomic. 5. Income streams are currently included in the social security assets test. In addition, product development requires interaction with multiple agencies and ASFA consider a single source of contact and source of truth regarding interpretation would encourage product development.
Question 3: What changes could be made to the annuity and pension rules to accommodate a wider range of income stream products while having regard to the need to protect against abuse of the earnings tax exemption and to promote appropriate and prudent retirement income objections?	ASFA considers that legislative changes to address the impediments outlined in Question 2 will encourage greater development and take up of income stream products.
Question 4: Would such changes lead to new products being brought into the market?	ASFA considers that legislative changes to address the impediments outlined in Question 2 will encourage greater development and take up of income stream products.

Question 5: Should people only be able to purchase a DLA with superannuation money?	In ASFA's view there is no reason why there should not be both: • superannuation DLAs – purchased from superannuation monies and eligible for concessional tax treatment • ordinary business DLAs – purchased from non-superannuation monies and not eligible for concessional tax treatment.
Question 6: Should people only be able to purchase a DLA for an up-front premium or should other purchase options also be allowed? If an annual premium approach is allowed, what should be the consequences if the premium payments cease?	ASFA consider that people should not be restricted to purchasing a DLA for an up-front premium. Other purchase options, such as annual premiums, should also be allowed.
Question 7: Should there be an upper limit on the amount that can be invested in a DLA?	ASFA can see no compelling policy reason to impose an upper limit given the nature and risks attached to DLAs (especially if there is no death benefit); that contribution caps will serve to limit the amount of super monies and the likelihood that, if not in a DLA, the bulk of the money would remain in a concessionally taxed environment.
Question 8: Should there be a minimum deferral period for a DLA? If so, what would determine the period?	ASFA considers that for a DLA with a death benefit a relatively short deferral period may be utilised to avoid minimum drawdowns and thereby avoid tax on earnings outside super which may arise if minimum payments were taken. Accordingly ASFA recommends taxing all death benefits from a DLA, to act as a disincentive and to recoup tax. ASFA is not concerned about DLAs without a death benefit allowing a relatively short deferral period as the member is assuming the risk they may die before, or not long after, commencement and should be able to manage this risk as they consider appropriate, in exchange for lower income payments.
Question 9: Should there be a maximum deferral age or period? If so, what should it be?	ASFA considers that if the DLA provides a death benefit then, provided the recommendation is adopted to tax all benefits arising from a DLA, there is little need for a maximum deferral period as the death benefit will be subject to tax. If the DLA does not provide a death benefit there is an argument that there is no need for a maximum deferral period, however, there is a need to mitigate the risk of a member acquiring, or being placed into, an unsuitable product, especially in context of a default MyPension. This risk could be mitigated through disclosure or, if considered insufficient, there could be a maximum deferral of the member's life expectancy.
Question 10: Do the payment features described in paragraphs 51 and 52 strike the right balance in allowing people to insure against longevity risk while avoiding unnecessary restrictions on product development?	**Paragraph 51 – Commutability** ASFA largely agrees with the statement in the Treasury paper, however, both from a behavioural economics perspective and having regard to the possibility of a default MyPension product, consideration should be given to a limited "cooling off" period. Consideration could also be given to the amount of the commutation being discounted, losing its super status or being taxed. **Paragraph 52 – Annuity payments** ASFA notes that a full guarantee is expensive and so there should be regulatory flexibility.

Question 11: Should providers of DLAs be able to offer a death benefit? If so, should there be restrictions on the size of the death benefit that could be offered? If so, what restrictions?	ASFA considers that the provision of death benefits should not be prohibited but note that some design features will need to be overcome to strike the right balance between, on the one hand, making products more attractive to consumers while also striving to make them affordable and mitigate the risk of their being used for estate planning or excessive tax deferral.
Question 12: Are the current minimum payment amounts for account-based products appropriate to achieve the objectives outlined above, given financial conditions can change?	ASFA does not consider that the current minimum drawdown schedule needs to change, although, given the linkage with residual life expectancy there may be merit in the Government Actuary reviewing the schedule every decade or so.
Question 13: Should there be an automatic mechanism for adjusting the minimum drawdown amounts in response to significant adverse investment market performance? If so, what should that mechanism be? How would this also satisfy the rationale for setting minimum amounts?	ASFA recommends that there be no automatic mechanism for adjusting the minimum drawdown amounts in the event of a significant market event.
Question 14: Should the minimum drawdown amounts also increase in response to very strong market performance? Would the mechanism be similar to that for decreases? Would this satisfy the rationale for setting minimum payment amounts?	ASFA sees any change as adding unnecessary complication to regulation.
Question 15: For how long should the change remain in place? Should it be left in place only for the year in which the shock occurs, or until balances have recovered by a particular extent?	ASFA sees any change as adding unnecessary complication to regulation.
Question 16: What other issues need to be considered if the minimum drawdown amounts should fluctuate?	ASFA consider that any changes proposed to minimum drawdown amounts should be considered in the context of the overall objectives of the superannuation and retirement system.

Background

In putting together this submission, ASFA has reflected its overarching views on the objectives of the superannuation and retirement system, and looked to ensure that this submission is consistent with those objectives.

ASFA notes that the Treasury discussion paper describes the objectives of regulation around concessionally-taxed income stream products as to ensure that they:

1. provide a regular, steady source of income to facilitate dignity in retirement – and specifically guard against individuals excessively deferring income
2. do not accumulate excessive balances (ie. are not used as an estate planning vehicle)
3. are objective, transparent and simple to understand and
4. allow flexibility and choice to provide for individual circumstances.

ASFA supports these and note they are consistent with ASFA's key principles for good design of the retirement income system which are outlined immediately below. ASFA's responses to the individual questions in the Discussion Paper are consistent with the ASFA principles for good design of the retirement income system.

Principles for good design

As outlined in our second submission to the Financial System Inquiry (FSI), ASFA identifies two mutually dependent objectives of the superannuation and retirement systems:

- **firstly**, a social objective to ensure that all Australians have the opportunity to live with dignity in retirement, and
- **secondly**, a fiscal objective, to ensure that the superannuation and retirement system is sustainable from a budget perspective.

With these in mind, ASFA identify five principles for good design of the retirement income system as:

1. Measurable goals for the system that are agreed and monitored.

As outlined in our second submission to the FSI, ASFA identify these goals as:

- an upper limit on spending on the Age Pension and appropriately costed tax concessions of 6 per cent of GDP
- 20 per cent of retirees reliant on full Age Pension
- an income replacement rate of 65 per cent (on average) and
- 50 per cent of retirees at the ASFA comfortable standard or more.

2. Having a 'whole of life' approach to superannuation and retirement.

The superannuation and retirement income system needs to be simple and easy for Australians to navigate and they must be able to invest into and through retirement to ensure better longer term planning. We need:

- a streamlined approach to moving from the accumulation phase to the drawdown phase. For disengaged members, this will mean allowing MySuper options to default into a 'MyPension' product, which offers an allocated pension alongside some form of optional longevity protection.
- products which allow individuals to create or purchase income streams, with flexibility to access capital later if required, for example for the purchase of an age care accommodation bond This includes the purchase of a future income stream in the accumulation stage, to allow individuals greater certainty of outcomes at retirement.
- to ensure that the design of the system is consistent with a policy where individuals consume the vast majority of their superannuation balance over their residual lifetime, based on reasonable estimates of longevity. This will avoid misuse of the system for estate planning and tax minimisation.

The approach taken must be consistent with the objective of providing a reasonable retirement income. It must also meet the sustainability objective by ensuring that the fiscal commitment of the government is matched by Australians using the savings which have accumulated in a lower tax environment to meet their income needs in retirement.

3. Being integrated with, and consistent with, other interdependent government policies

This integration needs to occur at two levels. Firstly, the rules around the superannuation and retirement system need to be integrated with those for the government pension and other social security benefits. Innovation is more likely to occur if there is a unified approach to the regulation of retirement income products across the relevant government departments. A single point of contact and "source of truth" for approval of new products would also help promote innovation.

