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Superannuation, Retirement and Savings Division  
The Treasury  
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30 September 2004

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Dear Sir

### **Review of the provision of pensions in small superannuation funds**

Thank you for the opportunity to make a submission in relation to the above review.

We consider that the recent changes made by the Superannuation Industry (Supervision) Amendment Regulations 2004 (No. 2) in applying an outright ban to small funds providing life-time and fixed term pensions (with fixed payments) were a very broadbrush and poorly targeted approach to dealing with the concerns which the government was seeking to address. We are of the firm view that more specifically targeted measures could effectively deal with the issues raised by the government, rather than applying a blanket ban which penalises the overwhelming majority of retirees who legitimately use defined benefit pensions for retirement purposes.

### **Consistency of ban with general government policy?**

Government policy over a number of years has sought to promote people to save for their own retirement and take more control over their own retirement funding. This has been encouraged via a combination of financial incentives to save more, concessional taxation treatment, increasing the flexibility with the superannuation system, introduction of an additional retirement pension option (the new Term Allocated Pensions or TAPs), the recent introduction of choice of superannuation fund legislation as well as generally trying to encourage people to draw down on their superannuation in retirement as an income, rather than a lump sum.

Denying a very large sector of the retirement market the ability to provide life-time and fixed term pensions from their own self managed superannuation funds seems inconsistent with this policy. We believe that the government should be making it as attractive as possible for people to take

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their superannuation savings in the form of an income stream in retirement, not reducing their choices and options.

**Allocated and Term Allocated Pensions (TAPs) do not meet everyone's needs**

While allocated pensions are a very popular retirement product due to the flexibility they provide, they do not meet everyone's needs:

- Allocated pensions do not provide access to the higher pension RBL or asset-test exemption for Centrelink purposes. Consequently, they may not be suitable for people with smaller account balances who may gain some benefit from a partial asset-test exemption, or those with larger account balances who are seeking to access the higher pension RBL;
- In many cases, a pensioner is unable to maintain the same real pension level for the rest of their life with an allocated pension, as the minimum drawing rate forces out the income too quickly in the early years, thereby reducing the capital available to support the pensioner in the later years (to illustrate, refer to the government cameos presented to the recent Senate Economics Legislation Committee hearings, which show that the allocated pension drawing at commencement is much higher than both the TAP and the life-time pension).

The new TAPs will be suitable for some retirees, but again, will not meet the needs of all:

- TAPs may not be suitable for retirees who wish to live off their retirement savings for the rest of their life. A TAP will cease after a set number of years, with retirees potentially falling back onto the social security system after that time, which could result in a significant reduction in income and adjustment in living standards at a late stage of life;
- TAPs may not be suitable for retirees who seek a stable level of income during retirement, since the income level will move up and down each year depending on the remaining account balance (there is no flexibility in the government's prescribed pension drawing factors).

In our view, the best way to encourage retirees to draw their superannuation in the form of an income stream is to provide them with sufficient choices to structure that income stream to suit their needs. Pensions with defined benefit characteristics can meet a number of needs which allocated



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pensions and TAPs cannot (and the above provides but a few examples). For this reason, we believe that life-time pensions (and fixed term/fixed payment pensions) still fill a valuable role in the retirement plans of many retirees.

### **Choices available where an allocated pension or TAP does not meet their needs?**

For the vast majority of people for whom an allocated pension or TAP does not meet their retirement needs, the only other options under the current SIS Regulations (post 30 June 2005) would be to:

- (a) purchase a retirement product through an institution; or
- (b) take their money as a lump sum.

We do not believe that the lump sum option is in the longer term interest of protecting government revenue. The emphasis should be on promoting a retirement income, not a lump sum which, after being exhausted, will usually result in the retiree falling back on the public purse.

For many people, purchasing a product through an institution is not an attractive option for a variety of reasons. While institutional products certainly have their place (such as annuities), they do not suit everyone. Annuities, in particular, are not perceived to offer value for money – the need to charge high risk premiums to protect the institution against both investment and mortality risk, as well as profit margins, results in pricing which is perceived to be very unfavourable to the average retiree.

Furthermore, many retirees who have saved all their working life are unwilling to give the remaining capital on their death to a large institution, rather than being paid to their dependants. There seems to be a belief within government that the recent changes to the SIS Regulations increasing the allowable guarantee period from 10 years to the lesser of life expectancy or 20 years will help address this concern. However, in practice, we believe that this will have very limited impact on the attractiveness of annuities. Many institutions manage their risks and profit margins by relying on the capital from people that die early to assist with the costs of those who live longer. This is the principle behind pooling of lives. If the guarantee period is extended, then the mortality risk is not really being diversified by pooling. The institution has to find a different source to maintain its profit margin, as well as find the funds to pay the income stream for those who live longer than expected. This will inevitably come by paying a lower initial income stream for a given purchase price –

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making the pricing of such products even more unfavourable to the investor. Consequently, the "value for money" perception becomes even worse, not better.

### **Addressing the government concerns**

The concerns of the government are set out in the terms of reference for this review. We believe that these concerns can be adequately addressed by making certain modifications to the existing rules for life-time and fixed term pensions (within the meaning of SIS Regulations 1.06(2), (3), (6) and (7)), rather than applying a blanket ban for small superannuation funds.

