FSC FINANCIAL SERVICES COUNCIL

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Personal and Retirement Income Division
The Treasury
Langton Crescent
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By email: superannuation@treasury.gov.au

Review of retirement income stream regulation

The FSC welcomes the opportunity to make this submission in relation to income streams in retirement and minimum payment amounts for account based pensions.

The FSC represents Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advisory networks, private and public trustees. The FSC has over 130 members who are responsible for investing over $2.4 trillion on behalf of more than 11 million Australians.

The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange and is the fourth largest pool of managed funds in the world. The FSC promotes best practice for the financial services industry by setting mandatory Standards for its members and providing Guidance Notes to assist in operational efficiency.

The FSC supports reform to allow a broad range of retirement products to come to market. The market should determine which products are best suited to retirees' needs.

There is strong industry support for a holistic review of retirement policy following the Financial System Inquiry that considers interrelated tax and social security issues. For example, it is unresolved whether products with an identifiable value that is deferred to address longevity risk should or should not be subject to an asset test exemption.

The FSC also submits that minimum payment amounts do not accommodate market fluctuations and should be reduced to avoid adverse consequences for retirees. The FSC recommends, however, referring to the Tax White Paper further consideration of the benefits of abolishing minimum payment amounts.

Please feel free to contact me on 02 8235 2566 if you have any further questions.

Yours sincerely

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THE REGULATORY ARRANGEMENTS FOR SUPERANNUATION INCOME STREAMS

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

The FSC supports policy settings that would allow a broad range of retirement products to come to market and compete. It is appropriate for the market to determine which products are best suited to the needs of retirees.

The FSC supports any changes made a result of the issues raised in the discussion paper to have regard to competitive neutrality across the eight categories of, currently identified, income stream products that cover the range of allocation of longevity risk:

1. ILA (immediate lifetime annuity)
2. DLA (deferred lifetime annuity)
3. RCLA Type A (ruin contingent lifetime annuity)
4. RCLA Type B aka Variable Annuity
5. GSA (group self annuitisation)
6. FTA (fixed term annuity)
7. TAP (term allocated pension)
8. ABP (account based pension)

The FSC submits that it would be an unhelpful distortion for the Government to determine particular retirement products are more suitable than others.

It would also be difficult to provide for some products and not others, given that most retirement products will consist of a combination of the types of categories outlined below to address different stages of retirement. For example, a product issuer may have an allocated pension that also contains a deferred annuity.

The FSC notes that each of the categories can be structured in a way that, to varying degrees, addresses longevity risk, such as through pooling, deferred consumption or choice of investment strategy. The FSC provides in Appendix A more detail on each of these categories.

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?

The FSC addresses this question in relation to each of the eight categories.

ILAs, in the current low real interest rate environment the minimum drawdown settings are incompatible with ILAs, particularly those that are indexed to provide protection against inflation risk. This problem is exacerbated for older retirees with higher mandatory drawdowns. ILAs are bought as the defensive component of an asset allocation but are required to meet the same drawdown requirement as an ABP with a substantial weighting to growth assets.

DLAs face a number of impediments which render them unattractive to retirees, uneconomic to provide and preclude their provision. Specifically:

a. Are not eligible for either an Earnings Tax or Benefits Tax exemption in pension phase and after age 60.
b. Are not treated as a risk product if they are non-commutable.
c. May be subject to accruals tax if purchased by a superannuation trustee.
d. Could be required to offer a minimum surrender value, which would undermine pricing by precluding the availability of mortality credits inherent in the pooling arrangement.
e. Are incompatible with the minimum drawdown rules, as discussed by AFTS.
f. Are not contemplated by the means test arrangements for the Age Pension and aged care during the deferral period.

RCLA Type A

a. Are not eligible for either an Earnings Tax or Benefits Tax exemption in pension phase and after age 60.
b. Are not treated as a risk product if they are non-commutable.
c. May be subject to accruals tax if purchased by a superannuation trustee.
d. Could be required to offer a minimum surrender value, which would undermine pricing by precluding the availability of mortality credits inherent in the pooling arrangement.
e. Are incompatible with the minimum drawdown rules.
f. Are not contemplated by the means test arrangements for the Age Pension and aged care during the deferral period.