4. Allowing innovation to flourish by structuring regulation around principles, rather than specific product features

It is not possible to anticipate the direction which product innovation will take over the coming decade. Regulation must be flexible enough to cater for the fact that retirement products in the future will likely be a combination of, income streams, account management and longevity insurance. They may be part of pooled products or individually managed accounts.

In order to maximise the opportunity for innovation in product development, we must ensure that the regulation is designed around the objectives of the superannuation and retirement system ie. provide regular incomes streams over retirement, rather than being tied to specific product features.

5. Being supported by an appropriate consumer protection framework

An appropriate consumer protection framework contains the following elements:

- a safe default in the event of the inability of individuals to make a decision or their choice not to make decision.
- disclosure and product fit for purpose comparisons – including product dashboards and income stream comparison information (dealing with matters such as cost, longevity, and the level of promise provided).
- regulatory framework that holds all providers accountable in terms of how close they will get their members towards their retirement goal.
- appropriately qualified financial advisors who are able to explain product features to their clients and ensure that they are fit for purpose for their client. In particular, be able to explain the risks faced by retirees, and the ability of specific products to mitigate these risks.
- complaint handling and trusteeship services for the more vulnerable
- community and members education including self-help advice tools, calculators and the placement of income stream projections on annual statements.

1. The regulatory arrangements for superannuation income streams

Question 1
What types of income stream products would enable retirees to better manage risk in the retirement phase (in particular, longevity risk and investment risk)?

The nature of income stream products which enable retirees to better manage risk will vary across individuals. For some individuals, whose parents and grandparents lived well into their nineties, longevity risk may be a major concern. For others, simply having enough money to live and meet healthcare needs may be the primary issue.

The very individual nature of retirement means that the system needs to offer a wide variety of products which cover the full spectrum of risk protection. These may be used on a standalone basis, or in combination, to achieve an appropriate level of income generation in retirement. Critical to this process will be an ability to build flexibility for the customer into product design. The needs of a retiree may change over the course of their retirement, at times unexpectedly. For example, a retiree having purchased an income stream may need to access the principal value some years later in order to afford a place in an aged care facility.

Assuming that the retiree has saved an adequate sum for retirement, the risks they face are:

- **investment** – loss of value as a result of market fluctuations
- **inflation** – the value of the portfolio does not keep up with inflation
- **unanticipated lump sum needs** – the risk that a large, and unanticipated costs arises, for example the purchase of an accommodation bond in an aged care facility and
- **longevity** – living longer than anticipated, and therefore falling back on the Age Pension.

In terms of the cost of mitigating the risk, investment risk is the greatest risk retirees face followed by longevity risk, although longevity risk itself magnifies all three other risks above. The retirement income stream product that would help the greatest number of retirees would likely be one which helps manage investment risk and longevity risk to manage these two primary risks.

In designing these products however, the market needs to consider that: a) across all retirees there will be different tolerances for each of these risks; and, b) the cost of fully insuring either of these two major risks may be prohibitive for many retirees, especially those who were underfunded at the point of retirement. As such, it will be important that retirees have the ability to "dial up" and "dial down" the amount of protection they choose to purchase against investment risk and for longevity risk. This will allow them to balance a preference for certainty and security again the opportunity cost of investment returns which could have been earned on the capital used to obtain the right level of risk protection.

The current range of products can be summarised as:

	Longevity risk protection	Investment risk protection	Inflation risk protection	Provide lump sums	Death benefit
Life annuities	**High**	**High**	**High/low**	**Low**	**Low**
	Provide income until point of death	Volatility of investment returns is removed by the setting of the annuity rate at the point of purchase	Can be indexed to CPI at additional cost	Annuities may be commutable, generally for no more than a 10 to 15 year period after purchase and this if allowed will be at a cost	Annuities can provide a death benefit but this will be at a cost in terms of lower periodic payments
Life pensions	**High**	**High**	**High**	**Low**	**Low**
	Provide income until point of death and often have a reversionary beneficiary	Volatility of investment returns is removed by the setting of the pension rate at the point of first income instalment	Typically life pensions provided by an employer sponsored fund will be indexed to CPI or AWOTE	Fund rules may allow for a partial commutation	Although may depend on specific details of the arrangement with the employer
Account-based pensions	**Low**	**Low/medium**	**Low/medium/ high**	**High**	**High**
	Longevity risk can be covered if the principal amount at retirement is large and spending is kept to minimal levels but there is no guarantee	Investment risk will vary depending on assets	Capacity to cover inflation will depend on the choice and performance of assets held	Capital can typically be accessed quickly	High likelihood of death benefit provided the initial balance was adequate and substantial lump sums have not been required
Variable annuities (minimum withdrawal benefit)	**Medium**	**Medium**	**Medium**	**Medium**	**High**
	Depending on design can provide income until point of death and often have a reversionary beneficiary but can be depleted by withdrawal	Volatility of investment returns is reduced by the setting of the minimum withdrawal benefit or other investment guarantee at the point of purchase	Depends on the guarantee provided and the choice and performance of assets held. Protection against adverse investment outcomes can be at the cost of missing out on above average returns if they occur	Capital can typically be accessed quickly, although this may proportionately reduce the value of the investment guarantee provided	High likelihood of death benefit provided the initial balance was adequate and substantial lump sums have not been required

Fixed-term annuities	**Low**	**High**	**Low**	**Low**	**Medium**
	Only provide income over a set period	Volatility of investment returns is removed by the setting of the annuity rate at the point of purchase	Annuity rates is set at purchase and typically not linked to inflation. May be CPI indexed but most are not as most are short-term	Annuities are commutable at a cost. Some annuities do have a residual capital value at the end of the term	Capital balance is paid to estate
Hybrid products	**Medium/high**	**Medium**	**Medium/low**	**Medium/high**	**Medium/high**
	May allow include an annuity stream	May include exposure to various interest rates	Annuity stream likely not to provide inflation protection, other assets may	Non-annuity assets may be accessible as a lump sum	Non-annuity assets may provide a death benefit
DLAs	**High**	**High**	**Medium**	**Low**	**Low**
	Will provide income until death, albeit starting at a later date	No risk as annuity rate set at the point of purchase	Likely to be CPI indexed	No access to a lump sum	Death benefit possible depending on regulation and product design but this will impact on product cost

Life pensions and annuities

Current life pensions and annuities address the need to protect retirees against investment risk and longevity risk in retirement. The amount of the payment is guaranteed and the counter-party bears both market and longevity risk. However, they tend to fall short of many consumers' preferences for the following reasons:

- there may be a genuine need for access to capital during retirement, especially with respect to housing or eventual access to residential aged care
- the largely irrevocable nature of the decision, although some annuities for a price do allow commutation in the first 10 to 15 years or in certain limited circumstances
- the pricing can be complicated and appear expensive relative to other products given that while the pricing reflects current market conditions the provider needs to maintain reserves to ensure that the yield can be paid over decades
- there can be concerns about counter-party risk
- they are out of line with the "lump sum" culture where control over the capital is retained (while noting that recent data suggest that this culture is not as prevalent as some market commentators might think)
- they limit the ability to leave a bequest.

New products incorporating the features of lifetime pensions or annuities will need to address these needs and concerns to become more popular amongst consumers.

Account-based pensions

Account-based pensions, while providing access to capital, a death benefit, the ability to manage investments and flexibility as to payments, do not provide great protection against longevity risk, unless only the minimum drawdown is taken, and are exposed to market risk.

Variable annuities

Variable annuities offer a blend of attributes including longevity protection, capital guarantee, liquidity, and access to growth assets. The precise mix will vary from product to product and option to option, with the fee paid varying according to the attributes of each product. The member pays for the guarantee or guarantees incrementally, through ongoing premiums.

The fee is set by providers in the context of claims paid and the benefits that are delivered to the purchasers of such products and such fees can be substantial.

