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# Private Saving: The Role of Life Event Products

Produced by



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## Executive Summary

Households face a range of possible life events, such as education, health, housing, retirement, which can require significant expenditures for which they are often inadequately prepared by way of saving or insurance. This lack of preparation may reflect behavioral biases, inadequate information, or in the case of lower income earners, inadequate financial resources. Governments have taken a variety of actions to counteract these influences such as taxation incentives, government grants or expenditures, and compulsion. The most obvious is the promotion of superannuation as a preparation for retirement.

There has been less attention paid to how government policy can best be designed for assisting individuals in preparing for other life events. Indeed, the tax incentives given for superannuation may have impeded the development and growth of other financial products well suited for non-retirement life event preparation. In particular, the strong emphasis on superannuation tax-incentives has been at the expense of incentives for some existing well-established life cycle savings products currently offered by Australian Friendly Societies. These products have the potential to raise private savings levels and assist individuals to prepare for life cycle events without the need for complex and on-going financial advice.

In this paper, we examine the role of a particular type of financial product in meeting these objectives. That product is the “Insurance Bond”, and variants upon that structure (such as “Education Bonds”), offered to the public by Friendly Societies.

We conclude that:

- The insurance bond framework has significant benefits as a mechanism for promoting saving for life events. These include:
  - i. Product simplicity and consequent minimal financial advice needs;
  - ii. Application to targeted event-oriented products that can help overcome behavioral biases;
  - iii. Tax concessions, or government co-contributions, can be provided effectively and without complexity; and,
  - iv. Prudential regulation of providers by APRA provides comfort to investors that promises will be met. A range of investment options made available to investors provides (much like (accumulation) superannuation accounts) scope for tailoring risk taking to individual preferences, and the long-term nature of

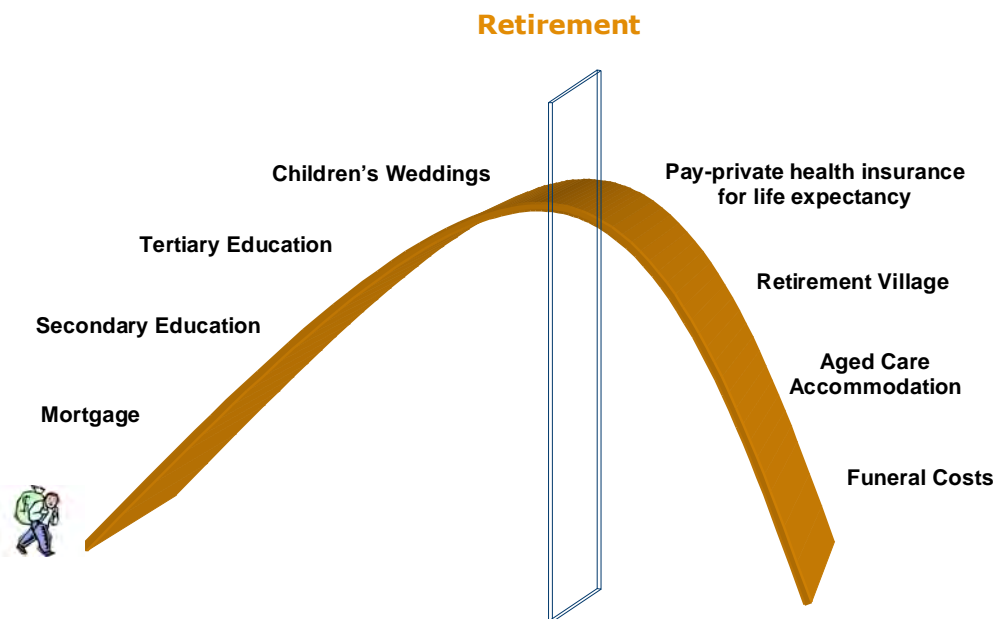
the contract enables risk reduction benefits from “time diversification”.

- Use of the insurance bond framework by Government for delivery of targeted social benefits fits with an “asset accumulation” approach to social welfare which:
  - i. Encourages personal responsibility, and
  - ii. Can assist in the development of financial literacy.
- The insurance bond framework has other advantages for individuals:
  - i. As a vehicle for targeted intergenerational transfers, which do not get entangled in inheritance or personal bankruptcy issues; and
  - ii. As a form of investment which does not involve any personal tax consequences or reporting requirements during the life of the investment.
- The promotion of life cycle event products such as insurance bonds has the potential to increase household savings and financial wellbeing.
- On the basis of international evidence it appears that Australian policy makers have failed to appreciate the opportunity that life event savings schemes offer, such as for education and medical savings in the USA, and, as a consequence, such products receive far less favorable tax treatment in Australia.
- To increase usage and social benefits from insurance bond products, and to reduce current tax and legislative distortions vis a vis superannuation, it is recommended that:
  - i. A reduction in the current tax rate of 30 per cent applied to earnings within insurance bond funds should be considered to provide a lower and targeted savings-incentive tax rate for policy-holder funds;
  - ii. A reduction in the current 10 year holding period required for tax-paid/tax-free payouts should be considered for specific types of targeted savings; and,
  - iii. The current annual contribution cap of 125 per cent of the previous year’s total contribution should be reviewed against an alternative annual cap expressed as a proportion (declining over time) of total accumulated contributions to date – to cover situations of a contribution gap or lower contribution in some years.

## 1. Introduction

Everyone's life experiences are different, with different consequences for their financial position throughout life. But there are common trends and events which enable a benchmark profile of saving and investment needs throughout the lifecycle to be established – which, in turn, enables analysis of how financial products and government policies might best be designed to deal with the “known and unknown” unknowns which affect us all. Those unknowns include such things as timing and/or occurrence of events such as sickness, unemployment, marriage, divorce, dependant-related expenses (such as marriage and post-compulsory education), retirement, and death (at least the timing thereof). Figure 1 provides an illustration of some of these possible events.

**FIGURE 1: Potential Life Events**



Source: Ross Higgins, Austock 2011

As Figure 1 also illustrates, there are many such potential events requiring substantial outlays at different stages of the life-cycle, and these are augmented by discretionary lump sum outlays on capital items or investments.

This paper focuses upon how financial products might be designed, and how government policies might be fashioned, to assist individuals in planning for and dealing with such life events which involve significant expenditures. Such policies would also ensure that individuals are less expectant of Government income or

lump sum support. It identifies specific life-cycle events warranting attention, provides an overview of financial products currently available (and issuers thereof), examines how regulatory and tax policy affects the design and use of such products, and provides recommendations for policy.

Underpinning the paper is the perspective that government regulatory and tax policies should, at least, not impede the development and take-up of financial products which help individuals and families to prepare financially for life cycle events. But also relevant is the view that an “asset accumulation” approach to welfare policy is worth exploring further. Using tax/transfer policies and grants to encourage individuals to accumulate financial assets can lead to greater private responsibility for dealing with possible life cycle events, rather than reliance upon government welfare. Government long-run budgetary outcomes may be improved, and increased responsibility and familiarity with financial products may help enhance financial literacy. More generally, targeted tax concessions for particular forms of saving may increase aggregate saving, although studies of how subsidized savings schemes affect total savings tend to generate conflicting results<sup>1</sup>.

Another consideration underpinning the paper is the recognition that many individuals have difficulty understanding the suitability of financial products and in planning household finances over the life-cycle. The growth of the financial advice industry reflects the growth of these problems in an increasingly complex financial world. It has brought with it, however, problems of conflicts of interest, suitability of advice, and levels of fees. For many individuals, financial advice is an unaffordable luxury. Simple financial products designed to deal with significant life events, and which can be explained simply to individuals, offer an advantage in that they can be achieved through low-cost, one-off advice associated with that product, rather than requiring expensive, on-going, relationship advice.

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<sup>1</sup> Poterba *et al* (1996) found that subsidization of savings in the form retirement savings accounts in the USA and Canada led to increased aggregate saving, but other studies have found conflicting results. See Japelli and Pistaferri (2003) for a review.



### 1.1. Saving, Investment and Life Events

Although all life-cycle experiences are unique, an often used benchmark for analysis is a scenario in which an individual is assumed to enter the workforce at the end of schooling (at an age of around 20) works full time for around 45 years, and retires with a remaining life expectancy of around 20 years. Over the working life wealth is accumulated (in the form of financial assets and property) and during retirement consumption is financed by running down of assets – perhaps with a bequest motive in mind. In practice, a more appropriate benchmark model involves incorporating household formation sometime after workforce participation commences, with the household subsequently involving dependants (and associated expenses), and potential dissolution of the household via separation/divorce or death of one of the partners.

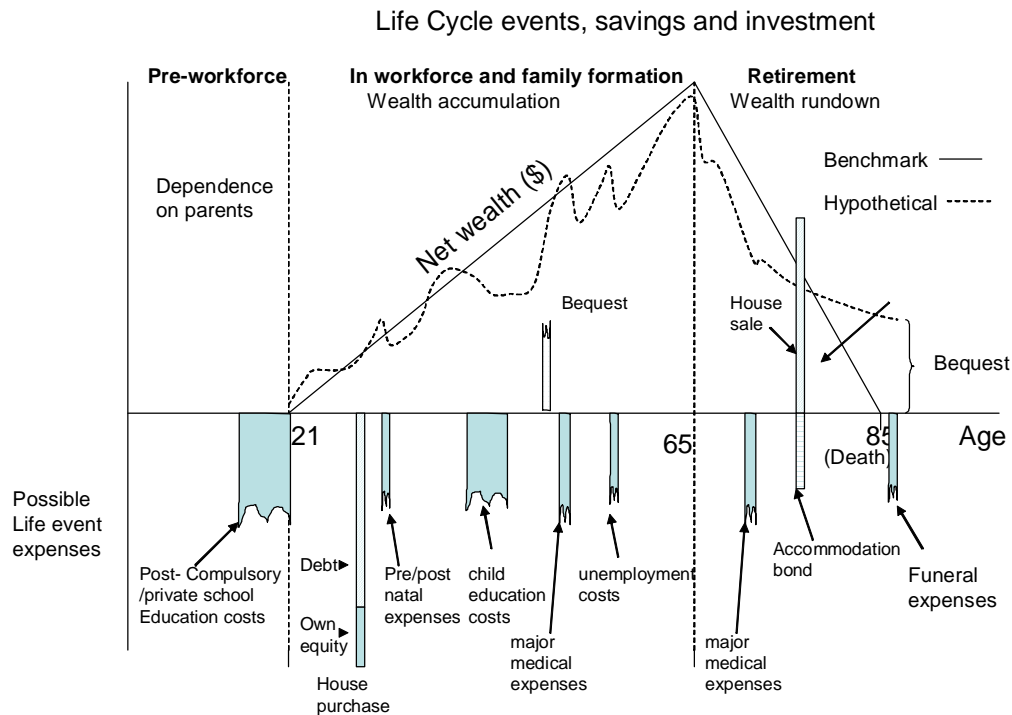
That benchmark model obviously abstracts from a multitude of complications (such as spells of unemployment or sickness, receipt of bequests etc), and needs further elaboration to deal with cross-sectional differences in lifetime earning capacity and parental wealth and financial support etc.<sup>2</sup> But it does serve as a useful benchmark to identify the consequences of major life-cycle events for household finances and financial product needs. Foremost among these are bad health, higher education, disability, retirement, frailty and intergenerational wealth transfer.

Figure 2 provides an illustration of how the standard life-cycle perspective on wealth accumulation and rundown is affected by life-cycle events. Various potential expenses affect actual wealth accumulation, and can be dealt with through insurance, pre-saving, or wealth run-down (or reliance on government benefits). Assets accumulated will also have differing characteristics affecting ability to run them down to meet expenses or for use as collateral for borrowings. Superannuation cannot (generally) be accessed until the preservation age is reached, home equity may be accessible via mortgage re-draw facilities or through reverse mortgages. Government asset or income tests for various social security benefits (such as the old-age pension) can create inducements for particular forms of asset structuring and expenditure patterns, in order to access those benefits. Desire to achieve effective tax planning, intergenerational wealth transfer, and allocation or control of assets within a family context, can also lead to the use of particular legal structures (such as family/discretionary trusts) for asset ownership to achieve those objectives.

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<sup>2</sup> Besley and Meghir (1998) analyze the effects of tax preference of some assets within this framework.

**FIGURE 2: Life cycle events, savings and investment**



Source: K Davis, ACFS 2011

Of course, for many low-income or disadvantaged individuals and households, wealth accumulation is a limited prospect, placing them at particular risk in dealing with both post-retirement living expenses and possible pre-retirement life-cycle event costs. Government policies recognize the resulting personal and social costs, and ameliorate them to some degree by way of subsidizing particular types of expenditures (health, education etc.) and through provision of social security benefits (unemployment, disability and old age pensions etc.).

Those policies can induce *moral hazard*, when government safety nets induce individuals not to take personal responsibility for financial preparation for life-cycle events. Consequently it is often desirable to find some form of risk-expenditure sharing between government and individual which provides an ultimate safety net but induces private saving or insurance for dealing with those potential events.

Some life-cycle events also involve discretionary expenditures – such as those on post-compulsory or private education expenditures for children.

Where these are seen as having social value, or where parents underestimate the private value accruing to their children, government policies involving subsidization of such expenses may be warranted, but again involve potential for *moral hazard*. Consequently, policies which encourage private savings for such expenditures, by attracting tax concessions or government funding, are generally preferable.

Life-cycle financial planning also requires individuals to be cognizant of the longer-term consequences of current savings and investment strategies for their own welfare. Arguably many are not, and government policies may involve compulsion or incentives to induce changes in savings behavior thought to be more compatible with private best interest. Compulsory superannuation is an example, although that also is motivated by moral hazard arguments – specifically as an attempt to increase private savings for retirement rather than reliance on government support through the age pension.