### **Concern 1(a): Access to unintended tax benefits, particularly from the use of "RBL compression"**

The following section addresses in particular the issue relating to "RBL compression". Other issues relating to level of income drawn or assets remaining within a fund are dealt with under the estate planning concerns later in this submission.

When assessing a life-time pension for RBL purposes, the ATO uses a series of valuation factors set out in Schedule 1B of the Superannuation Industry (Supervision) [SIS] Regulation 1994 to calculate the value of the pension. In many cases, these factors considerably understate the true value of the pension in the current economic climate, giving rise to an RBL value which is often lower than the actual purchase price of the pension. We believe that, by and large, the problem here is not people abusing the rules, but the actual rules themselves. People are simply applying the rules as they currently exist.

We also note from the recent Senate hearings Treasury's concerns that the use of large amounts of undeducted contributions can also give rise to a lower RBL value. Although we have seen very little of this in practice, we acknowledge that the current formula does give rise to the opportunity to achieve this, should a retiree have the willingness and resources to do so.



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*Possible solutions*

These concerns could be addressed by one or more of the following:

- (a) Updating the SIS Schedule 1B factors to better reflect the true value of a life-time pension.

Although this would affect members of both large and small funds, the current SIS Schedule 1B factors are understating the value of a life-time pension payable from every fund, not just small funds. Consequently, RBL compression is actually occurring with life-time pensions provided from both large and small funds. If the government is genuinely concerned with RBL compression, the same rules should apply to all life-time pensions, regardless of what type of fund they are being paid from.

In updating the factors, the following should be taken into account:

- Using more recent Australian Life Tables to reflect current and expected mortality and life expectancy rates;
  - Reviewing the economic assumptions used in the calculation of the factors to ensure that they are reasonable in the current economic environment;
  - Taking better account of the ages of any reversionary beneficiaries (at the moment, a 40 year old reversion is treated the same as an 80 year old reversion under the SIS Schedule 1B tables);
  - A mechanism to review the tables periodically to ensure they remain up-to-date (eg review the factors when new Australian Life Tables are published every 5 years).
- (b) In terms of the use of large undeducted contributions, manipulation of the RBL value can only occur because the current SIS Schedule 1B factors understate, in some cases significantly, the true value of the pension. If the SIS Schedule 1B factors are updated to better reflect the true value of a pension, the ability to compress the RBL value via large undeducted contributions will be very limited. Consequently, updating the SIS Schedule 1B factors may be an adequate step to also resolve this issue.

However, if the government did not believe that updating the factors on their own would be sufficient to address the concerns over the use of large undeducted contributions, then the

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RBL formula could be amended to ensure such manipulation did not occur. For "purchased pensions", the RBL formula could be amended as follows:

$$A = (\text{Annual Pension} \times \text{PVF} + \text{RCV})$$

$$B = \text{UPP} \times \text{A/Purchase Price}$$

$$\text{RBL Value} = A \text{ less lower of } (B \text{ or UPP})$$

This ensures that the addition of undeducted contributions has no effect on the RBL capital value of the pension.

For example:

	Example 1	Example 2
Taxable conts	\$1m	\$1m
Undeducted conts (UPP)	-	\$2m
Purchase Price	\$1m	\$3m
Annual pension	\$60,000	\$180,000
SIS 1B PVF	14	14
RCV	nil	nil
A (from above)	\$840,000	\$2,520,000
B (from above)	\$-	\$1,680,000
RBL value (A less B)	\$840,000	\$840,000

The proposed adjustment to the RBL capital value formula ensures that large amounts of undeducted contributions do not have any impact on the assessable value for RBL purposes.

The term "purchased pension" is already defined within several tax rulings relating to fixed term pensions. A similar definition could be adopted for the purpose of the above. In order to ensure that the definition was watertight, the government could consider defining a purchased pension to be:

- Any pension funded by an identifiable account balance on commencement (or words to this effect); or

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- Any pension provided through a self-managed superannuation fund (SMSF) or small APRA fund (SAF). Where there is no identifiable account balance on commencement within the SMSF or SAF, the purchase price could be defined as the member's actuarial reserve in the fund (or words to similar effect).
- (c) An alternative to amending the SIS Schedule 1B factors or the RBL capital value formula above would be to amend the assessment of a life-time pension so that the full purchase price is counted for RBL purposes, in much the same manner as applies to a purchased fixed term pension under TD 2000/29. For example:

$$\text{Capital Value} = \text{Purchase Price} - (\text{Undeducted Contributions} + \text{Concessional Component} + \text{Invalidity Component})$$

Although this is a simpler amendment, it does not have any impact on the undervaluation of pensions in larger superannuation funds for RBL purposes. Where part of the purchase price is held as a solvency reserve (eg to meet the high probability requirement for Centrelink purposes), then the solvency reserve could be excluded for the purpose of the above formula, as is currently the case for fixed term purchased pensions under ATO TD 2000/29.

**Concern 1(b): Access to unintended social security benefits**

In terms of access to social security benefits, we note that the asset-test and income rules for social security are effectively the same for small superannuation funds and for life office annuities. Thus the same outcomes can be achieved either through a small superannuation fund or by purchasing a life office annuity, so banning life-time and fixed term income streams from small funds simply moves the problem from one area to another, without dealing with the real issues causing concern.