Guaranteed fixed-term pensions/annuities and hybrids

Guaranteed fixed-term pensions, annuities and hybrid products offer some form of "middle ground" risk protection, somewhere on the spectrum between life pensions and account based pensions.

Deferred lifetime annuities (DLAs)

A key gap in the Australian market is deferred annuities. Deferred annuities can be a cost effective way for members to manage longevity risk.

Potential alternatives

There have been discussions in the market around possible alternatives to the current retirement income products, particularly alternatives which provide longevity risk protection. Although, currently prohibited by the pension and annuity rules, much of this discussion has been around products which pool investor experience in some form. These operate on the basis that:

- the amount of income payments can vary depending on the experience of the pool
- payouts are dependent on the number of surviving existing pool members and new members joining the pool
- the product is not guaranteed and does not transfer longevity risk to a counter-party, instead longevity risk is shared amongst the pool of lives covered by the product
- exposure to market risk will depend on the design of the product and may be retained by the member, pooled or even transferred to a counterparty.

Examples of these types of products include pooled annuities, group self-annuitisation products, and bespoke pooled unit trust structures.

Another possibility which has been floated to manage market risk, but also prohibited by the pension and annuity rules, is a partial transfer of market risk to a counterparty, with the amount of income payments varying in part on market performance.

ASFA supports a market-driven approach to product availability. Regulatory settings which support innovation and a competitive market place should improve the quality and variety of products on offer.

Catering for disengaged members and members who do not want to make a retirement decision

The system should also be explicitly catering for the disengaged members of superannuation funds and members who do not want to make a retirement decision. This can be achieved by a default arrangement which converts all or some of the balances of these members into a sensible low cost retirement income arrangement.

Given current restrictions on the transfer of balances from a MySuper product, legislative change would be required to establish a 'MyPension' equivalent to 'MySuper'.

The design of the 'MyPension' default arrangement should be consistent with the current approach to MySuper which sets general principles for the design of products, while allowing for variations between offerings, and puts in place a high level of fund governance.

As with MySuper, a MyPension arrangement would need to be APRA approved. As part of this approval process trustees would need to demonstrate that the proposed arrangement took into account the demographics and profile of their membership.

ASFA considers that the provider of the MyPension arrangement should, as a minimum governance requirement, consider whether to include longevity risk protection as part of the arrangement. If longevity risk protection is not provided then there should be justification for this provided in the form of "if not, why not" documentation which would be subject to review by APRA.

In terms of a maximum for what should be permitted in default MyPension arrangements, a provider should be allowed to have a default arrangement with a form of longevity protection, but with a requirement for opt-out being to be offered. This would help meet the requirement of members who do not wish to purchase or utilise such protection. A transitional approach might be to allow members to opt-in to a longevity risk offering as part of their MyPension.

Current regulatory settings in regard to transfer of balances, disclosure and member consent would need to be modified in order to allow such default arrangements while at the same time providing appropriate consumer protections.

An "if not, why not" approach to including longevity risk protection might initially result in many, if not most, MyPension arrangements looking more or less like customary account based income streams. However, over time it could be expected that many, if not all, default MyPension arrangements would provide longevity protection on an opt-out basis.

ASFA considers that access to some form of financial advice and/or advice tools is important for individuals, particularly at the start of retirement. These facilities should be accessible to both default and non-default members. Many members will want or need such advice and with the innovation in technology and self-guided advice tools we believe that it should become part of the services provided across the industry.

There are, of course, a range of details relating to the mechanics of the process and necessary consumer protections which would need to be worked through as we move to income stream default and generation. These include regulatory principles and specific requirements which:

- define the events which can be used by providers as the trigger point or points for establishment of MyPension arrangements
- set out the minimum requirements for notifying members about transfers to a MyPension arrangement
- define the opt-out opportunities that must be provided in regard to default arrangements, including restoring the financial position of a member if they opt out in a defined period after a default transfer
- specify when financial advice or financial tools should be offered to individuals prior or subsequent to retirement
- specify disclosure requirements more generally, such as a MyPension product dashboard
- set out processes to be used by the ATO and super funds when a member has multiple accounts.

While developing these various regulatory arrangements would involve challenges, all these challenges should be able to be resolved with appropriate consultation.

ASFA considers that the end result of properly designed and well governed MyPension arrangements would be very consistent with the high-level objectives of the retirement system.

Question 2

Do the annuity and pension rules constitute an impediment to the development of new products and if so, what features of the rules are of most concern from a product innovation perspective?

There are number of impediments to the development of new retirement income products. Some of these impediments relate directly to the regulation of retirement income products in the *Superannuation Industry (Supervision) Regulations 1994* (SIS), while others relate to rules and obligations in other areas, such as social security and taxation law. ASFA has previously published a paper on these various impediments in October 2013, *Changes to regulatory settings for financial products dealing with longevity*, which is available on the ASFA website.[1]

Success will only be achieved if impediments are removed in a consistent manner, across all "rules" and regulations relevant to the consumer of these products. This will require a co ordinated approach to changes in the SIS regulation with the relevant tax and social security legislation.

ASFA has identified five key regulatory impediments as follows:

i) SIS defines annuity too narrowly – Tax Act interaction
ii) SIS – Deferred lifetime annuities subject to minimum drawdown rules
iii) Tax treatment of deferred Annuities
iv) APRA minimum surrender value requirements in LPS360 – Deferred Annuities
v) Age Pension assets and income test – Social security and tax.

These are discussed below.

SIS defines annuity too narrowly – Tax Act interaction

To qualify as a superannuation pension under the SIS Act, a product must have the features specified in the legislation. This means anything that does not "look" like a "classic" annuity (narrowly defined) will not receive the earnings tax exemption. New, innovative products that do not fit these criteria will not receive concessional tax treatment.

This section of the SIS Regulations needs to move to a more principles-based approach. Regulatory treatment based on specific product features becomes counterproductive when new product features – not contemplated by legislation – appear. Of course, in taking this approach there will still need to be protection against "gaming" excessive tax deferral and estate planning.

Specifically, Regulations 1.05 and 1.06 of the SIS Regulations 4 should be amended to ensure that they allow product innovation. The current regulations are overly complex, prescriptive and not well-drafted. They discourage or prevent the introduction of most of the annuity products that have been successful internationally.

The Actuaries Institute points out in its 2012 White Paper on the Longevity Tsunami that:

> *"…the following product designs, which are "mainstream" internationally, and meet all of current policy objectives (mainly of a revenue nature), are either prohibited or difficult to implement:*
>
> - *Variable annuities with the pooling or guarantee of longevity risk.*
> - *With profit annuities, where investment and longevity profits and losses are shared with the pensioners.*
> - *Income stream packages that incorporate a deferred annuity from an advanced age.*
>
> *In each case, the product design should specifically allow payments to be varied to limit fluctuations in the combined payments from the pension/annuity and the Age Pension."*

[1] www.superannuation.asn.au/policy/reports

A particular concern with the pension and annuity rules from a product innovation perspective are those rules with respect to indexation, which preclude products which pool longevity risk and vary a member's income stream payment according to the experience of the pool. This, by necessity of design, results in variations in the amount of the income payments which are not a function of indexation but of the experience of the pool.

Prohibitions on residual capital value and/or death benefits can also act as an impediment to people purchasing income streams, as these are seen as inconsistent with the ability to leave a bequest. Similarly, unduly restrictive prohibitions on commutations restricting access to capital can act as a disincentive to an individual considering purchasing an income stream.

Finally, there is a prohibition on contributions being made into a pension or annuity. Under current arrangements for account-based products, the provider needs to commute the original pension and set-up a new pension. This represents a considerable administrative burden on superannuation funds and should be reviewed.

SIS – Deferred lifetime annuities subject to minimum drawdown rules

The rule requiring a minimum payment to be made from a pension every year does not cater for deferred annuities. Deferred lifetime annuities should be exempt from such a requirement during the deferral period.