Another fundamental consideration is the role of financial advice on an individual's savings and financial investment decisions. This is particularly relevant in the context of financial plan prepared by financial advisers – directed to the retirement life-cycle event – and often being oblivious to the plethora of other events on life's journey.

In rendering professional financial planning advice, planners should be factoring in to their client financial plans savings directed at life events, other than just retirement. There is widespread and elementary financial planning oversight in not recognising and using long term tax-paid investments (such as insurance bonds) for these purposes.

Since the global financial crisis investors have also naturally shied away from financial planning advice directed to investment outcomes (and superannuation), and there is an emerging shift for financial advisers to focus a lot more on “strategy-based” financial planning. As we discuss later, Insurance Bonds are tailor made for this changed focus, because they are inherently about meeting long-dated “strategy-based” objectives.

As this brief overview of life-cycle savings and investment suggests, there are a number of areas in which there are opportunities for financial products (insurance, savings/investment) to assist individuals in meeting life-cycle events, and where there may be a case for some form of government support. In some cases, optimal solutions may lie primarily in the realm of insurance (eg medical and unemployment insurance) while for others (eg education, retirement, funeral expenses) the solutions are more likely to involve savings products.

It is, in principle, possible for households to meet large outlays for life-cycle events by borrowing at the time the event happens and making subsequent repayments, rather than from accumulated savings and investments. In practice, that approach is likely to be more costly and disruptive to optimal life-cycle wealth accumulation. Moreover, it is simply not available to those with inadequate assets or potential income to meet criteria imposed by lenders – thus limiting ability to appropriately deal with those events.

The optimal design of such products requires understanding of how individuals approach saving, investment, and risk management decisions, and how they respond to various incentives and features of product design. That is discussed in the following section and important implications for financial product design drawn out.

## 1.2. Behavioral Finance, Savings and Investment

One approach towards analyzing individual savings and investment behavior is to view individuals as rational, anticipating that life-cycle events may happen, and planning their finances to deal with the possible consequences. To implement such plans, financial products are required which can enable such risk management, or wealth accumulation to “self-insure”. An alternative approach, based around behavioral finance, is to note that individuals and families do not behave like the rational beings in economics textbooks, and that products which assist them to deal with “non-rational” behavior regarding the possibility of such life-cycle events are of significant social and private value.

Behavioral finance, drawing on research in psychology, posits that there are a number of characteristics of individual behavior which prevent individuals from behaving like the rational *homo-economicus* of textbook theory.<sup>3</sup> This

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<sup>3</sup> In their survey of behavioral finance, Barberis and Thaler (2003) distinguish between formation of individual beliefs (which determine the “information” which underpins the process of decision-making) and the nature of decision making. Inconsistencies in behavior and decision making and choices which do not maximize individual welfare have been demonstrated repeatedly. A number of alternative approaches to analyzing individual decision making have emerged. One is the concept of *Satisficing* behavior, in which decisions are made which reflect information processing skills and “bounded rationality”. *Prospect Theory* is an alternative description of decision making behavior under uncertainty in which individuals evaluate prospects in terms of gains or losses relative to their perceived current situation (rather than in absolute terms). Also relevant is *ambiguity*

has significant implications for attitudes towards financial products and services and for the optimal design of financial products. For example, there is substantial evidence to show that individuals allocated to a “default” option will tend to stay with that option rather than switch to available alternatives.

It also has important implications for policy, implying a policy approach of “nudging” individuals to make better financial decisions by appropriate settings of tax/transfer arrangements, information provision, and setting of default options.

The most relevant issue as regards life cycle event products is the existence of cognitive biases in behavior. Ritter (2003) provides a concise overview, covering the following issues.

- *Heuristics (rules of thumb)*. Faced with potentially complex choices, individuals often follow some rule of thumb – which they may have developed based on past experiences, but which may lead to biases if circumstances have changed. Some studies have shown that faced with an allocation decision across N categories, investors tend towards a rule of thumb of allocation 1/N to each category, regardless of the size of N or differences in the characteristics of those categories.
- *Overconfidence*. There is widespread evidence, across a range of activities, that individuals are generally overconfident about their ability, and that males exhibit this trait more than do females. This may lead to insufficient diversification of investments, underestimation of risks, and a tendency to undertake trading too often.
- *Mental accounting*. Individuals appear to act as though they divide decision-making into separate compartments, reflected in maintaining separate psychological accounts for funding different types of expenditure.
- *Framing*. Individuals react differently depending on the way in which a choice situation is described or “framed”. Ritter (2003) suggests that one example of this can be found in investors overestimating real returns on debt in an inflationary period because financial accounts record nominal interest but not the decline in the real capital. If framing affects how individuals perceive their current situation, then according to Prospect Theory it can influence decisions.

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*aversion*, whereby individuals do not like dealing with situations in which they are unable to accurately assess the probabilities of particular events occurring.

- *Representativeness.* Individuals put too much weight on recent experiences in forming judgments about the future.
- *Anchoring.* Individuals tend to evaluate options relative to their current position.
- *Disposition effect.* Individuals are unwilling to realize losses but willing to realize gains.

What do these behavioral biases imply for the design of retail financial products?

- Individuals tend to treat cash flows differently from changes in capital value, even where those cash flows involve return of capital, and are more willing to consume out of cash flows perceived to be income. This suggests that financial products which involve automatic reinvestment of income (in the form of interest or dividends) are more likely to lead to greater accumulation than those which distribute such income.
- Because individuals have concerns about their self control, commitments to long term savings plans can be attractive. This suggests a place for financial products which involve a target long term accumulation amount with disincentives to withdraw funds or not make predetermined contributions.
- The use of “mental accounts” implies that financial products which have a sole purpose can be attractive, even if they involve sacrificing flexibility. Individuals may treat savings for such a special purpose differently to other savings and be less inclined to reduce other savings, thus increasing total saving.
- Individuals dislike dealing with situations in which there is substantial ambiguity about the timing and probability of events. Consequently products which resolve this uncertainty will be attractive, such as a wealth accumulation scheme targeted at meeting some possible event expenditure, but where there is sufficient flexibility for accumulated funds to be made available for other purposes should the event not occur.

## 2. Life Event Products in Australia

Life event products fall into a somewhat unique category of investment / savings products. While they generally have some characteristics of *collective investments* (in which investor funds are pooled and investment returns distributed *pro rata*) they are distinguished by the linkage of the timing and/or amount of returns to individual investor circumstances. This may be via some insurance component, or lifecycle event trigger (commencement of education, retirement etc). They are also distinguished by their long-term contractual savings/investment nature, involving incentives to lock-in funds until the maturity date or occurrence of a specified event. That long term nature (and insurance features) give rise to a case for prudential regulation of the providers of such products. And while most modern products involve the investor bearing the investment risk, capital guaranteed products are possible which require maintenance of higher capital reserves and lower expected returns and accumulation.

It is also important to note that the legal structure involved can have substantial tax or control implications. For example:

- Where an investment product is structured as an insurance product with a designated beneficiary, the payment of proceeds is not subject to challenge as part of an estate.
- A particular investment structure may provide the individuals controlling that investment with discretion in the allocation of earnings to particular individuals, which may also have tax planning benefits.

In Australia, institutions such as superannuation funds, insurance companies and friendly societies all offer products to assist individuals in saving for the future and manage lifecycle risks. Each type of institution and set of products, however, operates in a different environment with regard to tax-incentives and control, thereby creating an unlevel playing field and in some cases a disincentive for individuals wishing to plan for their own future, thereby imposing a consequent potential for greater reliance on the State.

### 2.1. Superannuation funds

The most common form of life event products in Australia, are superannuation accounts, whose growth has been promoted by government compulsion and taxation incentives. At June 2010, there was \$1,225 billion in superannuation, split between main types of funds: corporate, industry, public sector and retail funds.

Compulsory superannuation for employees (not covered by corporate or public sector schemes) began in the early 1990s. Employees had no choice between industry funds until legislation was introduced in 2004, and many industry funds have since become public offer and also offer a range of investment options to members. Few workers have exercised their freedom of choice of fund. Less than 10 per cent of workers have actively chosen a fund and switching rates are as low as 2 to 4 per cent annually.

Superannuation has also been encouraged by substantial tax incentives, which have varied over time. Currently contributions can be made (up to specified limits) from pre-tax earnings (as well as post-tax earnings), superannuation funds earnings are taxed at a concessional rate (15 per cent, with long term capital gains taxed at 10 per cent), and withdrawals after a specified age (currently 60) are tax-free. Access to accumulated funds before retirement is, however, generally not possible.

As well as providing a vehicle for accumulating funds for retirement, superannuation funds also provide life insurance, and accumulated funds will also become available to dependants upon death of the member. While beneficiaries can be nominated, ultimately the trustees of the fund determine how funds will be allocated.

Around 85% of working age Australians have a superannuation account, providing a broad-based coverage which allows individuals to prepare for their retirement. Despite this widespread coverage, however, Treasury modeling indicates that by 2047, when the superannuation system is fully mature, the proportion of people receiving an age pension will not change, although the proportion on a full pension will decrease. Consequently, the onus remains on individuals wishing to enjoy wellbeing in retirement to make additional financial provision for later life to assist with escalating expenses of accommodation and health care (Finsia 2010).

## **2.2. Insurance Companies**

Australia has over 140 insurance companies which provide financial protection to individuals and businesses to manage the risk of damage or loss from a wide variety of events. Insurance is most typically classified as general, life and health insurance.

General insurance includes fire and industrial special risk (ISR) insurance, household/house owner insurance, motor vehicle insurance (domestic, CTP and commercial), professional indemnity insurance and public and product liability insurance. General insurers pool risk and derive revenue from insurance premiums and the investment of premium reserves in bonds,



stocks and other assets. The vast majority of general insurance premiums are derived from the renewal of policies that relate to existing risk. The remaining premiums relate to an increase in risk exposure or a change in pricing conditions.

Australians have a history of underinsuring their exposure to property risks. In 2005 a survey conducted nationally by the Australian Securities & Investments Commission (ASIC) investigated the extent of non-insurance. Approximately 200,000 or one in six small businesses and 1.8 million or one in five home owners were found not to have insured their properties, while 70% of tenants failed to insure contents. Further, around 30% of properties were insured for significantly less than their replacement value (Ralston 2009).

Historically, life insurance companies provided life event type products through insurance products. Endowment policies involved regular premium payments which led to payment at a specified age (or upon earlier death) of the sum assured plus bonuses credited to the policy from investment earnings. Because the payment profile was relatively constant over time, early payments (after selling commissions to agents were paid) were partly pre-payments of the insurance premiums required at older ages, making these a form of savings vehicle.

For several reasons, such products have virtually vanished. One reason is the generally poor rates of return on products reflecting high distribution costs due to a substantial part of early year's premiums being absorbed by commission costs and also the growth of superannuation and the insurance/savings component involved therein.

Indeed, the growth of superannuation and the compulsory offering of life insurance in superannuation as specified by the SIS Act, has and will continue to have, significant effects on the take-up of life insurance in Australia. The provision of life, total and permanent disability (TPD), and income protection insurance cover through superannuation funds has become big business, involving changes in product designs, accessibility for consumers, distribution channels, and the nature of industry competition. It has also brought many non-insured workers into the insurance market – albeit often unknowingly

At the same time, however, it can be argued that the packaging of life (and TPD) insurance within super, rather than as explicit separate products, and past restrictions on super funds providing financial advice may have contributed to less awareness of the extent of coverage and availability of additional insurance coverage within super. This has led to a tendency to underinsure for a number of reasons. First, the minimum

default level of insurance in super tends to be quite low and is determined as a dollar amount (premiums or coverage) often inversely linked to the age of the member. Second, with an ageing membership, the average default amount of coverage is likely to decline because of that linkage (ACFS 2010).

Private health insurance is a critical and integral plank of the Australian health system. While the Medicare system ensures free universal access to hospital treatment and subsidised out-of-hospital medical treatment, around 44.6 percent of the Australian population also has private health insurance. There are currently 35 private health insurance companies, with the top 10 companies accounting for over 70 percent of the market (PWC 2011). Government policies play a significant role in shaping private health insurance in Australia, influencing its cost through the mandated approval of rate rises and the tax rules. Tax incentives such as a private health insurance rebate and a higher Medicare levy surcharge for those who do not take out health insurance provide a carrot and stick approach to ensuring that the public share the cost of health care provision.

Health insurance premiums are generally paid on an annual basis, but with an ageing population and increasing health costs, the need to provide longer-term health insurance cover to, or encourage saving to meet additional expenses for, both employed and retired citizens will only increase.

### 2.3. Friendly societies

Friendly Societies have operated in Australia since the mid 1800s, originating as mutual organizations providing insurance and savings type products for groups of individuals.<sup>4</sup> Originally established as mutual self-help organizations enabling individuals to save and insure against such life cycle events as such as sickness, accident, education, funerals, retirement accommodation etc., Friendly Societies were, in some sense a precursor to the modern, government provided, welfare state. Their role has declined with the growth in public welfare. Notably, the friendly society approach to enabling individuals to meet contingencies was primarily by asset accumulation and insurance.<sup>5</sup> Before World War 1, around half of Australia's population had some association with Friendly Societies. In terms of asset size, the sector

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<sup>4</sup> Information about UK friendly societies and their history and products can be found at <http://www.friendlysocieties.co.uk/>

<sup>5</sup> Green and Cromwell (1984) provide a history of Australia's Friendly Societies and emphasize the importance of their medical and hospital funds and operation of pharmacies etc. at that time. They also note the role of provision of holiday accommodation for members, and aged care facilities

reached its peak in the early 1990s when the then favorable tax treatment of insurance bonds saw the sector reach around \$10 billion of assets. O'Brien (1997) presents figures indicating membership in 1996 of around 1.27 million, with most assets being associated with flexible assurance products (such as insurance bonds).