We would also note that pensions from small funds are already assessed more strictly for social security purposes than life office annuities via the deprivation test. In many instances, the deprivation test results in part of a small funds assets being subject to the means test, even though a retiree is paying an income stream that meets the asset-test exempt rules. The deprivation test does not apply to life office annuities.



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From 20 September 2004, the government has tightened the ability for people to access the social security system by changing the asset-test exemption from 100% to 50% for complying pensions commencing on or after 20 September 2004. We believe that this change in itself should minimise or remove the ability of wealthy individuals to access the social security system via complying pensions.

However, if the government believes that the change in the asset-test exemption will still not adequately resolve the issue, other measures that could be considered include:

- (a) placing a cap on the amount of assets that can qualify for the asset-test exemption. Amounts above the cap would not qualify for the exemption, regardless of the type of product in which they were invested;
- (b) amending the income test relating to complying retirement products. A person must satisfy both an income test and an asset test before accessing the social security system. If there are concerns that people are able to gain unintended access to social security benefits, some consideration may need to be given to the income test as well as the asset test. We do not have any particular suggestions in this regard, but simply raise it as a matter to be considered in light of the stated concerns.

**Concern 2: Use for estate planning purposes outside of what was intended and not available to other superannuation fund members**

Although the terms of reference do not define exactly what the concerns around estate planning are, we assume that this arises from the belief that some retirees are deferring capital in retirement by drawing a lower pension than what can be supported by their assets and building up large reserves over time. It is in this context that we address the above concern.

**Initial level of income drawing**

Life-time pensions are very different to allocated pensions and TAPs. The mere fact that the initial income level paid under a life-time pension might be lower than what is paid under an allocated or TAP should not be of major concern to the government – this is merely a function of the fact that life-time pensions are intended to maintain a certain level of income for life. Allocated pensions, on the other hand, often result in a reducing level of income in old age, while TAPs are designed to last for a nominated term based on life expectancy, not for a person's entire life.



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However, under the current legislation, it is possible for a person to draw an unreasonably low pension relative to the level of assets supporting the pension, thereby deferring income and building up reserves. We believe that the attraction to do this is limited somewhat by the fact that the exemption from tax on the investment income earned on the assets is limited to a "best estimate" value of the pension. Any income arising from surplus or reserve assets is taxed at normal superannuation tax rates. Consequently, the lower the annual pension, the lower the best estimate value of the pension, resulting in more of the income within the fund being subject to superannuation tax each year. We believe that the cameos presented to the recent Senate hearings failed to take account of this.

There are a number of different measures that the government could consider in order to ensure that a reasonable level of income is drawn.

- (a) One of the simplest means of underpinning the initial pension level would be to require, under the SIS Regulations, that if the pension is a purchased pension, the amount paid as the purchase price must be wholly converted into income (ie a return of purchase price test similar to that under the Social Security Act 9A and 9B). Some guidance would need to be provided to confirm how this test is to be measured, in a similar manner to the guidance provided for the Social Security Act provisions. For example, using the payment term for a term pension, or the life expectancy for a person 8 years younger for a life-time pension. This would be a relatively simple mechanism for putting a lower bound on the initial pension level.

Some thought would also need to be given as to how residual capital values (RCVs) are taken into account in this test for SIS Regulation 1.06(6) pensions.

- (b) There are also other mechanisms that could be considered for placing a minimum bound on the amount of pension that must be drawn. For example:
- A set of pension valuation factors could be prescribed which define the minimum level of pension that must be drawn on commencement. The valuation basis used to calculate these factors would need to be reasonably conservative in order to cater for as many different circumstances as possible. For example, the factors could be calculated assuming that a person lived to (say) age 100, invested conservatively (eg 5% cash earning rate), and an appropriate and realistic allowance made for expenses. One set of factors could be calculated using a conservative indexation rate (eg

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5% pa), or separate sets of factors provided which vary depending on the indexation rate associated with the pension. Where reversionary beneficiaries are involved, the age of the reversionary would be considered for the purpose of determining the minimum pension.

A pensioner would have the ability to draw a higher level of income as certified by an actuary depending on their circumstances, investment profile, health, etc, but would not be able to commence an income stream lower than that obtained using the prescribed factors.

Where factors are being prescribed, a mechanism would need to be in place to ensure that they are regularly reviewed so that they do not become outdated.

- For SMSFs and SAFs, an alternative to prescribing a set of factors would be to require that on commencement, a pension is not to be commenced at more than a certain level of probability (eg 70% or 80%) of the fund being able to pay the pension, to try to ensure a certain level of income is drawn from the asset available. However, the income level relating to a given probability will vary based on the assumptions underlying the calculations, and consequently, such an approach would be difficult to define precisely and "police" in practice;

Both of these suggestions are more complicated than (a) above. If the idea of prescribing pension factors for a minimum pension drawing was to be given further serious consideration, we would suggest that the government first establish whether unrealistically low initial pension drawing levels are in fact a problem in practice, and if the practice exists, how prevalent it is. If such a practice is rare or even non-existent, then prescription of factors for a minimum pension level would seem to introduce unnecessary additional complexity and regulatory intervention for something that may not even be occurring in practice, or could be dealt with just as effectively both other more simpler means (eg like suggestion (a) above).