Tax treatment of deferred annuities

A specific implication of the above SIS requirement and Tax Act interaction is that superannuation assets invested in deferred annuities do not receive a tax exemption in their deferral period, as the annuity is treated as an insurance policy and not as a superannuation retirement income stream product. We understand this rule may have been put in place to prevent tax deferral in certain investment products.

To ensure a level playing field, it is important to ensure that all superannuation assets are given the same tax treatment. The tax rules on deferred lifetime annuities should be changed so that, during the drawdown phase, the product is regarded as a pension (rather than a non-pension) and therefore exempt from income tax. This has been raised previously by ASFA in its paper on impediments to the development of longevity products.

The Actuaries Institute 2012 White Paper also considers this issue and states in Appendix C that:

> *"The Actuaries Institute is not aware of any provider issuing deferred lifetime annuities largely due to the product's classification as a non-pension. Challenger has estimated that the price of a deferred lifetime annuity is 14% higher because of the current taxable classification.*
>
> *We understand that the Government is concerned about the impact on revenue from changing the tax status. Introduction of deferred annuities into the Australian superannuation system would involve a short term cost to government finances. By buying a deferred annuity, a retiree is deferring retirement income that will result in a reduction in retirement income during the deferral period. If the retiree is eligible for a part Age Pension this would result in a small increase in pension outlays. Provided retirees are complying with the minimum draw down rules they have the option to defer private income and take a larger Age Pension whether they are buying a deferred annuities or not. The Institute notes, however, that any rule changes would need to be carefully framed to apply tax free status to genuine retirement deferred lifetime annuities purchased with superannuation money, and not extend such treatment to other deferred annuities.*
>
> *The Actuaries Institute contends that if the proposed tax treatment is limited to non-commutable income streams purchased with superannuation money, there is no opportunity to exploit the system. People will not attempt to "hide" capital in something that is non-commutable, because they can never get the money back."*

ASFA supports this position and would submit that non commutable deferred annuities purchased with superannuation money should receive an earnings tax exemption in the deferral period.

APRA minimum surrender value requirements in LPS360 – Deferred Annuities

Another issue relating to deferred annuities is contained in the APRA requirements.

APRA Prudential Standard LPS360 "Termination Values, Minimum Surrender Values and Paid-up Values" (January 2013) treats deferred annuities as an investment product during the deferral period and requires there to be a surrender value. This would render a deferred annuity uneconomic to provide as a lifetime product and would defeat the attractive pricing, which is the basis of deferred lifetime annuities.

The requirement for minimum surrender values for deferred annuities should be removed.

Age Pension assets and income test – Social security and tax

In an environment where there is minimal tax paid by retirees, there is currently little incentive to take an income stream in retirement. Consideration might be given to adjusting the social security framework to promote the uptake of income streams in retirement, with the aim of ultimately reducing the use of the Age Pension.

An option may be to exclude non-commutable, guaranteed superannuation annuities from the social security assets test. While this has revenue implications, non-commutability is likely to limit the amount which is placed into a deferred annuity, while the guarantee will minimise the risk of the individual claiming the Age Pension in the future.

Question 3

What changes could be made to the annuity and pension rules to accommodate a wider range of income stream products while having regard to the need to protect against abuse of the earnings tax exemption and to promote appropriate and prudent retirement income objectives?

As noted above, ASFA believes that for long term success we need better retirement income solutions for Australians, while maintaining fiscal sustainability. This requires that any flexibility provided in the system is not at the expense of an unduly adverse effect on the fiscal position.

This requires the policy process to focus on two objectives. Firstly, that any requirements in the regulations are, to the greatest extent possible, product agnostic. Put another way, this means that the regulation focusses on the principles of what must be adhered to, rather than reference specific product features. Secondly, in the drafting of annuity, pension and other retirement income rules, there must be explicit reference to the need for the provider to ensure that the product is not being used for tax evasion or for the accumulation of wealth in a tax concessional environment.

The changes ASFA would like to be made have been described above in our response to Question 2.

Question 4

Would such changes lead to new products being brought onto the market?

It is impossible to know whether the changes above will lead to new products being brought onto the market. However, we can make two points with respect to this. Firstly, we can be fairly certain that, without change, we will not see many new or innovative products emerge. Secondly, the best chance for success will be if these changes to the pension and annuity standards are made in concert with the removal of impediments in other areas which affect Australian retirees, such as the social security and tax rules.

The current roadblocks to product development are significant – especially the tax issues which greatly affect product pricing and their attractiveness to consumers. Until these roadblocks are overcome many product providers are unable to justify placing time and resources into superannuation income stream product development.

There is no doubt that the capital requirements of offering guarantees – especially guarantees against market and longevity risk – are a challenge for many superannuation funds. Many funds do not have access to the capital that would be required. This challenge will remain, and may only be met through the use of life office annuity products.

It is important to note that the majority of superannuation funds have ageing memberships and an increasing number of members are reaching retirement each year. In a competitive market, funds are incentivised to keep these members, and will need to offer a retirement income stream product. Most funds already do this through allocated pension accounts.

It seems most likely that once these current regulatory roadblocks are removed, there will be an increase in product development in this space. This is likely to come from life insurance companies and funds with significant capital reserves, as well as specialist players who have experience in overseas markets.

2. Deferred lifetime annuities

Question 5
Should people only be able to purchase a deferred lifetime annuity with superannuation money?

As noted above, ASFA believes that, for long term success, there needs to be better retirement income solutions for Australians, which are consistent with fiscal sustainability.

It would consistent with the objectives of the retirement income system to allow Australians with money outside superannuation to purchase deferred lifetime annuities (DLAs), subject to appropriate tax and other arrangements. There seems to be no policy reason for prohibiting the purchase of such product with money from outside of superannuation; indeed there may be efficiencies from increasing the potential customer base and the size and scope of the overall market.

Accordingly in ASFA's view there should be two types of DLAs, as there are with other life insurance policies and life annuities:

- superannuation DLAs – which can only be purchased with superannuation monies and which are eligible for concessional tax treatment and
- ordinary business DLAs – which can be purchased with non-superannuation monies and which are not eligible for concessional tax treatment.

Question 6
Should people only be able to purchase a deferred lifetime annuity for an up-front premium or should other purchase options also be allowed? If an annual premium approach is allowed, what should be the consequences if the premium payments cease?

In formulating the regulations around DLAs, consideration needs to be given as to whether the regulations are flexible enough to prevent any distortion of the market. ASFA advocates that, where possible, regulations are drafted in a way which facilitates alternative structures and features which may not currently be offered.

As much flexibility as possible in product design should be allowed (refer response to Question 2 above) including other purchase options.

For example, an annual premium should be able to be paid from an account-based or term annuity which means that, on reaching age 85 (for example), a deferred annuity has been purchased which then commences for the retiree's remaining lifetime.

The pricing of a DLA will depend on whether it is:

- a non-commutable deferred annuity with no residual capital value or
- a product which can be commuted or has a death benefit.

Both may allow for a "mortality bonus", whereby those who die prior to their payments commencing forfeit their capital to the pool, which in turn increases the "return" to the surviving annuitants. The level of this mortality bonus depends on the amount of capital that is forfeited.

If premiums cease – for whatever reason – for a product with no death benefit, there should be no surrender value derived from the insurance premium paid. In other words, premiums paid to date should be forfeited for the benefit of others who will draw their eventual benefit from the annuity pool. This is the risk pooling principle in action and is reflected in the higher income payments which are received with such a product compared to a purely investment product.

For a product which offers a death benefit – refer Question 11 below – some form of refund of premiums already paid would be made on death. The consequences if the premium payments ceased could include either a reduced DLA being payable upon attainment of the deferral age or a refund of some portion of the premiums paid, depending on the design of the product.

In ASFA's view people should not be restricted to purchasing a DLA for an up-front premium. Other purchase options, such as annual premiums, should also be allowed.

Question 7

Should there be an upper limit on the amount that can be invested in a deferred lifetime annuity?

ASFA believes that regulation of this should be consistent with the overall intent of the retirement system. The Treasury paper outlines a number of key objectives, one of which is to ensure that the system does not promote excessive tax deferral.