At January 2011 there were 15 registered friendly societies, with a substantial decline in numbers having occurred over time from mergers. (There were over 25 friendly societies supplying data to the ABS in 2003). Some of those remaining have also demutualised and either become companies listed on the stock exchange (eg IOOF and Centuria Life) or acquired by other organizations (eg. Manchester Unity Australia).

Friendly societies primarily offer investment products to members (although some also offer health insurance and other related products). Contributions by members into an investment product are pooled into a "fund" and those monies invested in accordance with the product's requirements. The principal investment product offered is an *Insurance Bond* (described in more detail below). Such products have some of the characteristics of collective investments (such as unit trusts), in that the ultimate return to investors depends upon the performance of the fund's investments and are expressed in frequently updated unit prices (ie they are "unit-linked").

However, unlike typical collective investments Friendly Societies are subject to prudential requirements laid down by APRA (Australian Prudential Regulation Authority) designed to ensure that amounts promised to investors will be paid. But whereas once, insurance bonds were often "capital guaranteed"<sup>6</sup> by the Friendly Society, modern products generally involve the investor choosing an investment option and bearing the investment risk. Such unit linked products are now the main type of offered investment vehicle, but unlike many other collective investments where adverse short term performance can lead to withdrawals, the incentives for longer term investment provide the opportunity for "time-diversification" which reduces the longer term volatility of returns. Friendly Societies are required to have capital reserves adequate to ensure ongoing management of the funds they offer.

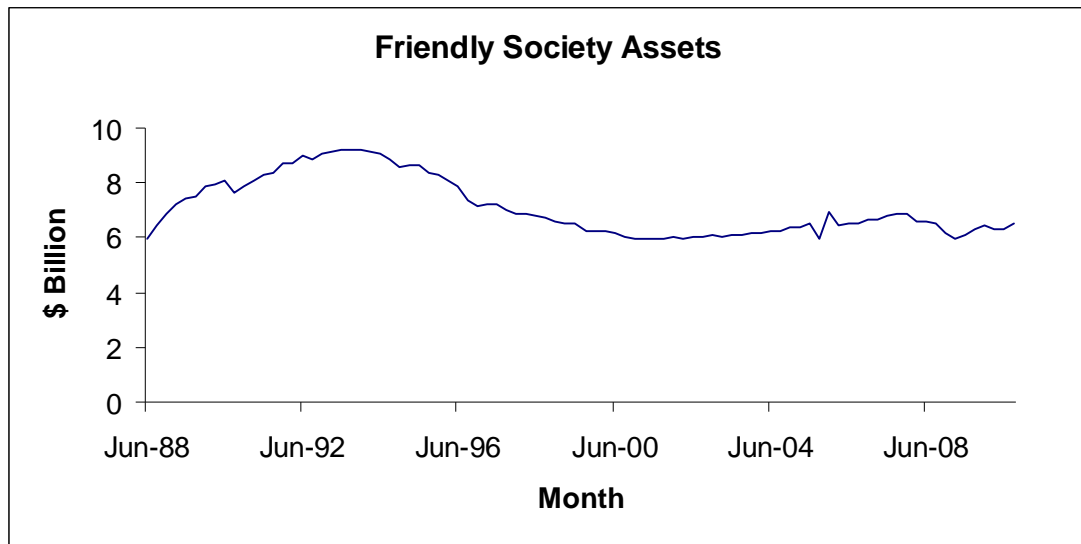
The sector has not grown in size over the past twenty years as Figure 3 illustrates, although the stagnation of total assets disguises ongoing new take-up of friendly society products, because of the maturing of older products. Taxation changes over time partly explain that, with tax treatment

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<sup>6</sup> McGing and Polic (1997, p27) note that capital guaranteed products "are the predominant area of friendly society investment business"

of friendly societies having worsened their competitive position – both generally and specifically relative to superannuation.

**FIGURE 3: Friendly Society Growth**



*Source:* Reserve Bank of Australia Bulletin, various

Friendly Societies are taxed under special provisions of the Tax Act, such that a tax rate of 30 per cent applies to earnings, regardless of whether they are composed of income (dividends, interest) or capital gains. Franking credits can be used to reduce the effective rate of tax below 30 per cent. Unrealised changes in the value of member/policy holder investments in the fund are not subject to taxation at the individual level.

There have been substantial changes in the tax treatment of Friendly Societies over time, which are shown in Table 1.

**TABLE 1: Taxation of Friendly Societies**

Period	Tax Rate (Life insurance and corporate funds)	Comment	Tax Rate (Complying superannuation and deferred annuity funds)	Tax Rate (Immediate annuity and superannuation pension funds)
Until 1982-83	Zero		Zero	Zero
1983-84 to 1987-88	20%		Zero	Zero
1988-89 to 1993-94	30%		15%	Zero
1994-95 to 2000-01	33%		15%	Zero
2001-02 onwards	30%		15%	Zero
2013-14	29%	proposed in 2010 Budget		
2014-15 onwards	28%	proposed in 2010 Budget		

Source: A Compendium of some important financial planning reference rates and tables, Australian Friendly Societies Association, March 2011.

The zero and lower tax rates prevailing prior to the late 1980s, reflecting their status as mutual, not for profit and self-help organizations, led to rapid growth in take-up of the “insurance bond” product till the late 1980s.

While the current rate of taxation is 30 per cent, it is possible for Friendly Societies to reduce the effective rate of taxation by investments in shares paying franked dividends. Depending on the extent to which investment returns take the form of franked dividends versus capital gains (or unfranked dividends), the tax rate in the fund can be reduced significantly.

### 3. Life Event Products - Insurance Bonds, Related Products, and Alternatives

#### 3.1 The Generic Insurance Bond<sup>7</sup>

As noted earlier, insurance bonds (and other related products built upon the same structure) are essentially a form of managed fund, but which have particular insurance and capital guarantee features, as well as other special features reflecting special taxation treatment.

They are a long-term savings and wealth accumulation vehicle providing investors with the ability to make one-off or ongoing contributions into a fund with accumulated capital and earnings accessible on a tax-free basis 10 years (or longer) after the initial contribution, or at any time in certain defined events<sup>8</sup>. Because of their insurance characteristic, a 'life insured' person is nominated, who may be the investor or someone else. Accumulated funds can also be accessed before the 10 year period ends (with loss of some tax benefits) or are paid out (without loss of tax benefits) on death of the nominated policy-holder.

This relatively simple structure is distorted by certain anomalies in the tax treatment of insurance bonds, as outlined below:

- Income earned within the bond fund is taxed at the life insurance fund rate (currently 30 per cent), but
- No distinction is made between the revenue income (eg. interest and dividends) and capital gains (viz. realized capital gains). Thus, the fund does not gain the benefit of the concessional capital gains tax discount available to individual investors, which exempts 50% of capital gains on investments held directly or indirectly via collective investment vehicles for more than one year (a corresponding 1/3 exemption applies for superannuation funds).

On the other hand:

- Like other investments, the fund is able to use franking credits received to reduce the effective income tax rate.
- There are no tax implications for investors in the fund prior to withdrawal of funds. Investors do not need to include changes in the value of their investment (or fund earnings) in their individual tax

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<sup>7</sup> For more discussion and examples of the flexibility of the investment structure see Higgins (2006, 2009) and Rubin (2005)

<sup>8</sup> Defined events include bond maturity due to death, disability or serious illness of the nominated 'life insured' or unforeseen serious financial difficulties of the bond investor.

returns. (The value of the investment may, however, be relevant for the assets test for the old age pension or other government benefits).

- Withdrawal of funds from the fund after 10 years of initial investment is tax free in the hands of the investor (policy holder/ beneficiary). Withdrawal before 8 years means that the earnings component of the distribution (ie not including contributions of capital) is taxable in full at the investor' marginal tax rate, but is subject to a 30 per cent tax rebate to offset the impact of tax paid in the fund. Withdrawals between 8 and 10 years receive some concessional treatment (2/3 taxed for year 9 and 1/3 taxed for year 10).<sup>9</sup>
- Investors are allowed to contribute additional amounts of up to 125 per cent of the previous year's contribution each year without affecting the initial investment date (thereby keeping the original 10-year period intact). This also means that should no additional contribution be made in any one year, any further contributions would cause a deemed recommencement of the initial investment date (although investors could avoid that trigger by investing in a new insurance bond commencing at that date).

This tax treatment means that investors on marginal tax rates above 30 per cent receive tax benefits from use of these products because of a greater compounding effect which is not offset by subsequent taxation. Thus, for example, a \$100 investment which earns 10 per cent p.a. before tax generates \$196.72 after 10 years in the insurance bond structure with a tax rate of 30 per cent, compared to a cumulated value of \$170.81 if taxed at an investor's top marginal tax rate of 45 per cent.<sup>10</sup>

This higher return is achieved at a cost to liquidity (early access to the funds leads to loss of tax benefits)<sup>11</sup> and segregation of the investment from other investments. However, the 30% tax rebate associated with early withdrawal can be used to offset tax on other forms of income,.

Despite the relatively complex tax treatment within the fund, the insurance bond remains a simple product whose structure can be easily explained to investors. In essence, an initial investment is made for 10 years, which can be supplemented by subsequent investments for the same maturity, with bonuses, based on the after-tax return on funds invested, added to the invested balance and available tax free after 10 years. Because the Friendly

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<sup>9</sup> This provision is contained in section 26AH of Income Tax Assessment Act 1936.

<sup>10</sup> The comparison is based on Amount =  $\$100(r(1-t))^t$  where r is 10 per cent and t is either 0.3 or 0.45.

<sup>11</sup> Not all of the tax benefit is lost, because the tax rebate of 30 per cent does not take into account the effect of compounding based on after tax rate of return of 70 per cent of the pre tax return rather than 55 per cent.

Society pays tax (currently at 30 per cent) on investment returns, there are no on-going tax implications for the investor prior to redemption (and none at all, if that is after 10 years or when withdrawn in the case of defined events).

As well as the simplicity of the product structure, the investment bond has a number of other merits as a life event savings product:

- A “target date” accumulation product, with provision of insurance and flexibility but tax disincentives for earlier access.
- Nomination of a beneficiary other than the investor enables intergenerational transfers directed at a specific purpose, and is not subject to intervention by other claimants on the estate of a deceased investor or in the event of bankruptcy (if the nominated ‘life insured’ were the investor or the investor’s spouse).
- Minimal on-going administrative/accounting requirements for the investor, who does not need to include fund earnings on the investment in a personal tax return.
- Managed investment of funds by the APRA-regulated Friendly Society aimed at achieving highest possible returns consistent with prudential management and ability to meet policy-holder liabilities.

Within the context of financial planning, Insurance bonds are a way to build into client financial plans the accumulation of “Tax-Free” lump sums for major “life-event” objectives. These include education financing, children’s endowments (e.g. for home deposits); succession funding, sinking fund strategies, health contingency funds, and in many estate planning applications.

Other strategy-based applications for insurance bonds include:

- sinking fund strategies – accumulating Tax-Free lump sums for early mortgage payout, discharging geared investments and for meeting margin calls;
- for other “life-event” contingencies, such as endowments, health contingencies and retirement accommodation, or perhaps paying up health insurance from a certain age;
- building an investment nest-egg to draw-down over a future period as a tax-effective and flexible income stream;
- provisioning for a child or a loved one with a physical or intellectual disability; and
- as dedicated funds to meet costs of financially maintaining children, such as in circumstances of a divorce.



### 3.2 Education Savings Plans

One variant upon the generic insurance bond structure is an Education Bond or Scholarship Plan which involves slightly different (and more complex) tax treatment of distributions from the Bond. These tax differences reflect a recognition by Government that household saving to meet educational expenses of dependents warrant a degree of government support and encouragement.

In a number of countries, education savings plans are supported by Governments as a way of encouraging specific purpose saving and increasing access to post compulsory education, particularly for lower income families. In Australia, the situation is somewhat different, with post compulsory education subsidized by the Government and deferral of fees possible through the HECS or HELP programs on an admission quota basis. No up-front payment of fees is required (but is an option), with students incurring a future tax liability (indexed to the rate of inflation) with repayments occurring only when income exceeds average weekly earnings through an increase in the individual's tax of 1 per cent. While there is some discount provided for up-front payment of fees, it is generally advantageous (in a Net Present Value sense) to defer payment. Consequently, to the extent the deferred payment option is taken up, one view may be that there is less rationale for government supported education savings plans to facilitate access to higher education by lower income families. However, with an increasing trend towards fee-based courses involving costs beyond those covered by HECS or HELP another view is that long-term education savings plans are even more relevant.

In any event many parents (and grandparents) see it as their responsibility to finance such education for their children (and grandchildren), providing a role for savings plans targeted at meeting likely fees, or covering living expenses and other associated education costs of students. Moreover, a preference among some parents to use private schools, and incur higher fees, rather than public schools (albeit with lower fees but increasing other costs) also provides a rationale for such schemes.

Under Australian tax legislation, scholarship (or education) plans can be established by a friendly society, as a variant on the standard insurance bond structure, which have certain tax benefits. In essence, friendly societies are able to establish a scheme (fund) which accepts contributions from parents (or others) to finance education expenses of the nominated student beneficiary. Funds in individual accounts are pooled in a benefit fund for investment purposes. In some cases, a variety of investment choices are

provided. The fund may operate a capital account (comprising plan contributions) and an income account (comprising fund earnings), and fund earnings on current scholarship plans offered are taxed at the friendly society's life insurance rate – currently 30 per cent. Amounts paid out from the income account for education expenses include recoupment of prior tax paid – for example, a balance (after tax) of \$70 in the income account grosses-up to a total payment of \$100. The income component of payments made to (or for the benefit of) students (which may include education-related living expenses) are treated as part of assessable income of the student, with the student's tax rate sometimes being lower than that of the plan contributor. However, in the case of a student under age 18 (who may be in primary or secondary school), Australia's punitive tax regime for minors can result in the student's tax rate being equal to or higher than that of the plan contributor.

