## Pension Payments by Small Superannuation Funds

Treasury has called for submissions concerning the alleviation of perceived concerns regarding the payment of defined benefit pension by small (and especially DIY) superannuation funds. A discussion paper issued by the Australian Treasury highlights the "concerns" of Government (Treasury?) concerning the payments of certain forms of superannuation pensions by small superannuation funds. The concerns are:

- access to unintended tax and social security benefits, particularly from the use of 'RBL compression';
- their use for estate planning purposes in the superannuation system outside what was intended and not available to other superannuation fund members; and
- whether a small number of members can effectively pool risk and guarantee income payments over the term of the pension.

A number of earlier submissions are included with the papers issued by Treasury when distributing the discussion paper. These submissions make interesting reading. However in the main they are either relatively brief dissertations on the views of those making personal submissions, or technical papers aimed at resolving the concerns raised by Treasury. In most cases the latter submissions make recommendations concerning changes to current superannuation legislation.

### Overriding Issues

There are, in my view, two overriding issues that receive little attention in the Treasury discussion paper or the earlier submissions.

(1) Retrospective impact of changes to RBL calculations for benefit payments

Many of the submissions for overcoming the "RBL Compression" concern involve making changes to the valuation methods for defined benefit pensions. A technical analysis of current valuation methods must conclude that current valuation methods are out of date and result in pension valuations that are substantially below their true value.

However, making any change to the valuation method will render invalid any projections of an individual's RBL position made using current calculation methods. This will make it very difficult for any person – especially members of defined benefit funds – to assess their RBL position in advance of retirement. An individuals RBL position will significantly influence their financial strategy ***while they are accumulating superannuation benefits*** – not just at the point of retirement.

The uncertainty generated by implementing any system that involves regular changes to RBL formulas applied to defined benefit pensions will significantly complicate retirement planning for a substantial number of retirees. The instant a change is made it will have substantial retrospective impact for the people affected. When the change is sudden the unsuspecting public is quite entitled to question the integrity of the superannuation system – something the regulators are keen to protect.

It is absolutely imperative – in the interests of fairness, the integrity of the superannuation system and the faith of Australians in the system – that the proposed changes to pensions from self-managed super funds be implemented (if at all) in such a way that does not retrospectively impact upon existing superannuation fund members. Up until 11 May 2004, many Australians will have been calculating their RBL position based on well established principles of interpretation of existing law and would have made plans accordingly. Overnight their RBL position has changed dramatically in much the same way as they would have been affected by the movement to fixed dollar RBLs in 1994. The major difference is that the regulators in 1994 had the good sense to make sure no one was retrospectively affected. An exemption to the proposed prohibition on defined benefit pensions must be given to all member balances as at 30 June 2005 (or at least 11 May 2004) if a just outcome is to be implemented. (Note the writer doesn't believe any such prohibition is necessary in the first place)

(2) Legislation becomes very difficult and divisive when it seeks to discriminate between individuals or entities on very basic issues.

Superannuation funds exist to receive contributions and pay benefits to Australians in respect of their retirement finances. Virtually every piece of legislation regarding superannuation has some impact upon the receipt of contributions by a superannuation fund, the payment of benefits by the fund or the protection of member benefits whilst accumulating assets within the

fund. A system that allows some superannuation funds to pay certain types of benefits not available to others is fraught with danger and ambiguities. If self-managed superannuation funds are not allowed to pay certain forms of benefits because of concerns that the application of the law provides a greater benefit to members of such funds than is available to members of other fund types, ought we not also be looking at legislating against benefits from other types of benefits available to members of non-self-managed funds that are not available to members of SMSFs? Examples of the latter can be found in many instances. For example, members of the Commonwealth Superannuation Scheme (CSS) can access a benefit (for RBL purposes) of roughly double that available to other Australians because of quirks that apply to members of the CSS.

We need a system where the rules regarding the receipt of contributions and payment of benefits are the same for all funds. Differences between benefits received from various funds may arise because of fund design, but should not arise because of legislative discrimination. This principle was applied when unifying the rules for deferred annuities, approved deposit funds and superannuation funds. Any other system creates an environment conducive to division and a lack of faith in the system itself. Some of the comments in earlier submissions to Treasury highlight the need for carefully nurturing faith in the system.

"The new regulations appear to reflect yet another triumph of superannuation industry lobbying."

"Is the Market Linked Income Stream a takeover by the Government of all super funds like the Singapore Government System, <u>OR</u> is it AMP and others trying to (stop) free enterprise and small business controlling their own funds."

"I suspect that the motivation behind the recent regulatory change was…to give branded publicly sold retail superannuation funds an unfair advantage.."

"Your proposed legislation FORCES them (retirees) to purchase a (defined benefit pension) from the big end of town in the finance industry. This is contrary to the ethos of SMSFs."

**Resolving Treasury Concerns**

The comments and recommendations which follow are based upon the following principles to be applied to all changes to superannuation laws and regulations;

a) Being free of any retrospective consequences;
b) Ensuring consistency in the basic rules relating to contributions and benefit payments across all superannuation entities;
c) Promoting faith in the system; and
d) Preserving the overall integrity of the system as regards taxation and social security outcomes.

These principles may at times run contrary to one another and decisions need to be made as to which is to be given the higher priority. However, setting out to achieve one objective and ignoring the others is likely to result in very poor outcomes in the long run. With this in mind, the following comments and recommendations are offered for consideration by Treasury and Government.

1. As pointed out in various submissions to Treasury on this issue in 2004, the Social Security concerns are now irrelevant following the introduction of the 50% exemption from assets test afforded to complying pensions. No further action is necessary.