Given the nature of DLAs and the risks which are attached to the purchase of a DLA – in particular that:

- premature death may result in total or partial forfeiture of the benefit; and
- generally there is no or limited ability to commute to access capital.

and that with respect to superannuation DLAs

- the likelihood is that, if not in a DLA, the money will be in a concessionally taxed environment anyway, such as a superannuation account-based pension; and
- the contribution caps work to limit the amount of benefits accrued within superannuation.

there is no compelling policy reason to impose an upper limit on the amount of superannuation money which can be invested in a DLA.

The one possible exception to this may be if a product were to offer a death benefit, limited to purchase price, this is likely to outweigh any potential tax benefits from placing a large amount into a DLA.

Question 8

Should there be a minimum deferral period for a deferred lifetime annuity? If so, what would determine the period?

ASFA believes that any regulation should be consistent with the overall intent of the retirement system. The question which needs to be answered is whether a minimum deferral period is consistent with the objectives of the retirement system. Would a minimum deferral period help guard against an individual excessively deferring income or accumulating excessive balances? Would such a regulation allow flexibility and choice to provide for individual circumstances? Would the regulation unnecessarily complicate the process of purchasing a DLA, and therefore be inconsistent with the objective of keeping the regulations objective, transparent and easy to understand?

With a DLA without a death benefit the member is taking a risk that they may die prior to, or not long after, the commencement of the DLA. Given this, ASFA is of the view that, if a member wants to reduce this risk by commencing the annuity earlier, in exchange for lower annual payments, this should be acceptable. Similarly, a member should be able to receive higher annual payments in exchange for deferring the annuity for a longer period.

It is unclear what harm would arise from allowing a relatively short deferral period – while this may have the effect of making the annuity more like an immediate annuity, immediate annuities still meet retirement income principles in providing an income stream in retirement and protection against longevity and market risk. The amount of the payments will be calculated to reflect the length of the deferral period, thereby still providing protection against longevity.

With a DLA with a death benefit, there is the risk that a relatively short deferral period could be utilised to avoid minimum drawdowns. Balanced against this, however, is the fact that if a death benefit for a pensioner is limited to a return of capital, this will act as a significant disincentive. Furthermore, similarly to immediate annuities, an amount equivalent to the purchase price, reduced by a factor every year based on life expectancy at purchase, should be exempt from the social security assets test.

Given the above, there should not be a minimum deferral period as the appropriate deferral period will be different depending on individual circumstances.

Question 9

Should there be a maximum deferral age or period? If so, what should it be?

ASFA believes that any regulation should be consistent with the overall intent of the retirement system. The question which needs to be answered is whether a maximum deferral period is consistent with the objectives of the retirement system. Would a maximum deferral period help guard against individual's excessively deferring income or accumulating excessive balances? Would such a regulation allow flexibility and choice to provide for individual circumstances? Would the regulation unnecessarily complicate the process of purchasing a DLA, and therefore be inconsistent with the objective of keeping the regulations objective, transparent and easy to understand?

If the DLA provides a death benefit there is an argument that it could be used to defer income payments unduly and therefore a maximum deferral period may be warranted. If, as per our response to question 7 above, all death benefits from a DLA were to be limited to being a return of capital only then this would be likely to act as a disincentive to members selecting excessive deferral periods.

If the DLA does not provide a death benefit then there is an even stronger argument that there is no need for a maximum deferral period as the member will be taking into consideration their risk of dying prior to, or not long after, the DLA has commenced when determining the length of the deferral period which best suits them.

Accordingly, we do not see the need for a maximum deferral period.

Question 10
Do the payment features described in paragraphs 51 and 52 strike the right balance in allowing people to insure against longevity risk while avoiding unnecessary restrictions on product development?

Paragraph 51 – Commutability

ASFA largely agrees with the statement about commutability in the Paper and think that this broadly strikes the right balance.

However, two factors which should be considered are:

- given Australia's lump sum culture and reluctance to relinquish control over their capital, the existence of a limited "cooling-off" may, from a behavioural economics perspective, make it easier for individual's to purchase a DLA
- if a "default" MyPension regime were to be introduced, with an "opt-out" – in order to enable a trustee to be able to incorporate a DLA in the product design it would be necessary to allow commutations for a limited period.

If commutations were to be allowed, consideration could be given to the amount of the resulting benefit payment:

- being significantly discounted
- losing its status as superannuation monies (assuming a superannuation DLA) and, or
- being subject to tax.

Paragraph 52 – Annuity payments

Whilst ASFA broadly agrees with the statement in the Paper with respect to annuity payments, it should be recognised that a full guarantee, which covers both market risk and longevity risk, can be expensive (although they may be fairly priced from an actuarial perspective). We recommend there be regulatory flexibility to facilitate product innovation with respect to the strength of the guarantee.

For example a provider could offer a fully guaranteed DLA, or a "with profits" DLA, whereby the amount of the future payment is not guaranteed but is dependent on the experience of the pool of lives insured or an external benchmark such as population mortality. This "tontine" style arrangement will have the advantage of being cheaper to acquire, however, the retiree in effect agrees to share in/take on some of the market and longevity risk. The risks borne by the retiree would need to be clearly disclosed.

The regulations should not be written in such a way as to prevent such an offer being made. We note that disclosure legislation will have to be quite stringent here to ensure that retirees understand what they are buying.

Question 11

Should providers of DLAs be able to offer a death benefit? If so, should there be restrictions on the size of the death benefit that could be offered? If so, what restrictions?

Consistent with the view that the regulations should be as flexible as possible to allow for product innovation, ASFA believes that the provision of death benefits in a DLA should not be prohibited. In ASFA's view providers of DLAs should be able to offer a death benefit but it should be limited to a maximum of the return of the purchase price.

This will serve to mitigate the risk of estate planning and excessive tax deferral. A balance needs to be struck between providing protection against longevity risk, and the pragmatic acknowledgment that offering at least a small death benefit may encourage members to acquire a DLA. Providing a death benefit will, of course, make that pension (or annuity) more expensive than an equivalent pension (or annuity) without a death benefit.

ASFA believes that, in the case of a DLA which has been acquired with a lump sum, the size of the death benefit should be restricted to a maximum of the return of the purchase price, however, providers should be free to design a product with a lower amount. This would be in exchange for higher income payments being payable. For example, the death benefit could reduce on a sliding scale so that no death benefit is payable on or after life expectancy (at date of purchase) has been reached.

If the DLA is being acquired through the payment of annual premiums and has not yet commenced then the annual premiums could be refunded.

Finally, reversionary DLAs should be permitted and the regulatory framework should ensure that there are no unintended consequences which may unduly restrict their development, commercial viability or attractiveness to consumers.

3. The minimum payment amounts for account-based income streams

Question 12
Are the current minimum payment amounts for account-based products appropriate to achieve the objectives outlined above, given financial conditions can change?

The Treasury discussion paper suggests that the objective of regulation around concessionally-taxed income stream products is to ensure that they:

- provide a regular, steady source of income to facilitate dignity in retirement – and specifically guard against individuals excessively deferring income
- do not accumulate excessive balances (ie. are not used as an estate planning vehicle)
- are objective, transparent and simple to understand and
- allow flexibility and choice to provide for individual circumstances.

ASFA observes that these principles are based around concepts that the monies accumulated through the tax-concessional superannuation system should be used for income in retirement and that the balance within the tax-exempt environment should be significantly reduced by the time of death.

ASFA highlights that any requirement to take money out of the tax-exempt environment, does not require that money to be spent. The money can be moved outside superannuation but earnings on these assets will be subject to the individual's marginal tax rate. The retiree will not be subject to capital gains tax on realising the asset to move the money outside the tax-exempt environment.

Below, we comment on the ability of the current minimum payment amounts to meet the objectives above.