RCLA Type B otherwise known as Variable Annuities, are complex. The primary concern is in relation to securing regulatory approval when bringing new products to market.

GSAs are not currently offered in the market and depending on their actual design, may be restricted by the pension rules that restrict variations in annual payments to a fixed rate of increase, the CPI or a wage index, as the income stream would be required to fluctuate with investment performance and mortality experience.

GSAs are conceptual in nature and as such further consideration should be given to their appropriateness as a product and any additional prudential regulation that may be necessary should they come to market.

FTAs face no impediments apart from the minimum drawdown rules in low interest rate environments.

TAPs face no impediments except for the absence of a market, because without social security incentives the market prefers products with equivalent financial performance and less restrictions (ie. that are commutable and do not have upper limits on drawdowns).

ABPs face no impediments except for the minimum draw down requirements that are designed to ensure superannuation assets are converted into an income stream and by doing so limit the duration over which superannuation assets enjoy concessional tax

treatment. Superannuation funds need to be able to offer ABPs and deferred income streams.

Question 3: What changes could be made to the annuity and the 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?

ILA, with a few protections there is no scope for tax deferral or estate planning mischief using immediate lifetime annuities**.** Provided death benefits and any commutation value are restricted to the nominal value of the premium with an eligibility period of no more than 15 years, and that they are required to make payments at least annually, immediate lifetime annuities (ILAs) should not be subject to the minimum drawdown rules. Use of lifetime annuities for tax deferral is already precluded by Taxation Ruling No. IT 2492, Income Tax: Eligible Annuities and Eligible Policies – Unreasonable Deferral of Annuity Income, dated 28 July 1988, and its Addendum dated 28 January 1993.

This policy change would facilitate provision of inflation risk protection to retirees buying lifetime annuities in low interest rate environments, as well as provision of protection against longevity risk, investment risk and inflation risk by those wishing to buy a guaranteed income stream late in life.

DLAs should be defined as a SIS pension from payment of the premium. This would exempt non-commutable DLAs from both Earnings and Benefits Tax. This was the essence of the unimplemented DLA measure of 2013.

Ensure no conflict of laws between treatment under the SIS Act and general provisions pertaining to accruals tax. This should ensure that DLAs receive the same tax treatment whether they are bought directly by an individual or by a superannuation trustee.

APRA needs to amend the prudential standard on paid up and minimum surrender values to explicitly exempt non-commutable DLAs from having a surrender value.

Exempt non-commutable DLAs from the minimum drawdown rules during the deferral period.

RCLA TYPE A

RCLA Type As should be defined as a SIS pension from the date of payment of the premium if they are non-commutable. This would exempt RCLAs from both Earnings and Benefits Tax. This is consistent with the essence of the unimplemented DLA measure of 2013. It would be preferable to treat non-commutable RCLAs as a risk product, whenever they are bought.

Ensure no conflict of laws between this treatment under the SIS Act and general provisions pertaining to accruals tax. This should ensure that RCLAs receive the same tax treatment whether they are bought directly by an individual or by a trustee.

APRA needs to amend the prudential standard on paid up and minimum surrender values to explicitly exempt non-commutable RCLA Type As from having a surrender value.

Exempt a non-commutable RCLA Type A from the minimum drawdown rules during any period when they are not paying a benefit, consistent with the proposed treatment for DLAs.

RCLA TYPE B aka VA.

Providers express a strong desire for a process to co-ordinate and streamline approvals between APRA, ASIC and the ATO.

GSA. Providers would require the ability to vary payments from the pooled fund depending on actual investment performance and mortality experience of the lives in the fund. This raises new issues that may require consideration by the regulators through a separate consultation process.

FTA. No changes necessary.

TAP. Funds should be able to offer TAPs in combination with an ILA, DLA or RCLA Type A.

ABP. Superannuation funds should be able to offer ABPs in combination with an ILA, DLA or RCLA Type A. The FSC also submits that current restrictions that prevent ABPs being 'topped up' after it has been purchased are inappropriate and have resulted in the unnecessary and costly proliferation of multiple retirement products per individual.

Question 4: Would such changes result in new products being bought onto the market?