- (c) Consider placing some limits on the reversionary beneficiaries that can be included in the calculation of the pension. If a pension is payable on death to a young reversionary beneficiary for the remainder of their life, then this can result in a very low initial pension level to the primary beneficiary. Limiting the payment of reversionary pensions to a spouse and/or placing some bounds on the age at which children can receive a reversionary payment (eg up to age 25) may assist in increasing the initial pension level;



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- (d) Amending the high probability test for Centrelink purposes from an annual test to a once-off test on commencement. The need to meet the high probability test annually encourages people to be more conservative when setting their initial pension level, because if experience is worse than expected and the reserves are required to be used, they still have to find extra reserves the following year to continue to obtain a high degree of probability certification. A once-only test on commencement would be more workable, and in our opinion, more appropriate.

A combination of the one or more of the above could be used to achieve the desired outcome in relation to ensuring a reasonable initial pension level is drawn. Our preference would be a combination of (a) and (d), with perhaps some consideration given to the issues raised under (c).

#### **Maintaining/building large reserves and transferring monies on death**

We understand that the government is also concerned about retirees building up large amounts of reserves in a tax concessional environment which could be used for purposes other than the provision of a retirement income stream.

As previously explained, the tax exemption on income each year within the superannuation fund only applies to assets up to the "best estimate" value of a pension each year. Consequently, the incentive of building up large reserves within the fund is reduced to some degree by the fact that the income and capital gains on the reserve component (ie the excess above the best estimate value of the pension) is taxed each year at the superannuation tax rates that apply to non-pension income.

Where an income stream meets the pension RBL standards or asset-test exemption criteria, then by definition, the pension cannot have a residual capital value (RCV). Consequently, after the death of the primary and any reversionary beneficiaries, any remaining assets are forfeited to the fund and become unallocated monies, losing their tax component status in the process (such as any remaining deductible component). Our understanding is that, in general, one of two things can then occur with the residual assets:

- They can be allocated to the account balances of other members within the fund, if other members exist. Some or all of these allocations may fall within the definition of "contributed amounts" under the surcharge legislation and be surchargeable in the

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accounts of the receiving members. They would also be preserved, ultimately assessed against the recipient's RBL and taxed as part of their own superannuation benefit when eventually withdrawn as either as lump sum or pension; or

- Some trust deeds permit the payment of a death benefit to a dependant or the estate from any residual assets. Since this represents a new benefit (it cannot be part of the original pension, since the pension by definition cannot have an RCV), it is our understanding that the payment of any lump sum benefit would be separately assessed for RBL purposes, and taxed at the appropriate lump sum and/or excessive tax rates. If, for example, a person had already fully utilised their pension RBL on commencing a complying pension, any lump sum benefit paid on death from residual assets would be taxed as an excessive component, regardless of who it was paid to.

Consequently, the attraction for using superannuation as a tax concessional vehicle to build up large reserves for estate planning purposes is limited by the above. The cameos presented by Treasury to the recent Senate hearings failed to take this into account.

With regard to life-time and fixed term pensions that do not meet the pension RBL standards or the asset-test exempt criteria, the tax status of any residual assets paid on death is less certain, since these types of pensions are permitted to have an RCV component under the legislation.

Despite the above, the government has stated that it is concerned that defined benefit pensions are being used for estate planning purposes outside of what was intended. In order to address these concerns, we suggest that the government give consideration to one or more of the following:

- (a) For pensions that do not meet the pension RBL or asset-test exempt requirements, limit the ability to structure residual capital values (RCV) past the compulsory cashing age. We are not referring to the practice of paying out any remaining assets that happen to be in the fund on death, but the ability under the current legislation to defer drawing on the accumulated superannuation balance by specifically allocating part of it as an RCV. Although, to our knowledge, this is not common practice, it is possible to structure a pension under SIS Regulation 1.06(6) with 100% RCV payable on death, with the pensioner effectively only drawing down the earnings on the asset each year. Such practice would seem inconsistent with the compulsory cashing rules, and the government's concerns about estate planning. A simple amendment to the provisions of SIS Regulation 1.06(6) could address this.



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- (b) For SMSFs and SAFs, the government could introduce a mechanism which limits the build up of excessive reserves in a fund by forcing out additional income in the form of increasing the annual pension payment if the reserves exceed a certain level (eg due to good investment performance). Conceptually, this could be achieved by requiring that if the net assets supporting the pension exceed the best estimate value of the pension by more than a nominated percentage (X% as a percentage of the value of the pension) at the most recent actuarial review, then the annual pension drawing must be increased in the following year to ensure that the value of the assets does not exceed the value of the pension by more than X%. The option of allocating the money to a member's account could also be considered.

The nominated percentage would need to be wide enough to cover the high probability reserve for such pensions. A percentage of 10% or 20% would not be sufficient to provide for a high probability of payment for a life-time pension, when the level of reserves required for high probability (70%) purposes are more likely to be in the range of 30-40% (or more in some cases). Alternatively, rather than setting the maximum reserve level around the best estimate, the level of assets could be compared to the high probability value of a pension and a more narrow range set around the high probability value. However, an exact high probability value can be more difficult to define in practice than a best estimate value (since it is based on additional assumptions). Consequently, managing the reserve around a best estimate value is likely to be more practical to define and implement.