Providing a regular source of income to facilitate dignity in retirement

For some individuals, an account-based income stream is their only retirement product (apart from the Age Pension and/or income from investments outside superannuation). They will likely not have a lifetime annuity, or a deferred annuity to manage longevity risk as relatively few lifetime annuities are purchased and deferred annuities are not yet offered in the Australian market. The baseline for minimum payment amounts, must assume that the individual needs an income stream right up to the point of their death, but for lower balance individuals it is likely that they will need to withdraw at least the minimum to meet their daily living requirements. The risk of outliving your savings needs to be balanced by the expenditure requirements of the earlier years or decades of retirement.

For other individuals, there may be less need to rely on the minimum drawdown for day-to-day living. An individual with a significant account balance might prefer to withdraw less than the minimum in order to maximise the amount they can pass on to the next generation. However, the objectives of the system make clear that the superannuation system is for income in retirement, not a tax effective means for estate planning.

This difference in the needs of individuals was highlighted in the post-GFC period, when an exemption to the minimum drawdown rules was given by the government. In this scenario, lower balance retirees largely continued to draw down on their balance at the same level, regardless of the change in the rules – they needed the money to fund their living arrangements. By contrast, higher account balance individuals were much more likely to take advantage of the temporary exemptions to the minimum drawdown arrangements, suggesting that they had other mean of support.

This is shown in a 2013 paper by George Rothman and Hongyang Wang of the Australian Treasury, *Retirement Income Decisions: Take Up and Use of Australian Lump Sums and Income Streams*. The paper indicates that drawing down no

more than the age dependant minimum is widespread, with most retirees taking a conservative approach to make their money last:

- the proportion using the minimum rises significantly with age
- the differences between men and women are fairly minor and
- those with lower balances have higher percentage drawdowns.

The use of the temporary minima following the Global Financial Crisis varied from around 30 per cent of retirees with allocated pensions with $100,000 of superannuation assets to over 60 per cent usage at the highest asset ranges (account balances of over $1 million).

Drawing down (and spending) too little may ensure that the account balance is not depleted by the time of death but it may be at the expense of a reasonable standard of living in retirement. For instance, a person with retirement savings of $800,000 who draws down only 2 per cent of their balance would have an income to spend each year of only $16,000 but would not be eligible for the Age Pension on the basis of the asset test. This would not be a good or sensible outcome for a relatively young retiree. They might not outlive their savings, but their lifestyle would be one of poverty over their retirement.

In considering what is a reasonable pattern of drawdown factors the interaction of account balance with the Age Pension needs to be taken into account as well as the spending needs of retirees.

Preventing the building up or retention of excessive balances in retirement

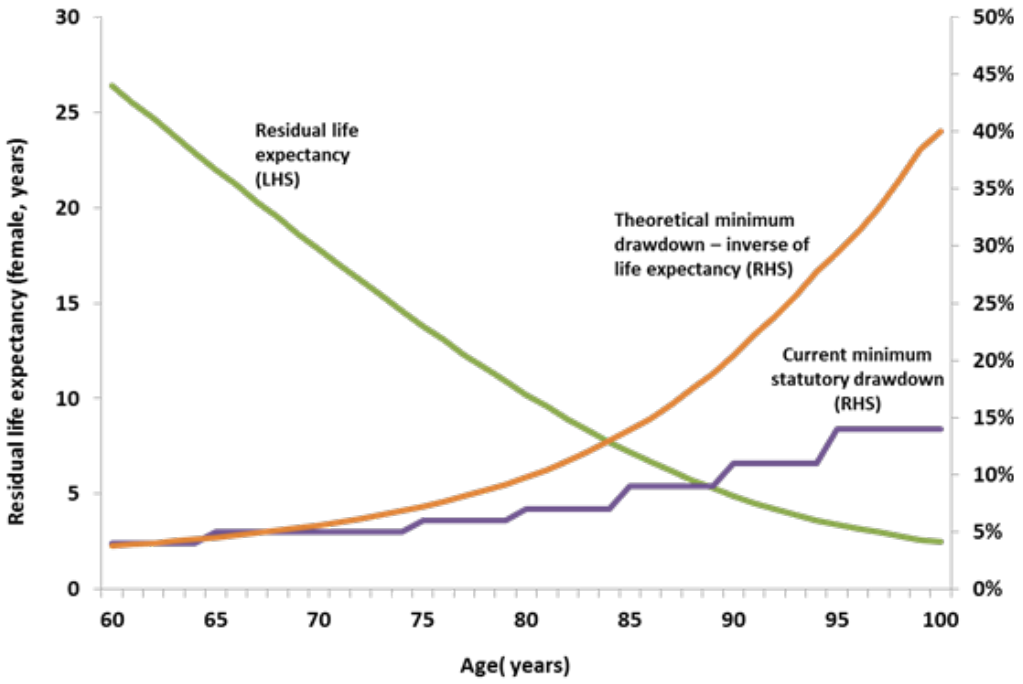
The current rules are set in the context of the age of the individual and ensure that there is a steady income flow. Further, they are set as a percentage of the balance each year, and therefore take into account growth in the portfolio. They are inflation agnostic as they assume the entire balance should be ultimately used by the individual, rather than attempting to quantify differences in purchasing power over time.

The theory behind the current rules of a minimum percentage payment is relatively simple. From a public policy perspective, it would be ideal if an individual's tax-exempt superannuation balance is fully utilised at the same point as you die. So, in theory, if you have 10 years to live, you should withdraw the dollar equivalent of 10 per cent of today's balance, every year.

In this theoretical world, the minimum drawdown at each age is calculated as the inverse of the residual life expectancy – 10 years to live, means a drawdown of 1/10 or 10 per cent. Of course if there was no uncertainty around how long each individual was going to live, then this would be a very simple process. However, the risk that individuals live longer than predicted must be factored into the formulation of the system rules.

The graph on the next page compares the inverse of residual life expectancy with the current minimum drawdown schedule, using female life expectancy as the benchmark.

Figure 1: Residual life expectancy and its inverse compared with current statutory minimum drawdown schedule



Source: ABS, Treasury.

The graph suggests that the current statutory minimums are fairly generous. For women, it is only in the first 10 years that minimum statutory drawdowns and the theoretical drawdowns are roughly equal. For men, who have a lower life expectancy, the minimum statutory drawdowns are consistently more conservative. The graph also illustrates the significant buffer in the minimum drawdowns to deal with longevity risk. Take, for example, a 91-year-old woman, who has a life expectancy of four and a half years. The minimum drawdown on this woman's balance is 11 per cent, which – assuming no investment returns – would provide income for an additional 9 years.

Further, the current approach does not explicitly factor in the growth in the portfolio, through either income or capital growth. Rather, it is self-calibrating; as market conditions change, the amounts of income which must be withdrawn adjust, to reflect the changing value in the portfolio.

Including the return on investment in this calculation adds some complication to the modelling process; we provide additional modelling with stochastic return assumptions below. In simple terms however, any additional ***positive*** return in the portfolio, would make the current statutory minimums look more conservative; each year, the balance of the portfolio is greater, than in the year before, and provided the return at least matches the rate of inflation, the purchasing power of the income stream will remain intact.

Conversely, negative returns in the portfolio will reduce the size of the income which must be withdrawn, and in the event of a sudden, significant shift in portfolio value (particularly for retirees invested heavily in growth assets) the amount of income which must be withdrawn under the statutory requirements, is lower by the same proportion as the devaluation of the portfolio. As an illustration, a 60-year-old with a portfolio worth $100,000 is required to withdraw $4,000 per year. Should that portfolio reduce in value to $50,000, the required withdrawal is only $2,000.

With the assistance of State Street Global Advisors (SSgA), we have modelled the impact of the statutory withdrawals on a portfolio of $250,000. The details of this modelling are provided in Appendix A.