Subject to the changes outlined in this paper being realised the FSC is confident that a range of longevity products will come to market that will address the current inability of beneficiaries to manage their own longevity risk.

The FSC notes, however, that the specific products considered in this submission are only a part of the retirement framework and a more holistic assessment of the retirement phase, as per the FSC's Financial System Inquiry submission, is warranted.

FSC members have expressed the view that regulatory impediments are a significant disincentive to bringing product to market, and that they would otherwise have interest in entering the market or expanding their product range.

There are of course other factors that will impact on a product provider's decision to launch a new product including:

- Systems complexity;
- Consumer testing and market demand;
- The capacity to match annuity liabilities with long dated assets (more detail below).

The marketability of GSAs will need closer scrutiny due to the requirement that investors may lose access to part or all of their capital without receiving a guaranteed return. This may require further consideration by the Government and APRA before such products can come to market.

Additional issues

Long-dated Bonds

Treasury's consultation paper is focused on design features of various retirement income options. However, for providers this is only one side of the equation, the liability side. In order for financial houses to offer such products they will need to have matching assets.

Currently there is a paucity of conservative long dated reliable yield assets. Recommendations as to the supply of such assets are a matter that is more properly dealt with by the main financial system inquiry chaired by David Murray. However, for completeness it is suggested that long dated Government bonds would form a base for such an asset supply and in turn should facilitate the issuance of long dated corporate paper.

Stamp duty

The issue of some types of annuity with particular features may result in part of the product becoming subject to State stamp duties which can be as high as ten per cent. This is because State Revenue Offices often apply a broad interpretation to what amounts to general insurance and will construe peripheral aspects of the product to be dutiable riders. These are superannuation annuities and should not attract stamp duty.

The final proposal should recommend consultation with State Governments to eliminate an unnecessary additional cost. The industry's experience with some OSRs is that an explicit clear announcement needs to be made at inception otherwise contrary interpretations can emerge from those offices at later points in time.

DEFERRED LIFETIME ANNUITIES

Question 5: Should people only be able to purchase a DLA with superannuation money?

The use of 'ordinary money' to purchase non-commutable lifetime annuities was contained in Recommendation 20 of the Final Report of AFTS (Review of Australia's Future Tax System). The FSC recognises, however, that the significant tax and pricing benefits that this would allow would necessarily have revenue implications as ordinary money enters the superannuation system.

The FSC therefore recommends that any changes arising from this review only relate to a person's 'superannuation money'.

The FSC notes, however, that with the significant delay in the increase in the SGC to 12 per cent the impact this will have on the adequacy of the system is not yet fully quantified. There would be merit in further considering the impact of lower retirement savings resulting from the delayed SGC and whether this would warrant an individual being able to purchase deferred annuities prior to retirement or using ordinary money.

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?

Flexibility around purchase options, such as regular premium payments, should be allowed. This includes annual, monthly or fortnightly. The FSC is aware, for example, that some superannuation funds may wish to cease paying life insurance premiums when a fund member retires and instead substitute the premium for a longevity insurance product.

Each payment should be determined on a financially neutral basis, by actuarial calculation, or through purchase of an identifiable tranche of the ultimate annuity. If a premium stream is agreed and then premium payments cease, the (reduced) annuity benefit should be unambiguously determinable.

Under this structure those purchasing the DLA would effectively have an option to cease premium payment; a de minimis rule. If payments cease very early resulting in a DLA which is uneconomic to administer, there should be a de minimis provision for the provider to return the premiums to the policy holder's superannuation account, with a statutory maximum of say $2000 able to be returned under this provision. If interest rates rose above the levels priced into the premium stream, it would generally be rational for an investor to cease payment and enter into a new contract at current market rates.

Therefore, product issuers should be allowed (but not required) to incorporate a defined mechanism to market-adjust the (reduced) annuity benefit for changes in market interest rates at the time when premiums cease to be paid.

A number of superannuation funds and potential DLA providers see merit in being able to offer DLAs with multiple and single premiums paid during accumulation. Non-commutable DLAs would not provide any scope for mischief with this arrangement and social security and tax arrangements should be consistent with other risk products.