Such a mechanism would ensure that any reserves are maintained within reasonable bounds over time. Since the best estimate value of a pension will usually reduce over time (as the pensioner ages or the remaining term reduces), such a mechanism would ensure that any reserves are "forced out" as income on a regular basis if the experience of the fund is as good as, or better than, assumed.

The nominated percentage X% (ie the maximum level of reserve) would need to be high enough to allow a fund to manage both increasing longevity risk as well as the volatility of investment market return, and would need to at least be sufficiently wide to encompass the level of reserve required to a high degree of probability. For the sake of presenting an example, assume a maximum reserve of 50% was agreed upon. If the purchase price of a pension was \$750,000, this would mean that the pension level would need to be such that the best estimate value of the pension was no less than \$500,000 on commencement. If, one year later, the level of assets had increased to \$900,000, then the annual pension drawing would need to be increased so that the best estimate value of the pension was no

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less than \$600,000. This would effectively force more income out via increased pension payments each year, reducing the level of assets in subsequent year.

We would also be willing to assist you in defining what is meant by the term "best estimate value of the pension" to avoid any manipulation or interpretation of this phrase.

Such a mechanism may be attractive to many retirees. The building-up of large reserves is not necessarily something that is desired by a retiree, particularly those on average levels of income. It is something that just happens under the current legislative rules if a fund's experience is better than assumed. A mechanism as described above would assist both the pensioner in using the reserves to draw additional income if experience is better than expected, as well as address the government's concerns about the accumulation of large reserves for estate planning purposes.

In order to accommodate such a mechanism:

- the existing cap on the allowable indexation rates under SIS Regulations 1.06(6) and 1.06(7) would need to be amended to allow the pension to be increased above these rates if required to meet the above, as well as the caps currently in place under Social Security Act 9A and 9B;
- on the flip side, if the pension is to be increased to force out any excessive reserves as additional income, there needs to be some ability to reduce the annual pension drawing at a later date if the value of the assets subsequently fall below the value of the pension in order to maintain the solvency of the pension. For example, if at a subsequent actuarial review, the fund was considered to be in an unsatisfactory financial position as defined in Section 130 of the SIS Act and Part 9 of the SIS Regulations, the pension level should be able to be reduced to a suitable level relative to the remaining assets.

The two points above allow a balanced approach to the management of reserves, allowing for the pension to be both increased and decreased to ensure that reserves are managed within reasonable bounds.

Such a mechanism to restrict the build up of excessive reserves will also remove the ability for people to commence unrealistically low pensions on commencement. Consequently, it may not be necessary to place a minimum bound on the initial pension level as discussed in the previous section if a mechanism to control the level of reserves was introduced.



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- (c) Rather than attempting to control the build up of excessive reserves each year, the government could consider introducing an additional tax that applies to the residual assets of a pensioner which are allocated to members' accounts or a reserve following the cessation of a pension. However, such provisions would have to be carefully drafted to ensure that there were no unintended consequences on other superannuation arrangements, which could be difficult to achieve. Given the complexity of the current tax rules, this would add a further level of complexity which is undesirable, and consequently, we do not favour this approach. Our preferred approach would be to limit the ability to accumulate excessive reserves and address the RBL compression issue – additional taxes on residual assets would then not be required. Also, for consistency, allocated and TAPs do not have additional taxes applied to their residual assets on death.

**Concern 3: Whether small number of members can effectively pool risk and guarantee income payments**

The concern regarding the ability to pool risk and guarantee income payments is, we believe, a separate issue to the revenue concerns above.

As with larger funds, reserving techniques are used in small funds to manage investment risk, and to help manage longevity risk. In most cases, this invariably involves setting aside a portion of the purchase price to act as a buffer or reserve against adverse experience. Where life offices use variable bonus structures to help cover their investment and longevity risks, small funds can also replicate this arrangement by providing for variable indexation, which can be adjusted in light of emerging experience. Small funds are also the subject of annual actuarial review and control.

We note that the legislation currently allows a pension to be commuted and repurchased if the need ever arises to adjust the pension level due to poor experience or other circumstances. Consequently, there are mechanisms in the current legislation which allow a small fund to manage these risks. However, the recent regulation changes made on 12 May 2004 (and associated transitional arrangements), in conjunction with the draft ATO determination SD 2004/D1, will make it more difficult for existing defined benefit pensions to use this mechanism after 1 July 2005.