The tax treatment of scholarship plans enables investment income earnings of education benefits to be essentially diverted to lower income students, but who personal tax rate may be low (if aged 18 and above) or high (if aged under 18). By applying on-going tax on fund earnings, tax deferral and "pre-tax compounding" of interest are prevented, although for high marginal tax rate investors, the fund tax rate of 30 per cent may give some advantages. Amounts in the contributions account can be withdrawn at any time without tax implications. As on-going earnings are taxed in the fund, plan contributors and students do not need to include its earnings in their tax returns. If amounts in the earnings account are withdrawn for non-education reasons (which, for example, can be done if the contributions account has been completely withdrawn), the income component of withdrawn amounts revert to being assessable in the plan contributor's hands - and the standard tax rules applying to insurance bonds apply.

As with all managed investments, there can be various fees and charges. These include contributions fees (of perhaps up to 4 per cent on amounts contributed) and annual management fees.

While scholarship plans have the behavioral benefit of a "defined purpose" saving scheme, with the current tax treatment of Friendly Societies, the tax advantages (of tax deferral and income diversion) may only be readily apparent for higher income families. Subject to due consideration being given to the anti-avoidance provisions, other alternatives with tax-preferred treatment may also be available to higher income families. These include:

- establishment of family trusts (enabling tax effective allocation of investment income among family members);

- establishment of a discretionary trust which invests solely in a tax-preferred insurance bond;
- salary packaging of school fees (although higher effective FBT rates may have made this alternative tax disadvantageous);
- additional contributions into superannuation by family members (grandparents) who will have reached the preservation age (and have retired) when funds are required; and
- mortgage pre-payments under loan structures which enable redraw facilities (to reduce loan interest payments made out of post-tax income).

### 3.3 Funeral bonds

Funeral bonds involve the investor making contribution(s) into a managed fund run by a friendly society and which pays out on the death of the investor (or partner). The funds may be paid to the estate (or surviving partner) to meet funeral expenses. The fund may invest in a specified range of assets and an income amount (bonus) is allocated to the investor's account out of fund earnings (after tax) – generally at the end of each year. No tax is payable by the investor on these amounts as they accrue and are taxed in the fund (for currently-offered funeral bonds). Upon death – and in the case of a funeral bond that continues to be held by the investor, accumulated earnings (including a recoupment of prior taxes paid by the fund) are paid to (or as directed by) the trustee of the estate and this amount is taxable to the estate.

In the case of a funeral bond where a funeral director becomes entitled to proceeds on death (as a result of the investor entering into a prepaid funeral plan and conferring such entitlement as consideration), no amount is received by the estate – nor is the estate subject to tax on the proceeds.

The principal distinction between this and a generic insurance bond is that the accumulated value can only be received upon the death of the contributor. It also differs from a separate “funeral plan” which typically takes the form of an insurance policy requiring either a one-off contribution or regular contributions as purchase payment for a defined benefit amount upon death.

An effective limit is imposed on contributions as follows:

- For income tax purposes, the total amount contributed must be commensurate with the reasonable cost of funding a person's future funeral expenses. Tax law's definition of a 'funeral policy' has a sole purpose test, which relates to this principle.

- For social security means test purposes – as would be relevant to recipients of (for example) the age pension or veterans service pension, special income and assets test exemption is allowed for up to two ‘exempt funeral investments’ where total contributions do not exceed a prescribed CPI-indexed limit. That limit is \$11,000 for contributions (or top-up contributions) made during the 2010-11 year.<sup>12</sup> If funeral bond proceeds have been conferred to a funeral director (in consideration for acquiring a prepaid funeral plan), there is no contribution limit, as the amount contributed is regarded as immediately expended.

The bond may be *capital guaranteed* by the issuing institution, but this is not a requirement.

### 3.4 First Home Savers Accounts (FHSA)

Another life event product recently created through Government tax incentives is the FHSA launched in October 2008. This was aimed at providing incentives and assistance for individuals to save and accumulate funds for the purchase of a first home. Use of the scheme was limited, with only 20,000 accounts opened in the first two years, prompting changes to the scheme to be announced in the 2010 budget.

Rather than build upon existing life event product structures such as the insurance bond, the Government implemented the scheme via creation of a new type of savings accounts at banks, credit unions, building societies, life insurance companies (including friendly societies) and superannuation fund trustees. The scheme involved the creation of tax-preferred deposit accounts, designated as being for first home purchase by the account holder, in which interest paid on the account was taxed at a lower rate than for other income, as well as a government co-contribution. The Government contribution is currently set at 17% on the first \$5,500 contributed in any financial year. The maximum tax rate on earnings in the account is set at 15 per cent. Contributions can be made by anyone on behalf of the account holder. Withdrawals from the account to purchase a first home are tax free, but could only occur after reaching the 4<sup>th</sup> financial year (since original contribution) and only where contributions of at least \$1,000 have been made in each of at least four financial years. An indexed account balance cap of \$80,000 applies to the 2010-11 year (will be \$85,000 for the 2011-12 year). Once the

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<sup>12</sup> There are also special arrangements for situations in which the funeral bond has been assigned to a funeral parlor as pre-payment for a funeral.

account balance cap is reached, no further personal contributions can be made, even if indexation increases the cap in later years.

A significant disincentive to use of FHSA was the requirement that purchase of a first home by an account holder before the four year maturity meant that accrued funds could not be put towards the house purchase but were required to be paid into a superannuation account. Changes were proposed to the scheme in the 2010 Budget (but as of March 2011 are yet to be enacted) which still do not allow accrued funds to be used for a house purchase prior to the four year maturity, but allow accrued funds to be used to pay down a mortgage on a first home when the four year limit is reached. No further contributions were to be allowed after a first home is purchased.

As noted above, the scheme has not attracted much interest among potential home-owners, nor amongst institutions eligible to supply the product. This can be attributed to complexity of design, administrative costs, and constraints imposed upon withdrawals from the account. No friendly society is currently offering an FHSA product.

An alternative approach could have been to build upon the existing insurance bond structure. For example, a special purpose insurance bond allowing for early redemption of accumulated balances without losing the concessional tax rate treatment if a first home is purchased, and receiving the government co-contribution in those circumstances would have been relatively easy to implement and administer. The option to withdraw early for other purposes (and lose the tax concessions) or at the maturity of the insurance bond, would reduce the "lock in" effect associated with the original or proposed alternative arrangements.

It is emphasized that 'first home' seekers need to have the time flexibility of funding a home purchase when a desired home at the desired price is found. As home prices values are sizable, the 4-year time-constrained FHSA incentive is negated – if 'first home' seekers wish to avail of a perceived bargain price whenever it arises.

### **3.5 Taxation and Life event products**

There is a variety of tax arrangements applied to financial products, and the current situation is a far-from-level playing field. To some extent that is driven by government policy aimed at encouraging particular forms of asset accumulation. The substantial tax concessions involved in superannuation are a clear example, and these are accompanied by various constraints on usage to prevent excessive exploitation of those concessions. Other forms of investment which receive concessional tax treatment are owner-occupied

housing, as well as levered investments in real or financial assets such as investment properties and shares.

To provide a basis for comparison across investment types, it is helpful to think of tax characteristics according to the “3T” framework. This framework is based on noting that concessional tax treatment can occur at three stages of the product life-cycle: (1) on injection of funds, (2) on earnings while funds are within the product, and (3) when funds are withdrawn from the product. A triplet  $(t_1, t_2, t_3)$  can thus describe the tax treatment where  $t_i$  is tax treatment at stage  $i$ . Each  $t_i$  can take on one of three values:  $t_i = 0$  for tax exemption;  $t_i = t$  for preferential tax treatment; and  $t_i = T$  for non-concessional tax treatment. (Preferential tax treatment could also involve government co-contributions, or not including the value of the asset in calculation of the means test for government benefits). Thus, for example, a financial product involving contribution of after tax income, receiving preferential tax treatment of earnings, and subject to zero tax on withdrawal would be represented by  $(T, t, 0)$ . In practice, things will rarely be this straightforward, with tax treatment possibly conditional on some event or investor characteristic, and with various contribution or withdrawal restrictions imposed.

Nevertheless, it is useful to characterize a range of financial products according to this framework, and this is done in Table 2.

**TABLE 2: Taxation Treatment of Alternative Investment Types**

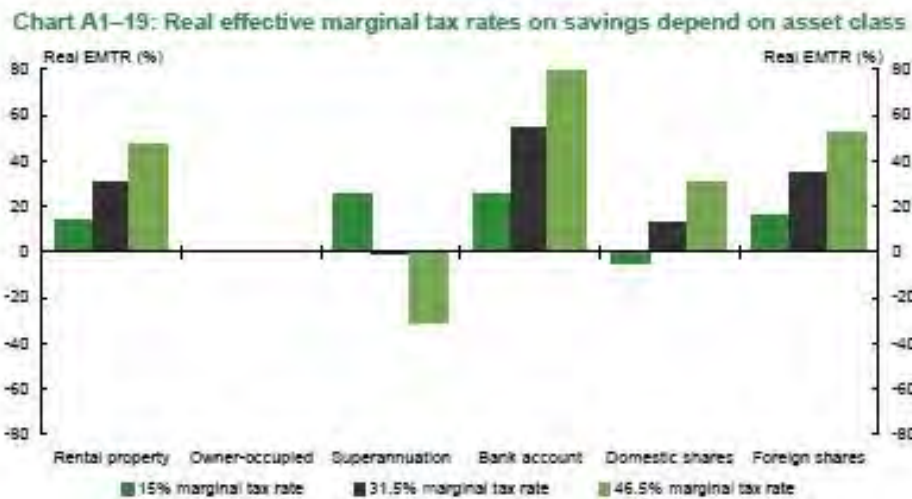
Product	t <sub>1</sub>	t <sub>2</sub>	t <sub>3</sub>	Comment
Savings account	T	T	0	Contributions are from after tax income, earnings are taxed as they accrue, and thus no requirement for taxation on exit when principal is returned.
Shares	T	t	t	Investment is from after tax income, there is concessional treatment of dividend income (imputation) and deferral of tax on capital gains until realization, and then at a concessional rate (if held for more than one year).
Complying Superannuation (funded schemes)	t	t	0	Contributions can be made from pre-tax income, there is a concessional tax rate (15 per cent) on super funds, and no tax payable on withdrawal (past age 60)
Insurance Bond	T	T (<10 years) t (>10 years)	0	Contributions are from after tax income, earnings are subject to 30 per cent rate (beneficial for high income earners), and no tax is payable on withdrawal (after the 10-year period).
Owner Occupied Housing	T	0	0	Purchase out of after tax income (and/or borrowed funds), imputed (self) rental income not taxed, no capital gains tax on sale
Levered Rental Property or Equity investments	T	t	t	Purchase out of after tax income, tax deductibility of loan interest, concessional capital gains tax (if held for at least one year).

Some of these differences in tax treatment are reflected in Chart A1-19 from the Henry Review of Australia's Tax System (Henry, 2009) reproduced below as Figure 4.<sup>13</sup> In particular, the highly favorable tax treatment of superannuation for

<sup>13</sup> This chart involves specific assumptions about inflation and pre-tax rates of return. A zero tax rate as from owner-occupied housing corresponds to an expenditure (consumption) tax (ie

high income earners is apparent. And it should be noted that the tax rate comparisons for rental property and shares do not involve leveraged investments.

**FIGURE 4: Relative Taxation of Savings Products**



Source: Henry (2009)

Without further information, it is not possible to do a similar calculation to that underlying Chart A1-19 for investment bonds, but a comparison with domestic share investment is possible. Table 3 provides a calculation of the real rate of return on an investment in shares directly by an investor and indirectly via an investment bond. (It is assumed that the nominal rate of return is 6 per cent p.a., half via capital gains and half as unfranked dividends, and that the inflation rate is 2.5 per cent p.a. The share is purchased and held for 10 years in both cases).

Because the Insurance Bond is taxed at the level of the Friendly Society and involves no tax consequences for the investor, its real after tax rate of return is the same for all investors (if amounts are later withdrawn tax-free to the investors). It can be seen that this tax treatment makes the Insurance Bond a higher yielding investment for high (45 per cent) tax rate investors, but not for low (15 per cent) tax rate investors. It is also noticeable, that the denial of concessional capital gains tax treatment means that the Insurance Bond return is slightly less than that available from a direct investment for a 30 per cent tax rate investor.

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investment out of after-tax income and no subsequent taxes). Recent changes to superannuation will have caused these estimates to change for low income earners.



**TABLE 3: Comparative Returns on Share Investment**

Investor	Real After tax rate of return (% p.a.)
Individual share investor on 15 per cent tax rate	2.80
Individual share investor on 30 per cent tax rate	2.18
Individual share investor on 45 per cent tax rate	1.55
Individual investing via Insurance Bond	1.81

*Assumptions: 3 per cent unfranked dividend and 3 per cent nominal capital gains p.a., inflation rate of 2.5 per cent p.a. Share held for 10 years. Insurance Bond taxed at 30 per cent on both dividends and realized capital gain.*

Combining these results with those of Chart A1-19 of Henry (2009) suggests that, given current tax treatment, there are incentives for low (and medium) tax rate investors to invest directly in shares or levered investment properties in preference to products such as insurance bonds, even though their financial resources and expertise are unlikely to be suited to such investments.

More significantly, it is apparent that the tax treatment of Superannuation is vastly more favorable than that of Insurance Bonds, even though both are long-term savings vehicles. Table 4 provides a comparative analysis of the key characteristics of Superannuation and Insurance Bonds. As this analysis demonstrates, while superannuation has a more favourable tax treatment, Insurance Bonds have benefits in terms of simplicity and flexibility.