Question 7: Should there be an upper limit on the amount that can be invested in a deferred lifetime annuity?

No. If deferred annuities are non-commutable it is unnecessary to have an upper limit. The risk of death before payment commences creates a natural barrier to 'excessive' contribution, as would the limited need for a very large income at the later stages of a lifetime.

The FSC submits that there is no mischief in the policy parameters outlined in this submission that are cap is needed to solve. The FSC notes, however, that this is subject to the de minimis rule outlined in question 6 above.

The amount of money that an individual or a superannuation trustee will commit to a DLA will also be constrained by the need for income from another source during the deferral period, subject to an individual's eligibility for the age pension.

These constraints set a natural limit that has both practical and behavioural aspects. A decision about how large a DLA to buy will depend on individual circumstances

including, starting balance, attitude to risk and the shape of the income profile sought in retirement.

These natural limits will differ depending on whether the individual is paying a relatively small premium for pure longevity insurance, such as a deferral period until the policyholder reaches their age cohort life expectancy, or if they are purchasing a much larger DLA, which has a much shorter deferral period and would require a death benefit. Obviously any dollar value upper limit applied in one of these cases would not be appropriate for the other.

Question 8: Should there be a minimum deferral period for a DLA? If so, what would determine the period?

No. The size of income stream payments relative to premium for a DLA are highly sensitive to the length of the deferral period because of the combined effect of compounding and mortality credits. The marketability of DLAs, however, are very sensitive to behavioural biases and, in a choice environment, a minimum deferral period may result in unnecessarily curtailing the take up of longevity insurance.

Bought as pure longevity insurance the attraction of a DLA is a comparatively large amount of annual income for a relatively small premium. In practice it may be found that a significant proportion of retirees prefer a larger DLA and a significantly shorter deferral period. The acceptability to retirees of DLAs in that form is also very likely to be dependent on the availability of a death benefit.

One view is that DLAs with small premiums will allow advisers to introduce the concept of longevity insurance into the retirement planning conversation with a client without meeting the resistance that the subject might if the adviser began by talking about committing a much larger portion of their accumulated retirement savings to an ILA or RCLA Type A, RCLA Type B or VA. It is anticipated that the client's improved understanding of post-retirement risks will in many cases result in them choosing either a larger DLA with a shorter deferral period or an immediate lifetime annuity for the defensive component of their retirement portfolio asset allocation, or an RCLA Type A or B, or a VA, depending on their specific needs and objectives.

As a result it is important to allow DLAs to be used across the full spectrum of retirement solutions, based on the the expectation that these will be welfare enhancing for the retiree and produce long term fiscal savings for government as a guaranteed income is subject to Age Pension means testing.

For superannuation fund trustees and advisers wanting to offer or advise a DLA in combination with an account based pension, the presence of an arbitrary minimum deferral period would become a constraint in optimising an individualised retirement solution. Optimising retirement solutions is complex, requiring consideration of factors including heterogeneous retirement goals, age, gender, risk appetites, expected social security entitlements, hereditary and health status.

The Discussion Paper questions whether DLAs with a short deferral period of 2 to 3 years are akin to an immediate lifetime annuity with a "drawdown holiday". That probably ascribes the wrong motive and a much less significant economic reason for offering and choosing such a product, since the value of the Earnings Tax "holiday" would be relatively small. Sequencing risk, which is at its peak at and around the time

of an individual's retirement, has two relevant aspects. The first is that an adverse event may impact the size of the retirement balance. The second is that conditions in capital markets at the time of retirement may make the cost of a given guaranteed income stream more expensive.

DLAs with a short deferral period offer retirees who want income from a lifetime annuity from the time that they retire the possibility of better managing the risk attached to the timing of their retirement.

There is some risk of untimely ruin for non-guaranteed superannuation assets which the retiree is relying on to provide income during the deferral period. There is also a possibility if investment performance exceeds expectations a policy holder may want a further deferment of their income stream. There is a good argument for allowing the DLA provider discretion to adjust the date on which income will be paid, provided that adjustment is made on an actuarially fair basis.