We also believe that the arguments relating to "pooling of risk" and "guaranteeing of income payment" are largely irrelevant in relation to SMSFs and SAFs. For example:

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- Term allocated pensions (TAPs) attract the same tax and social security concessions as defined benefit pensions. If a TAP suffers a significant investment loss and has to reduce its pension drawing going forward, why is there a concern over a defined benefit pension suffering the same fate, if the revenue impact is the same under both scenarios? TAPs also make very little attempt to manage longevity risk, unlike defined benefit pensions. Since the same concessions apply to both pensions, it is difficult to see the concern from a revenue perspective over defined benefit pensions.
- Defined benefit pensions are often compared to allocated pensions and TAPs in relation to concerns over the pooling of risk and guaranteeing payments. In fact, at the recent Senate hearings, a statement was made that *"There is no risk that they [allocated pensions and TAPs] will not be able to deliver what they promise..."* to justify the difference between the risks of a defined benefit pension and account based pensions. To the self-funded retiree using their own superannuation fund to pay an income stream, we submit that the risks are remarkably similar. If the pensioner loses 50% of their assets, then regardless of whether they are paying themselves a TAP or a defined benefit pension, they are invariably going to need to reduce their income drawing. The difference is the method of adjusting the income level - TAPs have a simple mechanism for adjusting the income stream, while a defined benefit pension has a more complex mechanism (via a commutation and repurchase).
- In fact, from the pensioner's perspective, in many cases defined benefit pensions assist them to better manage their risks. Defined benefit pensions usually hold reserves to help manage the risks. In terms of investment risk, the impact of a fall in the value of a fund's assets can be cushioned by the reserves being held within the pension, assisting the pensioner to maintain the same level of income. In the case of a TAP, the pensioner will feel the full effect of short-term market movements the following year via a reduction in their income drawing. In terms of longevity risk, unlike a defined benefit pension, a TAP does not even attempt to maintain payments for the remainder of a person's life – at the end of the nominated term, the pension will cease. A defined benefit pension helps the pensioner to manage this risk by smoothing the pension payments over a longer period and reserving for longevity risks under the control of an actuary.
- While it is true that even though the risks are managed they are ultimately borne by the members of SMSFs and SAFs, members enter into these arrangements in full knowledge of these risks. This applies whether the member is using an allocated pension, TAP or defined benefit pension within their SMSF or SAF. There are no "public protection" issues



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for these types of funds. These members have made a conscious decision to bear any risks that arise, rather than pay an institution to bear these risks for them. The majority of Australians bear all of the risks in the accumulation phase of their superannuation, and we believe should be allowed to continue to do so in retirement phase if they so choose. In fact, TAPs and allocated pensions pass all of the risk back to the retiree, so it is difficult to see why this is considered so undesirable with a defined benefit pension.

- If members of SMSFs and SAFs are not permitted to provide their own life-time or fixed term (fixed payment) pensions, the only option for most retirees to obtain a pension payable for life is to purchase an annuity from a life office. Annuities, however, are not perceived as offering value for money – yet, if you take away the ability to pay a life time or fixed term (fixed payment) pension from a small fund, this leaves the retiree with no other option to provide a life-time income stream.
- The terms of reference specifically mention pooling of risk. However, pooling of lives does not address the very significant risk of increasing longevity. Pooling among a large number of pensioners helps to spread the risk of some members living longer than others by using the residual capital of those who die early to help fund those who die later. However, pooling does not address the larger risk of all of the lives in the pool living longer. Consequently, pooling is not the answer to increasing longevity.

There is evidence emerging that annuity providers are finding it increasingly difficult to cope with the increasing longevity. Life offices use a variety of techniques to try to manage the different risks involved. One such technique is the use of variable bonuses, which in effect, just pass the risk back to the consumer. Consequently, if a life office is permitted to pass risk back to the consumer, the question must be asked as to why it is considered inappropriate that a small fund does the same? The Equitable Life experience in the UK also highlights that even with a life office, there are no absolute guarantees on the promised pension being provided.

The issue of "liquidity" risk has also been raised in the terms of reference for the review. However, liquidity risks are relevant to all superannuation funds, not just those paying defined benefit pensions. In fact, funds that pay lump sum benefits and pensions which can be commuted (such as allocated pensions) can represent a greater liquidity risk than non-commutable defined benefit pensions, since the cashflow requirements are more lumpy and timing is more uncertain. With a defined benefit pension, the cashflow requirements are more certain (ie regular payments of fixed amounts each year) and therefore, more easily planned for. In this respect, it can be argued that

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there is actually less liquidity risk associated with a non-commutable defined benefit pension than an allocated pension where lump sum withdrawals are permitted.

TAPs can also represent a very significant liquidity risk in any type of fund, and are possibly one of the most difficult type of pensions to manage from a liquidity perspective due to a combination of (a) the drawdown of capital being completely exhausted over the nominated term, (b) the inability to vary payments within a minimum/maximum range and (c) the volatility of payments that can occur from year to year if the investment experience of the fund is volatile (ie there is no stability in the annual income payment if the assets are rising or falling).

TAPs can also represent a very significant liquidity risk in any type of fund, and are possibly one of the worst pensions to manage from a liquidity perspective due to (a) the drawdown of capital being completely exhausted over the nominated term, (b) the inability to vary payments within a minimum/maximum range and (c) the volatility of payments that occurs from year to year if the investment experience of the fund is volatile (ie there is no stability in the annual income payment if the assets are rising or falling).

The issue of liquidity risk is one which faces all superannuation funds. Small funds can invest in large pooled products just the same as large superannuation funds, as well as listed shares and other liquid investments. Small and large funds can also invest in less liquid investments, such as unlisted shares, infrastructure pools, hedge funds, etc. We believe that liquidity risks are best dealt with through the investment strategy requirements of the SIS Regulations, rather than banning certain funds from providing certain types of benefits or income streams.