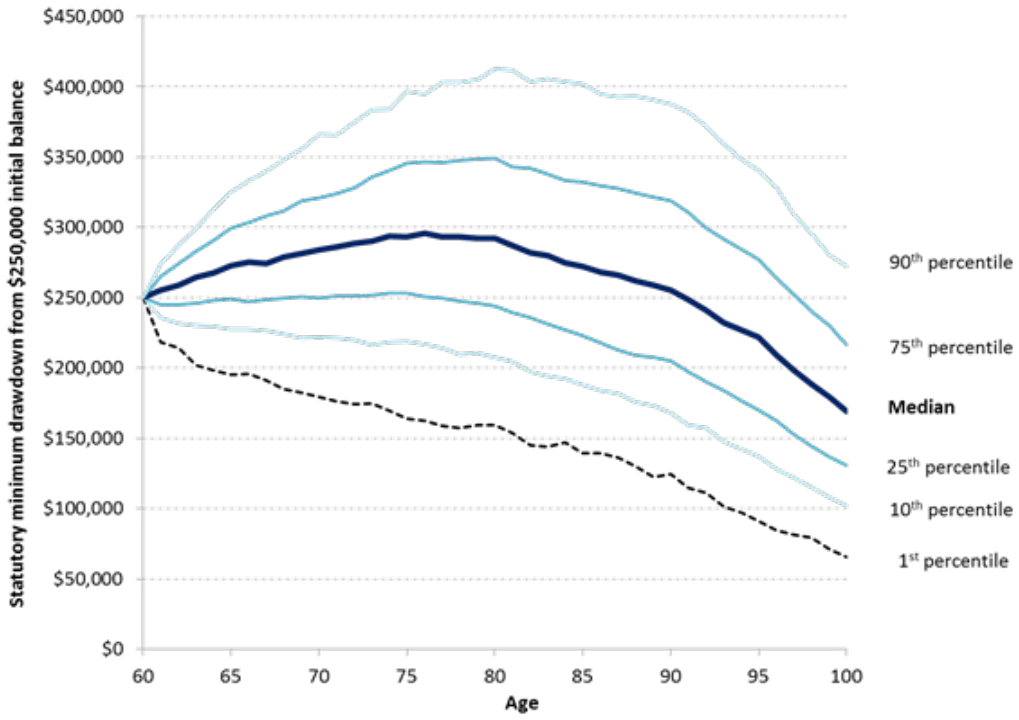
The graph over the page shows the impact on the tax-exempt superannuation balance for a portfolio with around 50 per cent in equities and property and the remainder in more defensive assets, where only the statutory minimum withdrawals have been applied. The graph demonstrates that:

- on average, starting with opening balance of $250,000, there will still be a tax exempt superannuation balance of

around $170,000 if the individual lives to 100

- a 60-year-old woman today, is expected to live to around 86 and based on this modelling will have a higher balance tax-exempt superannuation balance at death, than at age 60, if only the minimum statutory withdrawals are made and
- in extreme scenarios, where the worst one per cent of market impacts occur, the individual will still have a positive balance at age 100, after only withdrawing the minimum balance.

Figure 2: Medium risk portfolio with statutory withdrawal schedule applied

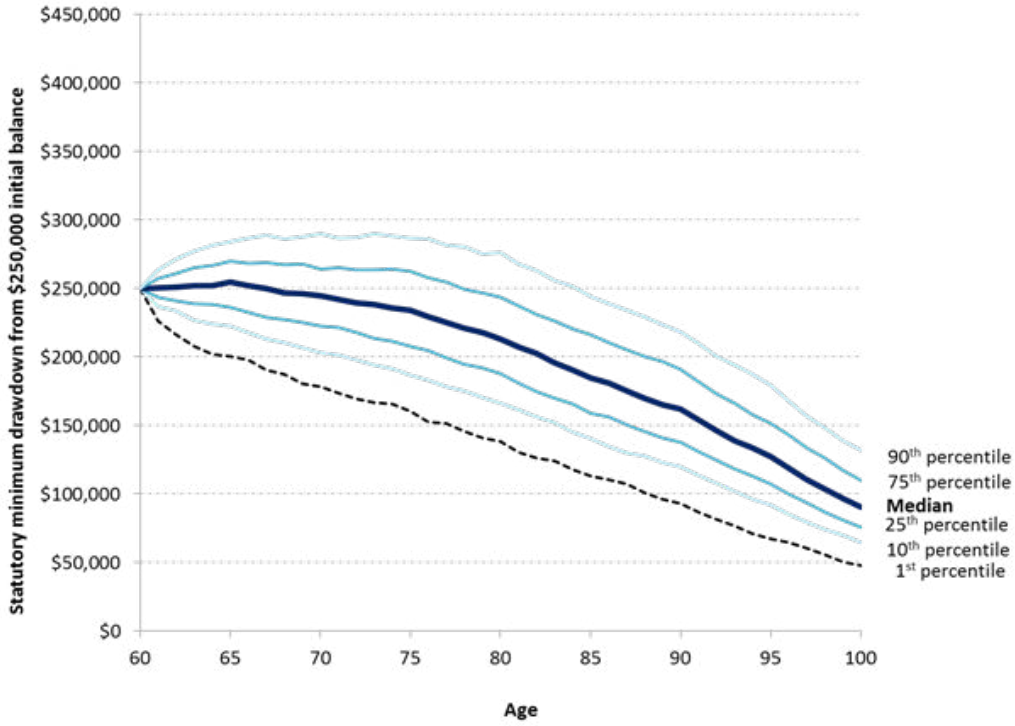


Source: SSgA, ASFA.

We can also assess the impact of a more defensive portfolio that invests 25 per cent in Australian equities with the remainder of the portfolio invested in cash and fixed interest. Again, only the statutory minimum withdrawals have been applied. The graph demonstrates that:

- on average, starting with opening balance of $250,000, there will still be a tax exempt superannuation balance of around $90,000 if the individual lives to 100
- a 60-year-old woman today, is expected to live to around 86 and based on this modelling will have a tax-exempt superannuation balance of around $180,000 when she reaches her life expectancy of 86, If only the minimum statutory withdrawals are made.

Figure 3: Lower risk portfolio with statutory withdrawal schedule applied



Source: SSgA, ASFA.

As the formula is based on percentages, these results can be extrapolated for difference starting account balances. So, for example, with a starting balance of $500,000 in the lower risk portfolio, the tax exempt superannuation balance will be around $180,000, on average, if the individual lives to 100, and withdraws the statutory minimum.

Rules which are objective, transparent and simple to understand

On the basis of the analysis above, ASFA considers that the current minimum drawdown schedule is simple yet effective. It allows for a considerable degree of conservatism to cover longevity risk, but does not preclude individuals from drawing income more quickly, if their own circumstances warrant.

This conclusion is confirmed by analysis undertaken by Professors Hazel Bateman and Susan Thorp in a paper titled *Choices and Constraints over Retirement Income Streams: Comparing Rules and Regulations* (2007).

Their study assessed five alternative drawdown rules in terms of simplicity, adequacy, risk and consumer preferences. Along with the current legislated minimum drawdown schedule attention was given to a number of "rules of thumb" based on life expectancy sometimes used by financial planners and others.

A key finding was that the different drawdown rules perform differently under each of the criteria for assessment, for retirees at different ages and for different levels of risk aversion.

However, in terms of the overall performance of each of the possible rules examined, the current schedule of minimum drawdown factors was assessed as superior to the others examined on the basis that:

- it is relatively simple
- it provides a relatively high level of income for the retiree over the retirement period and
- it deals relatively well with worst case scenario investment return outcomes.

Another paper that is sometimes used to support arguments for lower minimum drawdowns is one prepared by Professor Michael Drew and Dr Andrew Walk, *How Safe are Safe Withdrawal Rates in Retirement? An Australian Perspective*, which was published earlier this year by FINSIA.

The foreword of this paper by FINSIA suggests that, even with the exceptional performance of the Australian stock market over the last century, a 4 per cent withdrawal rate over 30 years on a 50:50 growth to defensive asset allocation is associated with a 20 per cent chance of financial ruin.

The 4 per cent withdrawal considered is a percentage of the initial account balance which is indexed each year by inflation. This represents a more aggressive drawdown of account balance than the age-related minimum drawdown factors for account based income streams. For instance, when an account balance is down to 10 per cent of the initial account balance the 4 per cent rule implies a 40 per cent drawdown from the then account balance.