Requiring no minimum deferral period for the non-commutable retirement income streams described above is competitively neutral and is not inconsistent with maintaining the necessary boundary between accumulation and pension phase provided the DLA is non-commutable. As the policy objective is to facilitate increasing the range of products that retirees can choose to help manage both their longevity risk and investment risk, there should be no minimum deferral period.

Question 9: Should there be a maximum deferral age or period? If so, what should it be?

Provided DLAs are non-commutable and have either no death benefit or an appropriately restricted death benefit as discussed under question 11 below, there is no risk to the taxpayer in terms of tax deferral or estate planning, in not having a maximum deferral period.

There may be cases of extreme adverse selection where individuals might feel they have an incentive to take the risk of a very long or late age deferral. However, it would be reasonable to assume that life offices would be cognisant of the risk they would be accepting and would design their product offerings to mitigate that risk.

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?

As a form of longevity insurance DLAs require mortality credits to provide attractive pricing. If DLAs were able to be commuted or required to be commutable, the latter having been the case under APRA's previous prudential standard on paid-up and minimum surrender values, it would be impossible to provide policy holders with mortality credits because every policy holder who had any forewarning of their demise would have an incentive to commute. Commutability would therefore defeat the purpose of the product, to provide protection against longevity risk.

The absence of an ability to commute is also an essential integrity measure protecting the boundary between accumulation and pension phase and the taxpayer from the abuse of DLAs for tax deferral and estate planning purposes.

As the policy objective is to facilitate increasing the range of products that retirees can choose to help manage both their longevity risk and investment risk, a prohibition on commutation is essential. Providers, taxpayers and individuals seeking efficient protection from longevity risk and investment risk have a mutual interest in there being an absolute prohibition on commutation of DLAs.

It is desirable that new income stream products that are intended to provide protection against longevity risk and investment risk also provide effective protection against inflation risk. CPI indexed DLAs provide this protection. The absence of effective protection against inflation risk may result in the value of protection against longevity risk and investment risk being eroded to insignificant levels.

DLAs specified in real terms as CPI linked also remove the risk of mis-selling using money illusion created by quoting nominal values for benefits to be paid some decades into the future.

As the policy objective is to provide more product options which retirees could choose between to manage their longevity risk and investment risk it is appropriate that after the deferral period payments be made regularly and at least annually and for life. If the pension rules for deferred annuities allowed fixed term annuities, there would be scope to use the deferral period for tax deferral and estate planning.

Payments from a DLA should be guaranteed by the annuity provider so that there is clarity for consumers that the trade-off for committing part of their superannuation assets to the pooling arrangement is that their return is guaranteed, if necessary by the providers' shareholder funds. There is also no ambiguity as to the intensity of the promise that APRA is regulating.

The Final Report of the Review of Australia's Future Tax System, at page 124, said:

> "The government should also consider removing other legislation constraints that may inhibit the development of longevity products. However, this should not be at the cost of necessary prudential and consumer protection. Given the nature of these products, they should only be provided by prudentially regulated entities. Products that provide a guaranteed income should follow consistent prudential requirements to reduce the risk that a provider is unable to meet their obligations as they fall due."

Subject to removal of the current ambiguity in relation to the accruals tax treatment of DLAs referred to in the answers to questions 2 and 3 above, small superannuation funds should be able to provide DLAs to their members by purchasing them from an entity regulated by APRA under the Life Act. DLAs are completely unsuitable for provision within SMSFs or small APRA regulated funds, because their memberships are very small relative to the number of lives necessary to provide adequate pooling of risk. Those funds also lack suitable capital backing to provide protection against unanticipated systemic population mortality improvements.

Additional issue: Multiple reinsurers

The terminology in paragraph 52 speaks of "the annuity provider". A product should be able to be designed with insurance provided by multiple underwriters supporting a guarantee.

This would maintain competitive neutrality between insurance firms issuing a product (with an element of credit risk for the issuing institution) and superannuation funds developing product which accesses a number of underwriters to reduce single institution credit risk.

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?

Many retirees are reluctant to purchase a lifetime annuity because they fear their money will be lost to their estate if they die early. A means of overcoming this particular behavioural bias is to allow joint life DLAs (restricted to spouses) and to guarantee a minimum return in the form of a death benefit. A DLA should also be allowed to provide a reversionary benefit to a spouse only.