Consequently, we do not believe that government concerns of whether small funds can effectively "pool risk" or "guarantee income payments" are justified.

*Suggested improvement for managing risks*

The legislation already allows a small fund to effectively manage their risks. A specific mechanism also exists in the legislation to allow a small fund to adjust the level of a defined benefit pension if ever required (in the form of commuting and repurchasing). However, we believe that a simpler and more efficient mechanism should be introduced. This could be achieved by allowing a pension to be reduced on the advice of an actuary where this was required to maintain the fund in a satisfactory financial position, as defined under Section 130 of the SIS Act and Part 9 of the SIS Regulations. This would help to avoid the more cumbersome process of commuting and repurchasing, whilst minimising any opportunity for potential abuse of the increased flexibility. In



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order to protect non-arms length members in larger funds, we suggest that this mechanism only apply to "purchased pensions" (refer to previous sections of our submission), and only where the written consent of a pensioner has been obtained prior to any reduction in the pension level.

### Alternative pension designs

While we believe that a combination of the above measures will address the concerns raised by government, other pension designs could also be considered to compliment the existing suite of defined benefit pensions, allocated pensions and TAPs provided for under the current legislation.

We put forward the following alternative pension designs that may be worthy of further consideration:

- (a) A life-time allocated pension. Conceptually, this would look similar to an allocated pension structure, but with the following exceptions:
- The pension would be non-commutable;
  - The pension would attract complying status for taxation and social security purposes;
  - The minimum and maximum pension valuation factors would be set in such a way that a person has a high degree of probability of maintaining their initial pension level in real terms for life. For example, the factors used to calculate the maximum pension drawing at each age could be based on a best estimate or 50% probability basis, while the factors used to calculate the minimum pension at each age could be based on a high degree of probability (eg 70% or 80% probability) of paying the current real pension level for the remainder of a person's life. Realistic assumptions would need to be made regarding investment returns, expense levels and future mortality improvements.

This type of structure would allow a person to draw an income payable for their life-time. Appropriately determined minimum and maximum factors will also assist the pensioner in obtaining some stability in their year-to-year pension drawing level, which is not possible with the existing TAP structure. However, prescribing the pension valuation factors would mean

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that the structure may not be flexible enough to suit the needs of everyone. For example, a prescribed set of pension valuation factors will not necessarily cater for:

- people with very good or very poor health;
- different indexation rates to suit different people's needs – eg nil indexation for people who need more income now or who have income from other sources; CPI or CPI+1% indexation for people who want to maintain their real level of income in retirement; 5% or higher indexation for retirees who are happy to take a lower income now but a higher income later in life when medical expenses are expected to consume a greater proportion of their weekly costs;
- differing risk/return profiles which affect how people invest their assets and therefore, the expected future earnings on those assets;
- differing expense/cost structures between funds;
- partial reversionary beneficiaries (eg 100% to primary and 50% to spouse).

Prescribing a set of pension valuation factors would also require the factors to be updated from time-to-time to reflect changes in economic conditions and improvements in mortality to ensure that they remain current and relevant to retirees. Given that both the general RBL pension valuation factors and the allocated pension minimum/maximum factors have not been updated in over 10 years, it is likely that updating any prescribed factors would not receive a high priority in practice.

On the other hand, the regular actuarial involvement in the monitoring and review of defined benefit pensions ensures that assumptions are regularly reviewed and updated, and can be tailored to suit the individual circumstances of individual retirees.

(b) Increasing the flexibility in the existing TAP structure. Specific enhancements to the current rules for TAPs could include:

- Allowing a pensioner to choose a longer term on commencement to cover increasing longevity risk, such as a term which takes them up to age 100 or such longer age as allowed (age 110 is the oldest age in the current life expectancy tables);



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- Providing minimum and maximum pension valuation factors to apply for TAPs in a similar manner as described above for the life-time allocated pension (but with a narrower range since longevity risk does not need to be allowed for) so that people can try to maintain a stable income level from year-to-year. In this case, best estimate and high probability factors would be used for the remaining term, rather than entire life-time.

However, prescribing the pension valuation factors results in the same drawbacks as outlined above for life-time allocated pensions.

(c) Alternative life-time pension. Conceptually, an alternative life-time pension structure which could be considered is as follows:

- Each year, a "target pension" would be calculated by the actuary, based on the remaining assets in the fund. In principle, the target pension would be a term pension based on the pension being payable until the youngest pension/reversionary reaches the limit of the current life tables (eg age 110). In calculating the target pension, a target indexation rate would be nominated by the retiree at the outset, and the actuary would select assumptions based on the profile of the pensioner for future investment returns and expenses, on a best estimate basis (as is the case for the tax exemption calculation). This would ensure that the target pension is flexible enough to cater for the individual circumstances of each client. We would envisage that the process for calculating the target pension could be legislatively prescribed, but not the actual pension valuation factors used to calculate the target pension, to ensure that the target pension can be tailored to the circumstances of each individual retiree.
- On commencement, the actual pension level would be the target pension that can be supported by the purchase price (for example, the purchase price divided by the relevant pension valuation factor for the target pension at commencement, where the valuation factor is calculated by an actuary in line with the above criteria and based on the individual circumstances of the retiree).
- Each year (eg at 1 July), the target pension level is recalculated as the assets divided by the relevant factor for the remaining term:
  - If the actual pension level is within a nominated rate (say X%) of the target level, then the actual pension is indexed as originally intended.