The concept of financial ruin of course needs to be considered in the context of the means tested Age Pension which will provide all retirees with some income protection. As well, less than 10 per cent of males retiring at age 65 and less than 17 per cent of females retiring at age 65 are likely to be still alive after 30 years. So even if there is a 20 per cent chance of having no private savings left by age 95, only a small minority of retirees will still be alive then to potentially experience complete depletion of retirement savings (other than the value of own home).

ASFA also some issues with the accuracy of the life expectancy figures used in the Drew and Walker paper, and believe that the conclusion of the paper may be impacted by an overstatement of life expectancy. We understand that these figures are currently under review by the authors.

In any event, the paper actually concludes that for the future, we need to move from a silver bullet approach (such as the 4 per cent rule) to a veritable arsenal of weapons (based on dynamism: withdrawal rates; asset allocation; planning horizon; fees and after-tax management; scenario testing; risk management; investment governance) to assist retires in managing and mitigating the asset-liability mismatch in retirement.

One implication is that retirees should consider sophisticated approaches to managing longevity and investment risks. These might include the use of life or deferred annuities for some part of their retirement income and/or investment asset allocation and investment risk overlays which mitigate investment return and sequencing risks. Linking drawdowns to current rather than initial account balance also will generally assist.

While some retirees may consider using these various tools for managing longevity risk, this does not provide a strong argument for replacing or amending the current drawdown factors for account-based income streams.

Allowing flexibility and choice

The minimum drawdown factors do not require retirees to spend money which is withdrawn from superannuation. They have the flexibility and choice to invest all or part of it outside superannuation. For most low to middle income retirees, this will involve little or no income tax liability due to superannuation income generally being tax free and their other investment income falling below the tax free income threshold and benefitting from various tax rebates.

The absence of a maximum drawdown factor also provides retirees with flexibility and choice, albeit at the risk of drawing down savings too early and not having any private income later in retirement.

Conclusion

ASFA recommends no change to the current minimum drawdown schedule, although, given the linkage with residual life expectancy, there may be merit in the Government Actuary reviewing the schedule every decade or so.

Question 13

Should there be an automatic mechanism for adjusting the minimum drawdown amounts in response to significant adverse investment market performance? If so, what should that mechanism be? How would this also satisfy the rationale for setting minimum payment amounts?

We do not believe there should be an automatic mechanism for adjusting the minimum drawdown amounts in response to significant adverse investment market performance. The modelling which ASFA has undertaken shows, that notwithstanding significant equity market drawdowns, the continuous application of a minimum withdrawal based on a percentage of the balance of an individuals allocated pension account does not significantly impact their final portfolio balance.

This result reflects the self-calibrating nature of the current percentage based approach to minimum withdrawals. Indeed the current approach is a simple way to automatically reduce the amount of money which must be withdrawn in a market downturn. As noted above, negative returns in the portfolio will proportionally reduce the amount which must be must be withdrawn; a 50 per cent reduction in the value of the portfolio is accompanied by a 50 per cent reduction in the dollar amount which must be withdrawn.

Any automatic mechanism would not be able to take into account the context of an investment downturn, for example, whether the downturn followed a period of relatively high investment returns. It would also be unable to predict future prospects for investment returns, based on forecasts of domestic and international economic activity, which are important in any decision about adjusting the minimum drawdown amounts.

An additional complication would be the diversification in assets held within superannuation accounts. Would the mechanism take into account adverse investment returns in just one asset class (for example, Australian shares)? Or would it consider whether a number of asset classes were experiencing adverse investment returns?

The potential diversity of investment returns also highlights the potential problems associated with applying an automatic rule to individuals with an income stream in retirement. For example, an individual using bank term deposits or a residential building to generate retirement income will not be directly impacted, by a drop in the ASX 200 share index.

ASFA recommends that there should be no automatic mechanism for adjusting the minimum drawdown amounts in the event of a significant investment market event.

Question 14

Should the minimum drawdown amounts also increase in response to very strong market performance? Would the mechanism be similar to that for decreases? Would this satisfy the rationale for setting minimum payment amounts?

Consistent with our response to Question 13, we do not believe that there should be a requirement to increase the minimum drawdown as markets rally. The self-calibrating nature of the current percentage based approach to minimum withdrawals means that proportionally more money in dollar terms must be withdrawn as portfolio values increase.

We see any change as adding unnecessary complication to the regulatory regime.

Question 15

For how long should the change remain in place? Should it be left in place only for the year in which the shock occurs, or until balances have 'recovered' by a particular extent?

We do not believe that an automatic exemption process is necessary; therefore we have no response to this question.

Question 16

What other issues need to be considered if the minimum drawdown amounts should fluctuate?

Any changes which are proposed to the minimum drawdown amounts must be considered in the context of the overall objectives of the superannuation and retirement system, and the public policy principles which have been outlined in the Treasury discussion paper.

ASFA recommends that any proposed changes be assessed against these, and that change should only be pursued if there is a clear and significant improvement against the measurable goals which have been set for the system.

Appendix A

Retirement simulation process

In order to assess both the efficacy of the minimum drawdown factors applied to allocated pension products and the benefit, if any, of allowing an automatic exemption in the event of a significant market event, ASFA has asked State Street Global Advisors (SSgA) to undertake an extensive simulation of portfolio returns in retirement.

The main inputs for the simulations are regime dependent average return, risk (standard deviation) and correlation estimates. In order to get more representative estimates at the individual asset level, depending on the data availability, the base period started as early as July 1990 with the last month being June 2012.

We assume a multi-variate normal distribution to generate random monthly returns, which are regime based (crisis and normal). This gives a skewed distribution for the overall portfolio returns, which is more representative of actual return experience than using the assumptions for the "normal" regime only.

We also used the observed transition probability of four per cent in the simulations which represents the probability experiencing two consecutive crisis months.

Asset class returns

Assets	All months		Crisis months		Normal months	
	Mean	Standard deviation	Mean	Standard deviation	Mean	Standard deviation
Australian equity	6.70%	13.0%	-6.95%	3.70%	9.88%	12.02%
Australian equity – high dividend yield	6.70%	14.0%	-8.78%	2.75%	10.66%	12.71%
International equity	6.70%	13.0%	-7.21%	1.86%	9.99%	12.13%
International equity – high dividend yield	6.70%	14.0%	-7.69%	4.11%	10.19%	12.88%
Emerging market equity	7.60%	23.0%	-13.45%	5.07%	13.56%	21.21%
Listed property – Australian	4.70%	17.0%	-15.86%	4.22%	11.58%	13.26%
Australian high yield bonds	5.90%	13.0%	-3.96%	2.38%	7.79%	12.80%
Alternatives – diversified futures trading fund	9.00%	15.5%	4.43%	4.73%	7.44%	15.27%
Alternatives – active commodities fund	11.00%	26.5%	0.917%	7.65%	11.00%	26.50%
Australian bonds	3.90%	7.0%	0.325%	2.02%	3.90%	7.00%
Australian cash	3.00%	1.5%	0.250%	0.43%	3.00%	1.50%

Asset allocation – portfolios

	Medium risk	Lower risk
Australian equities	26%	25%
International equities	17%	0%
Property	5%	0%
Alternatives	10%	0%
Cash and fixed income	43%	75%

Cash withdrawals and contribution from the income and capital growth of the portfolio are assumed to occur monthly. Total number of simulations used in this analysis was 1,000 for each case and these are ranked to obtain the percentile summary reported.

The percentile rankings are assessed at the end of each 12 months, and these data are used in Figures 2 and 3 of this submission. Given resources constraints we have not traced back the end results through the underlying "path" they have taken. These would be the most accurate simulation approach. As a result the extreme results are likely to be overstated, meaning that the first percentile path is worse than is actually likely. Conversely, the best results are likely to also be overstated. The middle of the distribution, however, will be consistent across either approach.

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