In the choice environment sales of DLAs could be expected to be restricted if a death benefit were not available. The FSC considers possible default arrangements for those retirees who do not chose their retirement arrangements in our submission to the Financial System Inquiry.

Providers should also be able to offer a DLA without a death benefit for those who would prefer to receive a slightly higher income for the same premium.

The policy objective is to provide a wider range of products that can be used to manage retirees' longevity risk and investment risk. Small premium DLAs with long deferral periods may be able to be sold without a death benefit but larger DLAs with shorter deferral periods, as discussed under question 8 above, would be unlikely to find a significant market without a death benefit. These larger DLAs with shorter deferral periods would inevitably be used for tax deferral and estate planning if the death benefit was not restricted.

Misuse of DLAs for tax deferral and estate planning has a cost to taxpayers which is not directly targeted at providing protection from longevity risk and investment risk or even retirement income.

Death benefits should be permitted but restricted to the nominal value of the premium paid.

As a non-commutable DLA does not have a surrender value it is a risk product and, consistent with the treatment of other risk products, it should not be subject to the assets test during the deferral period. This treatment was supported by the Final Report of AFTS; "given the unique nature of deferred annuities, there is a case that they should only be means tested when they start to pay an income, unless a person can access the capital before this time." (AFTS page 119).

THE MINIMUM PAYMENT AMOUNTS FOR ACCOUNT-BASED INCOME STREAMS

The FSC would support any reduction in the minimum payment amounts for account-based pensions as a result of this review. Lower minimum draw down requirements would improve the flexibility of retirement settings to accommodate a broader range of market conditions. They would also afford retirees more flexibility in how they manage their retirement.

Setting new minimum requirements, however, is an imperfect science given continually improving life expectancy, unpredictable markets and different investment strategies between retirees. Lower requirements would necessarily be arbitrary and be an exercise in trading off revenue implications against a desire to accommodate the impact of market volatility on individual balances. There is also evidence to suggest that, with improvements in longevity, even lower minimum drawdown requirements at higher ages will continue to be too high.

It is undesirable to continue the current, informal amendment of minimum payment amounts each time markets fluctuate. This would ultimately generate ad hoc policy responses and undermine individual's capacity to proactively plan their retirement.

It is also undesirable for a formula to be established to link payment amounts to market conditions due to the significant complexity and regulatory cost this would create for funds and members.

The FSC recommends that, in addition to any reductions that may arise as a result of this review, the Government also refer the matter to the Tax White Paper for further analysis. The White Paper is the appropriate forum to consider the interaction between the minimum payments and tax policy.

Policy concerns with the minimum payment amounts

The minimum payment amounts are a blunt policy instrument for managing the consumption of superannuation benefits. The FSC recommends a more holistic review of minimum payment amounts through the Tax White Paper process and provides the following analysis and options to prompt that discussion.

The FSC supports an assessment of the benefit to retirees and the significant simplification of the system that could be achieved through abolition of the minimum payment amounts. The FSC notes that this would necessarily require consideration of the impact on Government revenue and measures to avoid such a change for estate planning purposes.

The FSC agrees that superannuation should not be allowed to become an estate planning vehicle, where a tax preferred benefit can be passed on from one generation to another. Estate planning is contrary to the intent of the system, which is to afford an individual tax concessions to enable and encourage them to fund their own retirement and, to a limited degree, the needs of dependents.

The minimum payment amounts are designed to require beneficiaries to consume their superannuation savings during their lifetime. The requirements, however, are ineffective and inflexible in many respects:

- beneficiaries may die before their savings are exhausted, leaving a benefit to dependent or the estate, regardless of intended integrity measure; and
- market conditions may change and cause excessive consumption of retirement savings, eventually forcing the retiree onto the age pension.

The FSC also notes that the minimum payment amounts are supplemented by two additional integrity measures that exist to prevent the system being used for estate planning purposes:

- the current death benefit arrangements that require payments to non-dependent beneficiaries to be moved out of the system; and
- concessional and non-concessional contribution caps, which limit the quantum of new money that can be moved into the superannuation system.