**TABLE 4: Comparative analysis of Superannuation and Insurance Bonds**

Characteristic	Superannuation	Insurance Bond
Taxation	Pre-tax contributions, 15 per cent tax on earnings (10 per cent for capital gains), tax free on exit if over sixty	Post-tax contributions, 30 per cent tax on earnings (including capital gains), tax free on exit if after 10 years or on defined events
Life Insurance	Accumulated sum paid out on death (plus some part of contributions allocated to an insurance policy) – tax status would depend upon type of beneficiary	Accumulated sum paid out on death – tax-free to any beneficiary
Tax Reporting by Investor	Generally not during accumulation mode (provided contributions under allowable cap) reporting required in pension mode	None
Legal Status	Policy or account managed by superannuation fund trustee.	Contract with Friendly Society/Life Office
Control and Access	Limited prior to preservation age (unless hardship or terminally-ill conditions are met)	Unrestricted
Change of Ownership	Not possible	Possible via assignment of policy
Assets Investment	Range	Range
Capital Guaranteed	Can be	Can be
Cash Distributions	None prior to preservation age	None prior to maturity or withdrawal (part-withdrawals permitted)
Use as security for borrowing	Prohibited	Possible
Creditor protection in personal bankruptcy	Yes	Yes (if life insured is investor or investor's spouse)

## 4. Public policy towards life event financial products

There are a number of dimensions of public policy which are relevant in considering life event financial products. First, is there some form of market failure or imperfection which inhibits the development of financial products which can meet needs and desires of individuals? Second, is there a role for “paternalistic” behavior by government in creating a demand for such products by way of tax-transfer incentives or other means? Third, do government policies inappropriately advantage some financial services and products which meet these needs, but not in a socially optimal way? Fourth, is government support for such products for lower income groups an appropriate way of achieving distributional and equity goals? Fifth, what type of regulation of providers of such products is appropriate?

- *Market Failure Rationale.* There are two main sources of potential market failure in the case of life cycle event products. One is the pervasive effect of imperfect information which can lead to individuals incorrectly assessing the probability and timing of these events and thus the merits of such products. Moreover, the imperfect ability of individuals to discriminate between possible products can create substantial quality related problems such as the “lemons” problem.<sup>14</sup> Policies to enhance financial literacy and entry/product quality restrictions are potential policy measures. The second major source of market failure can arise from the operation of the tax system which may affect demand for investments in / saving through these particular types of products.
- *Paternalism Rationale.* Individuals may under-invest in life cycle event products relative to what is socially optimal for various reasons. One is through behavioral biases or irrationality. A second is that other forms of government financial support are available when such events occur, such that private provision for these eventualities is replaced by public provision. In these circumstances, there may be grounds for government incentives for or mandating of investment in such products. Another reason for government promotion of asset accumulation can be the desire to improve financial literacy – based on the argument that increased familiarity with, and stake in, the financial sector may help encourage interest and learning.

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<sup>14</sup> The “lemons” problem introduced to the economics literature by George Akerlof (1970) argues that inability of purchasers to differentiate (*ex ante*) between the quality of products from different suppliers creates incentives for lower quality producers to enter the market, driving down average quality and thus demand and price, and causing higher quality (higher cost) producers to exit in a vicious spiral and potentially collapse of the market.

- *Government Induced Distortions.* Substantively different tax rates apply to different types of savings vehicles in Australia – as pointed out in Figure 4 (Henry 2010) reproduced earlier. Tax incentives exist for saving via way of (levered) investment in property and superannuation. While individuals may be able to access some of the accumulated wealth in those forms of saving to meet life-cycle events, it is not apparent that this is optimal.
- *Redistributional Motives.* Public and political support for redistributional measures is often enhanced if those measures are linked to increased expenditure by the recipients on some products and services thought to have social value. Several authors (see for example Doling and Ronald, 2010) argue that a growing trend in social welfare policy is use of asset based policies in which individuals are induced to assume greater responsibility for their own welfare by investing in financial products to accumulate wealth for future expenditures. Such inducement may be by way of subsidies, tax concessions, grants, and directed at saving for particular expenditures such as housing or education.
- *Regulatory Policies.* Life Cycle event financial products involve significant promises by providers. For this reason providers can be expected to be prudentially regulated.

#### *Funding of Life event expenses*

Mayhew, Karlsson et al. (2010) provide a useful taxonomy of possible financing options for life-cycle events in their discussion of the UK Green Paper on Long Term Care. They identify five main options. These are:

- Self funding – where individuals are responsible for meeting expenses.
- Partnership – where some proportion of expenditure required is met by the government and some part by the individual
- Insurance – where (compulsory or voluntary) insurance would provide additional funds to any available from government
- Comprehensive – where mandated contributions (income linked) to a government (or private) scheme are required and expenditures met by the scheme
- Tax funded – where expenditures are met by the Government out of tax revenue.

The preferred financing arrangement will depend upon the type of expenditures being considered, and ideological influences. For example, universal self funding is problematic where predictability of need for the expenditure is low, and where consequences of not being able to meet the expenditure are severe. Also

important is how the quality of service or product for which expenditure is required might be affected by the financing mechanism.

Insurance Bonds are a good example of the partnership approach, in which individuals accumulate savings to meet expenditures and where some government contribution is involved via the tax concessions provided. It is also possible for that contribution to be achieved by government matching or co-contributions. However, at the current tax rate applied to Friendly Societies, the attractiveness of these products to low income individuals as a wealth accumulation vehicle is reduced.

## 5. Overseas experience

There are a number of international examples of governments supporting life event financial products. These often have distributional objectives, although they are also sometimes targeted at increasing the savings available to families to undertake socially desirable expenditures (such as on post-secondary education), and may have an objective of increasing national saving. Government support may be provided via tax concessions or by way of matching grants. Institutional arrangements and taxation systems differ markedly across countries, such that it is often difficult to make direct comparisons of similar types of schemes. A number of different schemes have also been introduced in some countries and subsequently terminated. In some cases this may be attributable to design flaws, while in others it reflects changes in government and political attitudes.

It is worth noting that the effect of such schemes on increasing savings appears to be greater for low to moderate income households (see e.g. Benjamin, 2003). And, *ceteris paribus*, the larger the proportion of lower income (lower tax rate) individuals who participate, the less will be the average tax revenue forgone (ie tax expenditure) per participant. And because such schemes often have a distributional objective, finding design features which lead to relatively greater take-up by lower income households is an important consideration – especially given their collective potential to boost national savings. The OECD (2007) undertook an analysis of tax preferred savings accounts, including those for education, children, and insurance. All involve some form of tax concession, while some also involve a government contribution or bonus amount (subject to certain conditions being met).

Table 5 (based on Tables 1.1, and 1.2 of OECD, 2007) summarizes the general approach at a national level, using the “three t” approach. Dual entries indicate different tax treatment of different schemes, and “B” indicates a bonus element, where the bonus is in the form of a government co-contribution or matching grants to the scheme. The Table also shows the period for which access to savings is limited in order to obtain the concessional tax treatment.

**TABLE 5: International tax treatment of tax preferred savings account products\***

Country	Contributions	Earnings	Withdrawals	Access limited for
Belgium	T/t	0	0/t	
Canada	T	0 (B)	T	Until expenses incurred

Denmark	T	0	0	7 years
Germany	T	E/T (B)	0/t	7 or 12 years
Ireland	T	0	0	3 or 5 years <sup>1</sup>
Italy	T/t	0	T	
Netherlands	0	0	0	4 years
Norway	T	T	0	4 years
UK	T	0	0	5 or 10 years or age 18
USA	T/0	0	0	Until expenses incurred

\* T indicates fully taxed, t indicates partially taxed, 0 indicates tax exempt, B indicates a bonus element. Data relates to 2005. Blanks indicate that information was not available in an appropriate form.

<sup>1</sup> The limit for Special Savings Accounts is 3 months

Source: OECD(2007, Table 1.1)

Two features stand out in Table 5. First, the time required before funds can be withdrawn without losing tax concessions is generally substantially shorter than for Insurance Bonds in Australia. Second, the taxation rate on earnings is generally lower than the statutory tax rate (and often zero) – again different to the case in Australia. It is also worth noting that in a number of cases government co-contributions or matching grants are used rather than tax concessions.

There are a range of schemes of tax preferred saving in operation internationally targeting child development/asset building, education funding, insurance, home ownership, health plans, as well as non-specific asset accumulation schemes. In the following we review some of those schemes. However, before reviewing these policies, it is worth noting that their implementation on purely financial criteria (availability of a lump sum for some purpose) assumes, perhaps rightly, that financial markets are imperfect in that loans would not be available to meet such lumpy expenditures when they arise. There is also a question as to whether subsidies provided for this specific form of wealth accumulation are offset by reduced saving from other income.<sup>15</sup> Finally, there is the question of what

<sup>15</sup> Japelli and Pistaferri (2003), review the research examining aggregate savings effects from tax concessions on IRA's in the USA (which has been the most intensively studied example). They conclude that there is evidence that tax incentives affect the composition of saving, but the effect on total saving is less clear.

happens to funds in these specific purpose designated accounts should the targeted event not occur.

### **5.1 Child Development Accounts**

One type of approach found in a number of countries is that of Child Development Accounts aimed at encouraging savings and wealth accumulation from a young age. Loke and Sherraden (2009) describe policies existing in Canada, UK, Singapore, Korea and a planned scheme for the USA. Underpinning these strategies is the perspective that asset accumulation provides resources for meeting lumpy costs or for aspirational expenditures, and that the process of wealth accumulation is a “merit activity” which warrants inculcation at an early age.

Table 6 provides information on the types of Child Development Account tax-preferred schemes in a number of countries.



**TABLE 6 Tax Preferred Child Accounts**

Country	Name	Tax Treatment	Available to	Contribution Limits	
Belgium	Tax preferred deposit accounts	(T, 0, 0)	All	None	If account opened in child's name, withdrawal is restricted
Denmark	Savings Accounts for Children / Grandchildren	(T, 0, 0)	All	Annual and lifetime	
Hong Kong	Child Development Fund	(T/B,T,0/B)	Disadvantaged Children aged 10-16	Target savings limit	3 year time span for specific purpose
Singapore	Children Development Account (SDCA)	(T/B,T,0)	2 <sup>nd</sup> -4 <sup>th</sup> children aged 0 to 6	Annual limit for government contribution	Use for education, child care etc.
South Korea	Child Development Account	(T/B, T, 0)	All children in welfare system	Monthly limit for government contribution	Available at age 18 for range of uses
UK	Child Trust Fund	(T, 0, 0)	All	Annual limit	Initial government bonus contribution. Matures at age 18

*Singapore*<sup>16</sup>: *Baby Bonus/Children Development Account (SCDA)*. The Baby Bonus involves a government cash grant at birth deposited into a savings account and a second tier component of the SCDA, where family contributions are matched by the Government up to a cap. The SCDA is

<sup>16</sup> <https://www.babybonus.gov.sg/bbss/html/index.html>

available only for 2<sup>nd</sup> to 4<sup>th</sup> children in a family and operates from ages 0 to 6. Funds can be used for education, child care, medical related expenses etc., and unused amounts transferred into the PSEA upon entering primary school. In 2011, the Government announced the introduction of new Child Development Credits to be payable into SCDA's to all children below 6.

*Hong Kong<sup>17</sup>: Child Development Fund (CDF)*. The CDF is aimed at developing savings behavior and personal development planning and targeted at children aged 10-16 from low-income and welfare-dependent families. It involves participation in personal development planning activities involving financial plans run by NGOs who provide matching funding for the targeted savings made, as well as mentoring. At the end of the 3 year program, successful completion leads to a government contribution and accumulated funds can be used for the activity specified in the plan.

*UK: Child Trust Fund (CTF)*. Government contributions are made under the CTF (Child Trust Fund) at birth and age 7, via a voucher (of larger value for low income families) which can only be placed in specified CTF account types. Family contributions, up to an annual cap, into the CTF account are possible, and earnings are tax exempt. The CTF funds can be withdrawn by the child after age 18 for any purpose. The scheme was abolished in December 2010 by the new Conservative Government.

*South Korea: Child Development Account (CDA)*<sup>18</sup>. The CDA<sup>18</sup> was introduced in 2007 with the objectives of improving financial education and asset accumulation by children from disadvantaged backgrounds. Families of children between 0 -17 can make contributions which are matched up to a prescribed limit by the Government, together with limited other contributions. The funds can be accessed at age 18 for education, medical, wedding, business, housing expenses.

*Denmark: (Savings Accounts for Children/Grandchildren)*. These were introduced at the start of the 1980s. There are both maximum annual and total contribution limits which can be made until the beneficiary reaches 21, when funds are available, and the account must be opened before the beneficiary is 14, since a minimum 7 year term is imposed. Earnings are tax free, and the account can be operated by the administering financial institution as a pooled investment scheme.

*USA<sup>19</sup>: KIDS (Kids Investment and Development)* accounts were proposed under the *ASPIRE* Bill introduced in Congress for introduction in 2007 with an initial government contribution (higher for lower income households) on birth.

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<sup>17</sup> <http://www.cdf.gov.hk/eindex.html>

<sup>18</sup> Nam et al (2010)

<sup>19</sup> Cramer (2010)

Private contributions up to an annual cap could be made and, up to a lower annual cap, would attract matching government funds in the case of low income households. Earnings would be tax exempt and no withdrawals allowed until 18 (when funds could be used for education expenses, or (after 25) for homeownership or retirement security).

## 5.2 Education Schemes

A number of countries operate tax preferred savings schemes for education. Table 7 provides a summary.