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- If the actual pension level is above the target level by more than X%, then the actual pension level should remain constant (ie not indexed).
- If the actual pension level is below the target level by more than X%, then the actual pension must be adjusted upwards to bring it within the range.

These adjustments help to both manage the investment risk, as well as smooth the impact of any short-term rises or falls in the value of the assets. During periods of poor performance, the pension level would be held constant (ie not indexed) to help maintain solvency levels. During periods of strong investment performance, the pension would be increased above the target indexation rate to limit the build up of excessive reserves.

- The use of an old age in setting the target pension level (eg 110) helps to manage the risk of increasing longevity.
- The tax exempt amount of assets would be determined actuarially on a best estimate basis, based on the actual pension level and probabilities of survival. Because the target pension does not allow for death until very old age (eg 110), there would usually be taxable reserves each year in the fund (the difference between the value of the term pension to age 110 and the best estimate value of the pension based on probabilities of survival). This helps to balance the revenue impact with the desire to hold reserves to manage the various risks.
- The pension would still need to meet the requirements of Section 130 of the SIS Act relating to satisfactory financial position on a best estimate basis. If simply holding the pension at its current level is not sufficient to ensure that the best estimate value is covered by the remaining available assets, the pension level would then need to be reduced to return the fund to a satisfactory financial position.
- In terms of the benefit payable on death:
  - If the full purchase price was reported for RBL purposes on commencement, any residual assets could be paid out as a death benefit.



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- If the reported RBL value on commencement was less than the purchase price (eg SIS 1B factor x initial pension level), then a death benefit calculated as *annual pension level at the time of death x SIS 1B factor at the time of death* could be permitted. Any residual assets above this level would be separately reportable for RBL purposes if paid out as an additional death benefit.

Conceptually, this structure is a little more detailed than the previous suggestions. However, it is effectively just a self-adjusting life-time pension, where the adjustments are smoothed over time so the pensioner can maintain some stability in their income level from year-to-year. Basing the target pension on a term into old age (eg 110) will help to offset the risks of improving longevity, but balancing the revenue impact by only allowing a tax exemption on income up to the best estimate value of the actual pension being paid. The adjustment of the actual pension level around the target level each year helps to minimise the build-up of excessive reserves. Allowing the actuary to calculate the target pension level, based on the individual needs of the retiree, enables this pension to be flexible enough to cater for different investment/risk profiles of clients, differing needs in terms of indexation rates, etc.

We would be happy to provide illustrations of the above concept should the government be interested in considering this further.

## Summary

As should be evident from our submission, we believe that the government's concerns regarding the provision of defined benefit pensions from small funds can be adequately addressed by some amendments to the current rules relating to defined benefit pensions, without the need for wholesale design changes. For example, we believe a combination of the following would adequately address all of the concerns raised by government:

- (a) modifying the calculation of the RBL capital value to avoid RBL compression;
- (b) inserting a return of purchase price test into the requirements for purchased defined benefit pensions;
- (c) introducing a mechanism to limit the build-up of excessive reserves supporting a purchased pension;
- (d) simplifying the mechanism for allowing a purchased defined benefit pension to be reduced if ever required for solvency purposes; and

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- (e) considering a limitation on structuring RCVs for SIS Regulation 1.06(6) pensions past the compulsory cashing age, as well as possible restrictions on reversionary pension beneficiaries.

Points (a) and/or (e) could be applied either for all defined benefit pensions or just "purchased pensions", while (b), (c) and (d) would be more appropriate to be restricted only to "purchased pensions".

We believe that life-time and fixed term (fixed payment) pensions fill a valuable niche in the retirement income stream market for retirees, and meet the needs of certain retirees that other income stream products do not fulfil, such as:

- Stability of income payments from year to year through the actuarial review and monitoring process;
- Ability for a retiree to draw down their retirement savings over their life-time and maintain their real income over the whole of that period based on their individual circumstances, to a high degree of probability.

Many retirees simply do not have the skills to manage the level of income they should be drawing from their capital in retirement to ensure, as far as possible, their capital lasts for their remaining life. Defined benefit pensions provide an automatic mechanism to assist the retiree in this regard through the ongoing actuarial review and monitoring process and therefore fill a very important role in the retirement income stream options for retirees.

We believe that the government should be seeking to encourage people to draw on their superannuation via an income stream in retirement, rather than a lump sum. Defined benefit pensions not only assist in meeting this objective, but also ensure that there is a reasonable range of income stream choices available to people in retirement. We believe that they are an important part of the overall retirement system.

Other product designs may also enhance and compliment the options available for retirees, but do not, on their own, replace the role filled by defined benefit pensions.



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We would be happy to work with the government to ensure effective implementation of these, or any other suitable measures, in order to adequately address the concerns raised.

If you would like to discuss the above further, please do not hesitate to contact me on telephone 08 9238 5259.

Yours sincerely,



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