The minimum payment amounts are one of multiple measures intended to prevent excessive use of the tax concessions and to prevent estate planning. The FSC submits, however, that they are one of the least effective measures to achieve this aim.

Option to abolish the minimum payment amounts

The FSC recommends that the Tax White Paper consider abolishing minimum payment amounts as a comprehensive solution that allows beneficiaries, or trustees on their behalf, to manage superannuation consumption in an optimal manner.

Abolishing minimum payment amounts would avoid the current potential policy outcome of requiring beneficiaries to draw down their retirement savings in adverse market conditions which causes them to expend their savings quicker than they otherwise would. Abolishing minimum payment amounts would therefore reduce a retiree's likelihood of receiving the age pension.

The Tax White Paper should also consider how to avoid any revenue leakage under this proposal in a manner that does not discourage people adequately saving for their retirement.

Summary of Position

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

No. As demonstrated during the financial crisis the minimum draw down requirements are unable to accommodate changing market conditions. The FSC supports a reduction in the requirements, but notes that any partial reduction would inherently be a trade off between a desire to offer retirees flexibility and the associated revenue implications.

The FSC proposes a solution above that provides significant flexibility for retirees without incurring any revenue implications.

Question 13: Should there be an automatic mechanism for adjusting the minimum draw down amounts in response to significant adverse investment performance?

An automatic mechanism that would provide sufficient flexibility to retirees when it is required would be complex to administer and for retirees to understand. It is not consistent with overarching objectives of boosting member engagement through simplifying the superannuation system.

Question 14: Should the minimum draw down amounts also increase in response to very strong market performance?

An automatic mechanism would be complex to administer and for retirees to understand. It is not consistent with overarching objectives of boosting member engagement through simplifying the superannuation system.

A mechanism that increases the draw down requirements during strong market conditions would further detach the income received from the actual consumption needs of retirees during retirement. Instead a link with market performance would be entrenched. This seems inconsistent with the primary objective of the superannuation system, which is to provide income for a retiree.

For these reasons, to the extent that this proposal is a method of offsetting revenue leakage through lower minimum requirements this would be a crude approach.

Question 15: For how long should the change remain in place? Should it be left in place on for the year in which the shock occurs, or until balances have 'recovered' by a particular extent?

The FSC's proposal would be a permanent solution to this question. However if a decision is taken by the Government to change minimum draw downs in the manner contemplated in the discussion paper, this should be in place until balances have recovered to pre-financial crisis levels.

Question 16: What other issues need to be considered if the minimum draw down amounts should fluctuate?

Abolition of the minimum draw down rates would be a permanent solution to many of the issues canvassed in the discussion paper and should be considered further through the Tax White Paper, in conjunction with measures to address any revenue implications for the Government.

APPENDIX A

BACKGROUND ON EACH EXISTING CATEGORY OF INCOME STREAM PRODUCT

1. ILA (immediate lifetime annuity)

An ILA provides an income stream for life commencing immediately on payment of a premium. It transfers all investment risk and longevity risk to the product provider. Most lifetime annuities sold in Australia also provide a guarantee against inflation risk. Because ILAs pool longevity risk they are non-commutable, at least after an initial period. ILAs involve an intense promise regulated by APRA with strict prudential standards, substantial capital requirements and guaranteed income.

2. DLA (deferred lifetime annuity)

A DLA will provide an income stream for life commencing at a specified later date, conditional on survival. DLAs provide full protection against longevity risk and investment risk later in retirement. A DLA may provide either a guarantee against inflation risk, or a very high nominal rate. There may be a gap in income if a market linked component of the total retirement solution fails earlier than anticipated. DLAs pool longevity risk and are non-commutable and involve a promise regulated by APRA with strict prudential standards, substantial capital requirements and guaranteed income.

3. RCLA Type A (ruin contingent lifetime annuity)

An RCLA Type A can currently only be found in academic literature. An RCLA could provide an income stream for life commencing at a later date, conditional on both survival and failure of a specified income stream. RCLAs could be based either on a real portfolio of assets or a notional drawdown against a market index. They could provide protection against investment risk and longevity risk throughout retirement. The terms of the policy could also provide a guarantee against inflation risk. There would be basis risk (a potential income gap) if the retiree invests in assets that differ from those on which the RCLA is based. RCLAs would involve an intense promise regulated by APRA with strict prudential standards, substantial capital requirements and guaranteed income.