**TABLE 7: Tax Preferred Education Savings Schemes**

Country	Name	Tax Treatment	Available to	Contribution Limits	Comments
Canada	Registered Education savings Plans (RESPs)	(T, 0, t) and bonus	All, Bonus linked to income	Annual and lifetime per beneficiary	Govt bonus payments through Canada Learning Bond and Canada Education Savings Grant
Singapore	SCDA/PSEA	(T/B,T,0)			
USA	ESAs	(T, 0, 0)	All		
	529 (Qualified Tuition) Plans	(T, 0, 0)	All		

*Singapore*<sup>20</sup>: Singapore operates three relevant schemes - *Edusave*, the *Post-Secondary Education Account (PSEA)*, and (as discussed above) the *Baby Bonus/Children Development Account (SCDA)*. The *Edusave* scheme involves government contributions into an account during compulsory schooling which can be used for particular education expenses, with unused balances transferred on leaving school into the *PSEA*. Contributions into the *PSEA* for children between 7 and 18 attract a matching government grant up to a cap. Funds in the *PSEA* not used by age 30 are transferred to the

<sup>20</sup> See Loke V and M Sherraden (2009)

individual's pension fund (CPF) account. (Baby Bonus /SCDA unused amounts are transferred into the PSEA upon entering primary school).

*Canada*<sup>21</sup>: The Registered Education Savings Plan (allows parents to contribute (after-tax) funds for post-secondary education into a registered savings account in which taxation of interest is deferred until withdrawal. These RESPs may attract additional Government subsidy through the Canada Education Savings Grant (CESG) or the Canada Learning Bond (CLB) schemes. The CESG involves government providing partially matching funding to parent contributions up to a cap, with the matching proportion linked to family income. The CLB involves a government grant into the RESP for low income families. The tax rate applied is that of the student withdrawing funds (which may be very low or zero) or a mark-up over the parent's tax rate if the child does not undertake an eligible education program.

*USA*: Education Savings Accounts (ESA) have operated since 1997 and number of states also operate "529" plans. Earnings are tax free if used for post secondary education, and some states allow limited income tax deductions for 529 contributions. If some distributions are not used for education expenses the earnings are taxed at the beneficiary's tax rate (plus a surcharge of 10 per cent). The maximum contribution limit is substantial.

### 5.3 Life Assurance Tax Incentives

There is generally quite complex treatment of life assurance savings, but some concessional treatment generally applies. Table 8 provides an overview.

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<sup>21</sup> <http://www.canlearn.ca/eng/saving/resp/index.shtml>

**Table 8: Tax treatment of Life protection**

Country	Summary	Tax Treatment
United States	Investment income is not taxed but withdrawals and contributions are. Employer-provided group term policies up to \$ 50,000 not taxed.	(T/0, 0, T)
Belgium	Taxpayer gets tax credit on premium, Insurance company subject to one-shot tax when assured reaches 60 and assured pay 10 per cent tax on withdrawal	(t,0,t)
Canada	Investment income and withdrawals are tax free if they provide only an insurance, rather than an investment element.	(T,0,0)
United Kingdom	Withdrawals are tax free, but returns are taxed (at 20%). Tax relief on premiums phased out in 1984.	(T,t,0)
	Friendly Society Tax-Exempt Savings Policies (TESPs) – maximum contribution limit imposed	(T,0,0)
Germany	Pre 2005, contributions are tax-deductible subject to a cap; returns are not subject to tax. From 2005, no deductibility of premia, concessional taxation of payouts if minimum age etc. met.	(t,0,0) – pre 2005 (T,0,t) – 2005 on
Italy	Contributions are tax-deductible subject to a cap and a time limit for life insurance products specifically designed to supplement social security pensions; withdrawals are taxed. Asset accumulation policies have non-deductible premiums and concessional (12.5% capital gains tax on withdrawal (no time limit).	(t,0,T) or (T,0,t)
Japan	Contributions are tax-deductible subject to a cap and a time limit; withdrawals are partially tax-exempt.	(0,T,t)
France	Contributions are tax-deductible subject to a cap and a time limit; withdrawals are taxed.	(0,T,T)
Argentina	Contributions are tax-deductible subject to a cap; returns are tax-free.	(0,0,T)
India	Contributions are tax deductible; returns are taxed.	(0,T,T)
Singapore	Contributions are tax-deductible subject to a cap; returns are taxed.	(0,T,T)
Taiwan.	Contributions are tax-deductible subject to a cap; returns are taxed	(0,T,T)

Source: Japelli and Pistaferri (2003), OECD (2007)

## 5.4 Non Specific purpose Schemes

Table 9 provides information on a number of schemes operating in overseas countries which do not have a specific purpose (such as education of child asset building)<sup>22</sup>.

**TABLE 9: Tax preferred (non-specific) accounts**

Country	Name	Tax Treatment	Available to	Contribution Limits	Comment
Belgium	Tax preferred deposit accounts	(T, 0, 0)	All	Annual limit on interest which gets concessional tax	
Germany	Employee saving bonus (Arbeitnehmersparzulage)	(T, t, 0), saving bonus not taxed	Low/ medium incomes	Limit on contribution matched by bonus	Employer payroll contributions
Ireland	Special term accounts	(T, t, 0)	All	Monthly contribution limit, Annual limit on interest which gets concessional tax	Commence 2002 and replaced a number of prior schemes
Netherlands	Spaarloon	(0, 0, 0)	All	None	Employer payroll contributions
Norway	Aksjesparing med skattefradag	(t, T, 0)	All	None	For equity investments, abolished in 2000
UK	ISAs	(T, 0, 0)	All	Annual contribution limits	No time limit on withdrawals (various prior schemes terminated)

Source: OECD (2007) *Encouraging Savings through Tax-Preferred Accounts* OECD Tax Policy Studies No. 15

<sup>22</sup> Hungerford (2006) provides an outline of a number of proposals considered by the Bush Administration in the USA including lifetime savings accounts (LSAs) and Individual Development Accounts (IDAs).

## 5.5 Contractual Home Savings Schemes

Schemes to assist the purchase of a first home are found in many countries.<sup>23</sup> Sometimes these take the form of a government grant (such as the First Home Owners Grant in Australia) which is not tied to any prior contractual savings scheme nor income tested. Some nations have adopted mandatory housing savings schemes, while some others allow mandatory pension savings to be used, alternatively, for housing purchase. In some other cases, tax incentives and/or subsidies may be given to savings schemes which are tied to ultimate first house purchase. In some cases, institutions may be established which both accept savings and make housing loans to their members.<sup>24</sup> (In Australia, some forms of building societies (Starr-Bowkett societies) and cooperative housing societies took this form, with varying approaches as to how available loan funds would be allocated amongst members).

Promotion of home ownership is often seen as an objective of social policy in its own right. But viewed over a life cycle perspective, there are other reasons for its promotion. One, based on a behavioral finance perspective, is that individuals will not save sufficiently over their working lives in preparation for retirement. Contractual mortgage repayments associated with home ownership involve a form of forced saving, which is unlikely to occur through voluntary saving by renters. While home ownership in retirement reduces living expenses relative to renting, a second important potential life cycle benefit exists. This is the resulting option to run down equity in the property (by “downsizing” or use of financial products such as equity release or reverse mortgages) providing extra resources for retirement living expenses. In practice, however, this option has been underutilized – and, in some cases, deterred by government policies (such as not including the value of the family home in the pension assets test).

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<sup>23</sup> Jappelli and Pistaferri (2003) provide an overview. See also Doling and Ronald (2010)

<sup>24</sup> Ronald (2009) outlines a number of contractual savings schemes for housing found in European and other countries.

## 6. Potential innovations in Australian life event products

The international experience surveyed above brings out a number of points:

- Tax concessions or government co-contributions are often found in a number of countries aimed at promoting particular types of saving and accumulation of “merit assets”
- There is a mix of approaches towards providing tax concessions (between deductibility of contributions, concessional (zero) taxation of earnings, concessional treatment of withdrawals). There is, perhaps, a slight bias towards non deductibility of contributions and concessional (zero) taxation of earnings and withdrawals.
- The savings and investment programs involved often have an objective of improving financial literacy through “learning by doing”
- Targeted and limited government co-contributions are often used to ensure that benefits flow primarily to lower income or welfare dependent groups
- Specific purpose programs (such as for education) have limits upon the use to which funds can be put without loss of tax benefits or government contributions
- The “lock-up” period for funds varies substantially across scheme and country, but is generally shorter than the ten years applied in Australia.

Drawing on this international experience it is possible to see how the generic and prudentially-regulated insurance bond can be enhanced to help Australian families plan and save flexibly, collectively and on an inter-generational basis for known future financial demands in the areas of health, aged care and funeral expenses. Tax incentives and co-contributions can be structured in such a manner as to increase the self reliance of individuals and reduce the potential demands on public welfare into the future. The potential benefits for improving financial literacy and reduced need for expensive financial advice should also not be underestimated. As well as the insurance bond structure, other products are also potentially available to meet gaps in the market, and Friendly Societies have long had an involvement in the provision of such products and services.

### 6.1 Family Health Management Fund (FHMF) proposal

The Family Health Management Fund (FHMF) has been proposed as a voluntary savings facility to positively encourage Australian families (grandparents, parents and children) to be proactive in planning for their



chosen levels of health care and independence in ageing years. In essence, the FHMf is a tax-paid, life insurance saving and investment product, designed to build an accumulation that is drawn against a range of eligible expenditures falling under five life-event categories as follows:

- **Health Maintenance:** This benefit category will assist with the costs of carrying through a health plan, a fitness plan or a wellness plan, including coverage of amounts and items generally outside the scope of Medicare and private health insurance. The health maintenance category will be relevant for all consumers - including those who do not have any, or adequate, private health insurance and who choose to have elements of self-insurance by using a disciplined investment vehicle specifically designed for the purpose. It will also be attractive to those not taking ancillary tables under private health insurance and/or in providing for items not covered under ancillary tables. (e.g. pharmacy, special dietary etc.).
- **Private Health Insurance Premium:** This benefit category is to build an accumulation to fully or partially “pay-up” private health insurance cover. The peace-of-mind of knowing that one’s health insurance can be paid-up for life or a defined term is thought to be most attractive. The FHMf strategy could be to reach a sufficient FHMf investment accumulation to finance a set level of private health insurance coverage for life (or joint lives), or for a selected term. (The required accumulation would be determined by actuarial estimates), from which automated draw-downs against the FHMf to meet premiums would be made. This category will be attractive to those families using private health insurance as part of their family health management strategy or plan.
- **Aged Care Accommodation:** The FHMf may be used to fully or partially meet the costs of a chosen retirement village, hostel or nursing home, including the funding of accommodation bonds, and self-care residential units.
- **Aged Care Services:** This category will be designed principally for those choosing a level of independence from the publicly funded support services. It will allow, for example, claims for home care as well as for specific aged residential and services needs. These may include the cost of home modifications, home cleaning and maintenance costs and the costs of selected personal therapy or lifestyle services that will allow the individual (or the family) a wider choice for staying longer at home.
- **Funeral:** This FHMf category will cover funeral benefits for the family. It will do so by permitting direct payment of funeral and related expenses,

allowing payments to funeral directors for pre-paid funerals, and/or funding funeral investment product subscriptions.

The founding family member (e.g. a parent or grandparent) establishes the plan by a lump sum and/or a regular savings plan. The FHMF then grows over a set minimum accumulation period to a point of benefit maturity, from which time the founder controls access to plan benefits. The FHMF will have options (with control vested in the founder) over the product's investment strategy. This can involve choice between portfolios managed by the friendly society or by external fund managers. On death of the founder, options exist for any Plan balance to vest in the estate of the founder, or to pass to eligible family members, including being used to seed an ongoing FHMF.

## 6.2 Disability and other insurance

A range of insurance products are available for events which are low probability-high cost events. These include total and permanent disability insurance, trauma insurance, and income protection (salary continuance) insurance. Currently the Productivity Commission is examining the merits of a National Disability Scheme.

Such insurance schemes share a characteristic with savings based life cycle event products that regular (or lump sum) contributions are made and a payment is received should the relevant event happen. Two significant differences exist however. One is that these "pure" insurance products do not provide a return to the individual if the event does not happen. The other is that the payout is substantially greater than the accumulated amount from contributions and earnings.

Historically, products existed in Australia which combined the savings and risk insurance functions. Life Endowment Insurance policies paid out an insured sum on death before a nominated date, or an accrued amount (including bonuses based on investment earnings) should the insured still be alive at that date. Thus, some part of the contribution paid was a form of savings and some part a pure insurance premium. Because the insurance cost increases with age and the contribution amount was constant over time, there was front end loading of the savings component.

## 6.3 Long Term Care

A significant proportion of elderly individuals will require long term care towards the end of their lives. Currently over 830,000 retirees receive assistance in their home under the Government's Home and Community Care

(HACC) scheme. Government funded Community Aged Care Packages (slightly over half operated by religious and charitable institutions) were used by 53,250 people during 2007–08, and around 7,500 received higher levels of community care assistance. At June 2008 there were 175,472 residential aged care places available in Australia provided by almost 3,000 providers from the religious, charitable, community and for-profit sectors.

As well as the aspects of physical provision of these services and facilities, an important issue concerns the financing arrangements. Mayhew, Karlsson et al. (2010) note several private sector financing instruments which can be used and which may involve pre-purchase (at any time), date (eg retirement) specific purchase, or immediate use purchase:

- *home equity release* (reverse mortgages), whereby accumulated equity in the family residence can be drawn-down.
- *Top up insurance* whereby an insurance policy is taken out which pays out if, and when, long term care is needed. (The insurance may be linked to use of particular long term care facilities)
- *Disability linked annuities* whereby an annuity purchase while healthy includes a step-up (uplift) provision to a higher amount should a disability event necessitating long-term care occur. (Mayhew, Karlsson et al. 2010) note that the negative correlation between longevity and long term care need may be beneficial in risk management by writers of such annuities).
- *Immediate needs annuities* in which an individual entering care purchases an annuity to meet expenses and avoid the possibility of running out of funds for care
- *Accelerated life insurance* in which the policy begins payout if a severe disability occurs, and with such payments reducing the amount payable on death.
- *Long Term Care Bonds* involving regular purchases of zero coupon bonds which promise a payout on death or prior event of disability. Mayhew, Karlsson et al. (2010) suggest adding a lottery prize component to increase attractiveness)

#### 6.4 A Re-Emerging Market for Modern Insurance Bonds

The 1980s and early 1990s were the heyday for insurance bonds, however from the mid 1990's onwards, they lost support of financial planners and retail investors. A major contributor was the increase in the head-line Tax-Paid rate to 30% as was the removal of means-tested pension advantages. The "lost" decade was also impacted by modest

investment performance and antiquated investment structures concentrated on capital guaranteed business.

Friendly societies and the wider Life Industry failed to move insurance bonds with the times by introducing modern multi-optioned investment platforms with switching facilities to higher performing equity and property options.

The insurance bond market today is seeing signs of new life with new entrants and existing issuers re-emerging with updated products and expansive investment menus. The re-kindling interest in insurance bonds is due to product design innovation by combining its long established taxation structure with a modern, investment platform.

The modern insurance bond operates like a mini master fund, and many are structured to give access to a menu of underlying managed funds under the bond's Tax-Paid investment environment. In comparison to single option "capital guaranteed" insurance bonds, this radically changes the Bond's performance capabilities. It is generally left to investors (or their Advisers) to construct their Bond's portfolio mix across the option selections from its menu.

Insurance bonds are generally written as "long-term" "strategy-based" business. As such, investment terms vary considerably. Many bonds are simply structured with 10 year plus terms aligned to the insurance bond taxation framework, which facilitates "Tax-Free" withdrawals after 10 years, or earlier death of the life insured. Longer post 10-year terms are commonly used for certain long-dated financial planning strategies using insurance bonds. For example, when using a bond rather than private trusts (where the rule against perpetuities can apply) or where the bond is used as the investment asset within a private trust. Also, Children's Advancement Bonds are typically 10 to 25 years, estate planning based business may track the client (or other person's) death maturity profile.

## 7. Regulation of Life Event Products

Life Event products must be consistent with government policies regarding financial products including prudential regulation, disclosure, marketing and distribution of financial products. This section provides an overview of the current (and changing) regulatory framework,

The delivery of financial products and services to individuals is significantly impacted by regulation and the tax system. Much of the regulatory structure and tax arrangements are designed to protect individuals from adverse financial outcomes or to induce particular types of saving and investment behavior. There can, however, be unanticipated effects upon the demand for some financial products and services which warrant a review of arrangements.

For the delivery of life cycle event products, a number of features of Australian financial regulation are relevant.

First is the requirement for suppliers of financial products and services to hold an appropriate Australian Financial Services Licence (AFSL), requiring compliance with licensing requirements.

Second, some institutions will, because of the nature of the products offered, be subject to prudential regulation by the Australian Prudential Regulation Authority (APRA). This regulation varies according to the type of financial institution (banks, other ADIs, life and general insurers, friendly societies, superannuation funds) but generally involves capital and liquidity requirements, supervision, and disclosure requirements. One consequence of regulation by institution type is that similar products offered by different types of institutions may be subject to different regulatory requirements.

Third, financial product offerings are generally required to be made under a prospectus or product disclosure statement made available to potential investors (although ADI deposits and friendly society funeral policies are excluded from this requirement). Complexity of these documents, which are often prepared with an objective of avoidance of potential future liability to inadequate disclosure, can be a significant impediment to retail investor understanding. Recent ASIC initiatives to allow simplified disclosure documents have been motivated by concerns that investors do not read or understand those long and complex documents.<sup>25</sup> ASIC has also recently provided guidance<sup>26</sup> enabling provision of disclosure documents online rather than via hard-copy. It is, however, worth noting that ASIC has increased disclosure requirements for

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<sup>25</sup> See, for example, ASIC Regulatory Guide 213 *Facilitating Debt Raising*, May 2010; ASIC Regulatory Guide 168, *Disclosure: Product Disclosure Statements (and other disclosure obligations)*, September 2010

<sup>26</sup> ASIC Regulatory Guide 221 *Facilitating Online Financial Services Disclosure*, December 2010

certain types of financial products through its “if-not-why-not” disclosure requirements which require a financial product provider to explain why particular aspects of their business model or structure differ from guidelines set out by ASIC.

Fourth, financial products are generally “sold” rather than “bought”, requiring marketing and involvement of sales agents and/or financial advisers to bring products to the attention of potential customers. Currently, under the Future of Financial Advice (FOFA) reforms announced in April 2010<sup>27</sup>, there are plans to ban “conflicted” remuneration structures for advisers (involving volume and commission based payments from product producers) and a “best interests” duty (placing interests of clients first) requirement. Given the links between financial advisers as part of dealer groups using platforms provided by major product providers, the best interests requirement raises a number of issues about determination of products from other suppliers which should be included on an “approved products list” on the platform.

In some cases, requirements for obtaining financial advice (or at least for the provider to advise the purchaser to seek independent advice) before product purchase apply. This is among the proposals included in stage two of the National Consumer Credit Protection reforms for Reverse Mortgage products where it is proposed that individuals are required to obtain both independent financial and legal advice.

One reason for such proposed changes, which is more generally relevant is that financial decisions to purchase particular products can have significant tax or social security implications. For example, the exclusion of the family home from the assets test for the age pension means that the receipt of a lump sum upon entering a reverse mortgage may increase the included asset amount and affect pension eligibility. Similarly, the “deeming” provisions for the income test for pension eligibility (whereby a “deemed” rather than actual rate of return is used in calculating income) may bias preferences among financial investments.

It is also relevant to note that a degree of self-regulation has long applied to certain friendly society products, as briefly outlined below.

**TABLE 10: Self Regulation of Friendly Society Products**

Insurance bond	In the absence of statutory or prescribed guidelines, the friendly society has its own integrity procedures to deal with tax concessional payouts arising from claimed death, disability, illness or financial hardship events.
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<sup>27</sup> <http://futureofadvice.treasury.gov.au/Content/Content.aspx?doc=home.htm>

Funeral policy	The friendly society has its own integrity procedures to deal with tax and social security concessional payouts arising from claimed death events, including the examination of relevant documents.
Scholarship (education savings) plan	<p>The friendly society has its own integrity procedures to deal with tax concessional payouts arising from claimed education expenses, including internal guidelines on what constitute acceptable education courses and expenses.</p> <p>Also, in the absence of statutory or prescribed guidelines, some friendly societies have consulted with the ATO on acceptable contribution caps.</p>

## 8. Policy Options and Conclusion

The recent Henry Review (2009) highlighted the lack of neutrality in the tax treatment of various savings products. With the dominance of the superannuation system in public policy, incentives to encourage individuals to be financially self-reliant and plan for the future through non-superannuation vehicles has gradually dissipated.

Other important issues in current policy discussions are the role of financial literacy and financial advice, as well as the use of the tax/transfer system to deliver welfare benefits and “nudge” individuals into making financial choices better suited to their long term welfare. Several Asian countries appear to have adopted the view that an “asset accumulation” approach to welfare policy, in which individuals are given tax/transfer incentives to accumulate “merit assets” and thus provide (at least partially) for particular life-cycle events has merit.

As this paper has outlined, the simple financial instrument of the Insurance Bond has many benefits which can be effectively utilized to encourage private saving for targeted life cycle events. In contrast to the disconnect experienced by many of the public in relation to their retirement savings through superannuation, the insurance bond allows individuals to tailor a savings regime that is more immediate and personalised, and does not require expensive on-going financial advice. Important events such as ill health, education, funeral costs and long-term care can be provided for in a targeted manner, thus allowing individuals a better quality of life and reducing reliance on public well fare

The Australian Tax Board (2010) (Australian Tax Board 2010) is currently reviewing the taxation of collective investment schemes, although this review excludes Friendly Societies and Insurance Bonds. It argues that a tax flow-through approach has merit, such that the tax consequences for investors would be the same as if held directly. It also argues the view that taxation should be related to the nature of the investments rather than to the particular investment vehicle used.

Currently, Friendly Societies and thus Insurance Bonds are treated quite differently to this, with no flow-through and differential tax treatment of capital gains relative to other investors. Superannuation is also treated quite differently. One consequence of tax-flow-through is that investors may incur tax liabilities without any cash flow currently being received from the collective investment.

To the extent that the Insurance Bond structure is seen as a valuable way of promoting individual saving for life-cycle events and/or for implementing some social welfare policies based around an asset accumulation/private responsibility approach, the current approach involving non-tax-flow through has merit. There



are however a number of characteristics of Insurance Bonds which result from legislation and tax treatment and warrant reconsideration.

### 8.1 Contribution Limits

Currently, investors are permitted to invest an additional 125 per cent of the previous year's total contribution in any investment year without affecting the date at which funds can be withdrawn tax free. The technical basis for this constraint relates to the 'eligible period' allowed (currently 10 years) after which tax-free withdrawals are allowed. It can perhaps also be rationalized on two integrity principles. One is the effect of encouraging continuing savings and investment into the bond, since a year without contributions precludes subsequent contributions. A second may be an objective of reducing exploitation of the special tax treatment involved. For example, without some contribution constraint, far sighted individuals could commence an insurance bond with a minimal investment and add substantially to it in the later years, thus getting the benefits of reinvestment at a lower tax rate in those years without having funds locked up in the bond for a long period.

The effect of the constraint is to limit total investment in the same bond, relative to the initial contribution amount and date, and to impose significant opportunity costs on individuals who do not contribute further funds in any subsequent year. While that latter effect may induce a more stable investment flow by the individual, the liquidity costs to the individual may be very substantial (if, for example, a spell of unemployment makes contributing difficult).

Information from individual Friendly Societies indicate that a significant proportion of contributors do not make additional contributions in one of the first three years following the initial contribution, and thus are precluded from further contributions – if wishing to maintain the bond's original start date..

An alternative approach (without comprising the integrity principles) would be to limit subsequent contributions to some multiple of aggregate prior contributions, where that multiple declines over time. For example, annual contribution limits relative to aggregate prior contributions of

- 125 per cent in year 2;
- 70 per cent in year 3;
- 50 per cent in year 4;
- 40 per cent in year 5,
- and then declining gradually to 30 per cent in year 10

would, if fully used, give approximately the same year 10 total contribution as if 125 per cent of the previous years contribution had occurred each year. The benefit of such an approach is that it reduces the penalty (inability to make further contributions) if an investor is unable to make contributions in any one particular year.

One potential downside may be that the 125 per cent limit may be easier to explain to investors than a declining schedule of maximum annual contributions relative to total past contributions. However, providing a schedule of maximum total accumulated contributions allowed at each year for each dollar initially invested would seem likely to overcome this problem and easy for the providers of the insurance bond to communicate to investors.

Regardless, it is noted that existing tax law does not actually prohibit making further contributions of any amount and at any time – only, if they breach the 125% further contributions cap, the bond's 'eligible period' start date is deemed to commence at the beginning of the investment year in which the offending contribution is made.

It is also noted that, with an established multi-premium policy, existing tax law accommodates delayed contributions into a bond – if the particular bond required the investor to make a contribution each year (within the 125% cap).

## 8.2 Headline Tax Rate

As shown earlier, the current statutory tax rate of 30 per cent applied to Friendly Societies (together with its less favorable capital gains tax treatment) means that insurance bonds are not tax effective investments for individuals on low marginal tax rates. Indeed, individuals on a 30 per cent tax rate would find a direct share investment held for 10 years preferable to making that investment through an Insurance Bond. (They would, however, not get the benefits of diversification, professional portfolio management, and avoidance of annual tax accounting regarding the investment that comes with the Insurance Bond).

Because Insurance Bonds are a simple product, requiring minimal financial advice, and suited to accumulation for life-cycle event purposes, it is unfortunate that the tax treatment weakens their appeal to those individuals to whom they may provide the most intrinsic benefits.

This problem could be resolved by reducing the tax rate paid by Friendly Societies to some lower figure, such as 20 per cent – or two-thirds of the prevailing corporate tax rate. While this would increase the tax benefits from

investment in Insurance Bonds for those individuals on higher tax rates (mindful the same argument may apply to superannuation), the social benefits from increased long term saving (additional to superannuation) may justify this. More generally, even at this lower tax rate, Insurance Bonds would still be taxed less favorably than some other investment structures (such as negatively geared investment housing or shares) intensively utilized by wealthy investors. To the extent that the simplicity, lower risk, lower administration costs of the product induced substitution out of those other structures, the net aggregate tax effect would be lower.

An alternative option is to follow the UK model where tax free savings accounts are offered by Friendly Societies and where no tax is paid by the Society on earnings. To prevent excessive tax arbitrage, the maximum contribution p.a. into such accounts is capped. To prevent individuals creating multiple accounts at different institutions, it would be necessary (much like with superannuation contributions) for information (eg a tax file number) to be collected about beneficiaries and provided to the ATO.

Yet another option is to introduce government co-contributions for specific purpose savings products targeted at particular low income groups, which are conditional upon income and subject to caps. This approach has the merits of more explicit targeting of a group of recipients with less spillover of tax benefits to higher income groups. However, non-cumbersome integrity rules may then be needed to ensure withdrawals are appropriately made for the specific purposes.

### **8.3 Reducing the Term**

Much as with other characteristics of Insurance Bonds, the rationale for the 10 year term is shrouded in the mists of history – mindful there was no ‘eligible period’ for bonds issued prior to 28 August 1982, it was then 4 years for bonds issued until 7 December 1983, and 10 years for bonds issued thereafter. It would seem to reflect a view that the tax concessions involved in the product for some investors are warranted if the product involves long-term savings and investment. While such a trade-off has appeal, the appropriate terms of the trade-off are less obvious. But it would seem appropriate that the length of the terms involved would be greater the more generous are the tax concessions. Interestingly – and by contrast, in September 1999, tax law recognized that a period of 1 year was long enough an investment period to offer a 50% capital gains tax discount to individual investors (or a corresponding 1/3rd discount to superannuation funds).