4. RCLA Type B aka VA (variable annuity)

An RCLA Type B, also known as a VA, is a hybrid combining an account based product with a guarantee typically to pay a fixed percentage of the starting balance for life. These products provide guaranteed income, exposure to the upside of the market and access to capital. The level of guaranteed income has the potential to ratchet up if the market outperforms. Guaranteed income reduces if the retiree takes a lump sum. VAs offer specified protection against both longevity risk and investment risk provided the retiree does not choose to drawdown their capital. The guarantee is typically in nominal terms with the retiree needing market performance to deal with inflation risk. VAs are fully commutable at which point any guaranteed income ceases. VAs offer a less intense promise with the longevity risk and investment risk protection they provide being paid for by the retiree by way of fees. Longevity risk is transferred to a life office and investment risk may be hedged by the provider on its own account or transferred to another institution.

5. GSA (group self annuitisation)

GSAs require pension fund members to commit their assets to a pool, with the superannuation fund endeavouring to provide an income for life. However, there is no guarantee and instead

conditionality that pensions paid may be adjusted up or down depending on actual market returns and survivorship of lives in the pool. Investment risk is carried by the fund members in proportion to their participation in the pool. A GSA could deal only with idiosyncratic longevity risk, the variation of the length of lives in the pool, and then only if the pool of lives is sufficiently large. One particularly difficult challenge with an open pool is how to avoid one cohort of entrants being subsidised by another. Depending on market movements, inflation movements, or pool mortality movements, situations may emerge where either too little or too much income (in retrospect) has been drawn from the pool. There is no capital other than members' assets in the pool to deal with systemic longevity risk, which is unanticipated improvements in population mortality. There is no intense promise or capital backing.

6. FTA (fixed term annuity)

An FTA provides a guaranteed income stream for a term of certain duration. FTAs pay a fixed rate, a fixed rate of increase up to 5%, or are indexed by the CPI. Indexation by an ABS wage index is permitted under the SIS pension rules but is not feasible due to a lack of available hedging. As an annuity the income stream can include return of all of the capital, part of the capital or none of the capital; 0%-100% RCV (residual capital value). FTAs are available in Australia with tenors of 1 to 50 years. FTAs provide guaranteed protection against market risk. FTAs can also provide protection against inflation risk but most FTAs are short term fixed rate.

FTAs with very long tenors can be used to address longevity risk but are less efficient than an immediate lifetime annuity for doing so for two reasons. First, the retiree may die early leaving part of the value of the annuity to their estate, which may not be a problem for the retiree if they have a bequest objective. Second, an immediate lifetime annuity will provide continuing income in the event that life exceeds the term of the FTA. The lifetime annuity should provide a higher rate than a fixed term annuity because early deaths are worth more to the pool than the cost of long lives.

Non-commutable nil RCV FTAs to life expectancy purchased before September 20, 2007 are complying income streams for the purposes of a social security assets test exemption (ATE). The ATE was removed for complying income streams bought after that date. These fall short of full longevity risk protection as half the population exceeds life expectancy. On death any remaining value in an FTA is paid to the estate of the policy holder. FTAs involve an intense promise regulated by APRA with strict prudential standards, substantial capital requirements and guaranteed income.

7. TAP (term allocated pension)

TAPs are a non-commutable allocated pension product with both a minimum and maximum rate of drawdown. Fund members can choose an income within the range of minimum and maximum drawdown. Non-commutability and the upper limit on the size of the pension taken are intended to ensure that the income stream lasts for an extended period. The fund member carries all investment risk and longevity risk. TAPs are complying income streams with the ATE grandfathered for those bought before 2007. On death the remaining value is paid as a death benefit or to the estate. There is no intense promise, the income stream has no capital backing and there is no guarantee.

8. ABP (account based pension)

ABPs are allocated pension products and are required to meet the minimum drawdown rules each year. They are fully commutable, the fund member carries all investment risk and longevity risk. There is no intense promise, the income stream has no capital backing and there is no guarantee.