Compared to the heyday of the Insurance Bond, when the tax rate was zero and the maturity was also ten years, the trade-off is significantly worsened. Consequently, given the current and even with a lower tax rate, there may be a case for reducing the maturity. Also relevant is the disincentive which a 10 year maturity creates, particularly if individuals are contemplating saving for potential life-cycle events which are not that far distant. In this regard, it seems relevant to note that society has generally moved to shorter-term expectations (compared with the early 1980s) – for example: in employment with the same employer, in residing in the same location, in tenure of a marital relationship, etc.

#### **8.4 Conclusion**

The Insurance Bond structure is a proven investment vehicle which can be adapted to a variety of special purpose savings needs. It is particularly suited for the provision of government incentives for the accumulation of “merit assets” which aim to meet life-cycle-event financial needs and for which individuals often make inadequate preparation. It thus can assist in implementing “asset accumulation” policies towards social welfare which promote financial literacy and personal responsibility for financial planning without the need for expensive financial advice.

Other potential benefits may flow from enhanced public awareness and use of Insurance Bonds, including increased focus upon the need for personal preparation for and funding of life-cycle events. Long term savings may be increased, potentially reducing the future taxation funding burden. Intergenerational transfers may become better directed towards helping meet important life events.

To enhance the use of this investment vehicle, and also to counterbalance the preferential tax treatment given to a range of other investment strategies, there is merit in considering changes to the current tax and legislative treatment of Friendly Societies and Insurance Bonds. These changes include: reducing the headline tax rate from its current value of 30 per cent; reducing the “lock-up” term from 10 years; simplifying the rules governing contributions subsequent to the initial investment; and in widening the circumstances for tax-free withdrawals.

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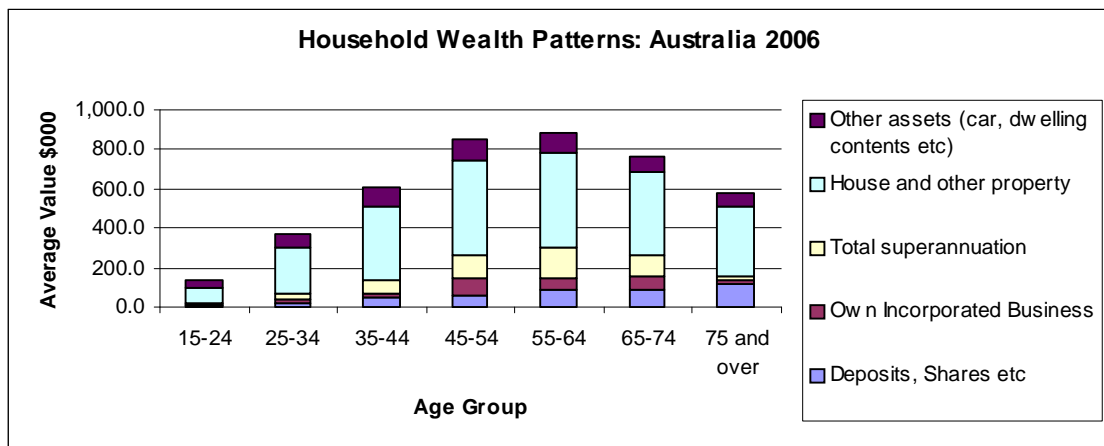
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## APPENDIX 1: Personal saving and investment choices: Australian experience

While individual financial experiences differ markedly over the lifecycle, Figure A1 illustrates that on average saving and wealth accumulation conform to the lifecycle perspective of wealth accumulation followed by decumulation in retirement. Several features stand out from Figure A1 which have implications for life event financial products.<sup>28</sup> First, most of the wealth accumulation prior to retirement is in the form of housing wealth, and that is not fully run down in retirement. Second, there is, on average, substantial wealth not drawn upon in retirement and left as bequests. While the bequest motive is generally believed to be strong, the concentration of wealth in housing which is not run down in retirement is relevant here.

**FIGURE A1: Household Wealth Patterns**



Source: ABS Cat. No. 65540DO001 Household Wealth and Wealth Distribution, Australia, 2005-06

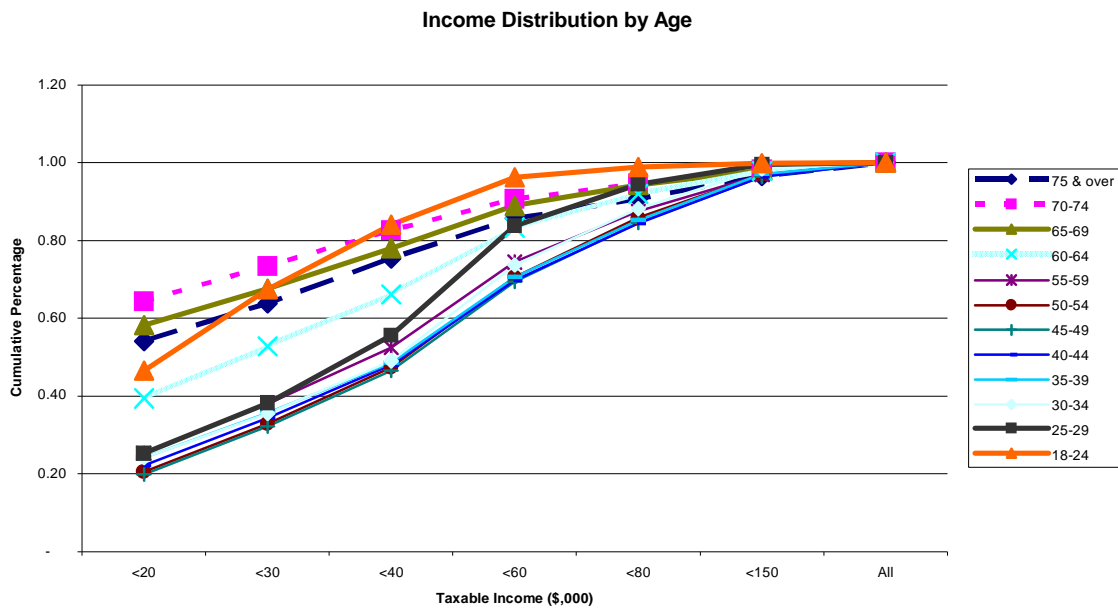
Another general characteristic of the financial lifecycle can be seen in Figure A2 which shows how income levels vary over the life cycle. Income tends to increase with age up to middle age, before declining during retirement. But what is also relevant is the substantial inequality of income at different stages in the lifecycle. For example, approximately 20 per cent of the 40-44 age group had taxable

<sup>28</sup> It should be noted that this cross sectional distribution may not fully reflect the lifecycle pattern of a particular cohort of individuals. For example, the introduction of compulsory superannuation in the 1990s could be expected to lead to higher superannuation balances in later life for currently young individuals, while increasing income levels over time will also affect wealth accumulation.



income of less than \$20,000, and approximately 20 per cent were above \$80,000 in 2006

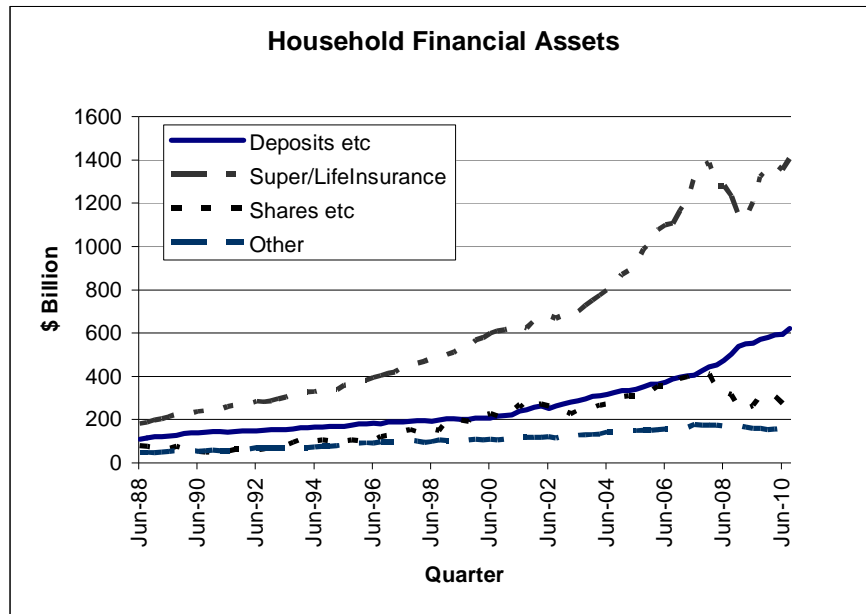
**FIGURE A2: Income Distribution by Age**



Source: [http://www.ato.gov.au/docs/cor00225078\\_2008PER11.xls](http://www.ato.gov.au/docs/cor00225078_2008PER11.xls)

Figure A3 shows the growth of superannuation in the composition of household financial assets over time. This reflects two factors, compulsion and tax benefits.

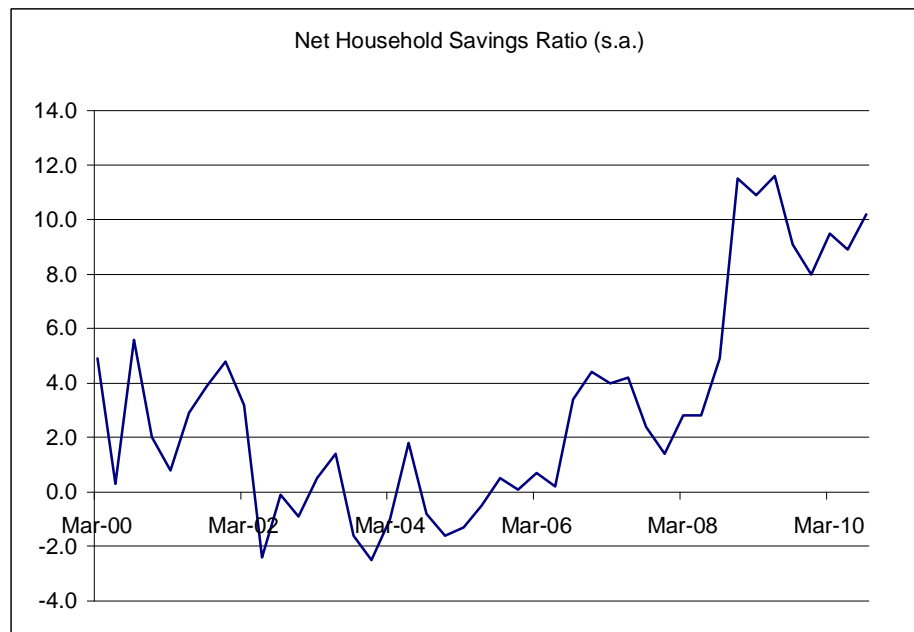
**FIGURE A3 : Household Financial Assets**



Source: ABS 5232.0

Figure A4 shows that after a long period of very low household savings, there has been a rebound in the savings ratio.

**FIGURE A4 ; Household Savings Ratio**



Source: ABS 5206.0

## APPENDIX 2: Friendly Societies, January 2011.

- Ancient Order of Foresters in Victoria Friendly Society Limited
- Austock Life Limited
- Australian Friendly Society Ltd
- Australian Scholarships Group Friendly Society Limited
- Australian Unity Investment Bonds Limited
- CUA Friendly Society Limited
- Druids Friendly Society Limited
- IOOF Ltd
- KeyInvest Ltd
- Lifeplan Australia Friendly Society Limited
- Newcastle Friendly Society Limited
- NobleOak Life Limited
- Over Fifty Guardian Friendly Society Limited
- Over Fifty Mutual Friendly Society Limited
- Sureplan Friendly Society Ltd

Source: <http://www.apra.gov.au/Friendly/FriendlyList.cfm>

## APPENDIX 3: Education savings Plans 2006

Name	Status	Start date	Regular savings plan?	Minimum investment	Entry fee	Ongoing fee % pa	Invests in...
Aust Unity Education Savings Long Term	Open	31 Jan 01	Yes	\$2500	4%	1.95	Australian shares, international shares, cash
Aust Unity Education Savings Medium Term	Open	28 Feb 01	Yes	\$2500	4%	1.95	Australian shares, international shares, listed property, Australian bonds, cash
Aust Unity Education Savings Plan Short Term	Open	31 May 01	Yes	\$2500	4%	1.95	Australian shares, Australian bonds, cash
CBA Education Savings Plan Balanced	Open	1 Feb 05	Yes	\$1000	0	1.75	Australian bonds, Australian shares, international shares, cash
CBA Education Savings Plan Capital Secure Option	Open	1 Feb 05	Yes	\$1000	0	1.75	Australian bonds, cash
CBA Education Savings Plan Diversified	Open	1 Jan 06	Yes	\$1000	0	1.85	Australian shares, international shares, listed property, Australian bonds, cash
CBA Education Savings Plan High Growth	Open	1 Jan 06	Yes	\$1000	0	1.95	Australian shares, international shares
Lifeplan Education Savings Plan	Open	13 Oct 03	Yes	\$50	0	1.65	Australian bonds, cash
Over 50's - Education Fund	Closed	6 July 92	No	\$500	5%	1.29	Australian bonds, cash
Australian Scholarships Group TEF Plan*	Open	1 Jul 06	Yes	\$46 a month	\$149	1.25	Australian shares, international shares, fixed interest, property, cash, deposits at call
Australian Scholarships Group SEP Plan*	Open	1 Jul 06	Yes	\$65 a month	\$89	1.76	Australian shares, international shares, fixed interest, property, cash, deposits at call

Source: Australian Scholarships Group website