2. The RBL compression issue needs to be addressed as a superannuation issue – not a self-managed superannuation fund issue. The purpose of the current formula was to provide an estimate of the “market value” of a defined benefit pension. Current market conditions (investment returns, life expectancy etc) are very different to those applying when the valuation factors were developed. Current conditions are also very likely to be different to those that will apply in ten years time.

   Submissions from individuals and professional bodies with actuarial expertise suggest updating the valuation factors to overcome RBL compression issues. This makes practical sense but presents very real issues surrounding retrospective implications for those who have been calculating their RBL position based on the current valuation factors. One could argue that their defined benefit pension simply represents a superannuation “asset” that happens to have

dramatically increased in value – just as a particular share or property investment could increase in value so as to cause an RBL issue. That argument is unlikely to be supportive of the third objective noted above (faith in the system) and so any such change will be viewed by those detrimentally affected as an example where the first mentioned objective (no retrospective consequences) has been breached.

Any change to the pension valuation factors therefore needs to be communicated well in advance of the implementation date. When changes to preservation ages were announced, superannuation members were given decades of advance warning. One suggestion is to reset pension valuation factors based upon reviewed life expectancy tables once every five years. This could be done by recalculating the factors and then allowing a transition period where either the old or the new factors could be used. The transition period would need to be of sufficient length to enable persons approaching retirement to understand the implications of the changed factors on their circumstances and, if necessary, make appropriate adjustments to their retirement plans. A period of at least two years would be required.

The only broad alternative is to introduce an entirely new valuation method for defined benefit pensions. This might include valuing the pension at cost with some method of determining cost for unfunded or formula based pensions. Making a substantial change of this nature would require a very long lead time or transitional period to ensure that no retrospective consequences arise. If a wholesale change to formulas for defined pension funds is to be implemented then it is only fair that interference to the retirement plans of Australians is minimized by granting a permanent grandfathering to members of SMSFs and other superannuation fund types at 11 May 2004 as applied when changing RBL rules, superannuation tax rates etc.

In my view, the best approach is to review the pension valuation factors on a regular (five year) basis with a two to five year transitional period at each change.

The separate but related issue of the role of undeducted contributions in the pension valuation formula would need to be modeled and assessed once the impact of changed valuation factors was understood.

3. The estate planning concerns raised in the discussion paper arise because of the application of superannuation law and trust law. They do not arise from any specific piece of legislation regarding self-managed superannuation funds. To be consistent with the second objective noted above, any change of law or regulations affecting outcomes for superannuation fund members should apply to all superannuation funds since the provision of death benefits is listed as one of the primary purposes of superannuation funds. The solution therefore lies in ensuring that defined benefit pensions and the reserves required to fund those pensions are prudently managed and that there is no scope to set pension and reserve levels at artificial levels. More analysis and consultation in regard to changes affecting estate planning outcomes needs to be undertaken. The banning of defined benefit pensions from a certain category of superannuation funds is not the solution to Treasury concerns.

   Certain design features of superannuation pensions generally may need to be addressed to overcome Treasury estate planning concerns. For example, a regulation requiring all term certain pensions to be for terms within a certain range (such as those applying to Term Allocated Pensions) and disallowing any RCV greater than zero would overcome concerns relating to the use of term pensions without causing any significant retrospective consequences.

   What must be proved (and as yet hasn't been proved) is that the net result of passing superannuation assets from one generation to the next via residual reserves of defined benefit pensions results in a net detriment to the public purse. Treasury have shown that, in certain conditions, the value of assets supporting an allocated pension will be less than those supporting a defined benefit pension once a member reaches their late 80,s (years of age). What they don't go on to analyze is the after tax position once reserves supporting the defined benefit pension are past on, and the long term impact on social security benefits if excess reserves are used to provide retirement incomes to future generations of the same family.

   In any event the end result of a prohibition on defined benefit pensions from SMSFs will not be a corresponding rise in the amount of dollars transferred to similar pensions provided by life offices. It

will result in an increased proliferation of allocated pensions and market linked pensions. If Treasury had used more commercial terms for the lifetime pension (I couldn't find a single actuary who would not sign off on a pension of at least $27,000 under the terms set out in the Treasury discussion paper), and taken into account re-roll strategies for market linked pensions, the tax and social security benefits would be almost identical for the market linked pension and the lifetime pension.

And Treasury's own figures show that the only pension type that provides a smooth, consistent income stream throughout a person's life is the Lifetime pension. Allocated pensions see income drop in real term's from roughly age 73 onwards while market linked pensions run out completely just a few short years after a pension recipient reaches their life expectancy. Some actuaries predict that up to 40% of the population will outlive their market linked pension. What a great system! We are going to encourage people to take retirement income streams that see significant falls in their real income from their early-seventies or that will run out completely before they die in 40% of cases.

I often say to my clients that having an objective of minimizing tax sounds rational but it isn't really if you minimize tax at the expense of being able to achieve the really important objectives in life. I would say to the Government that Treasury may have an objective of closing what they see as a loophole in the superannuation pension system but the remedies they have suggested are ill-conceived when other issues relating to retirement income policy, fairness to all, and faith in the superannuation system are taken into account. Estate planning benefits may well be a consequence of defined benefit pensions being paid from SMSFs but the major reason such pensions are implemented is to match retirement income with retirement income needs.

4. Managing risk in superannuation and retirement income planning is a significant decision for all superannuation trustees and fund members. This is the one area where there truly is a difference between self-managed superannuation funds and other superannuation funds. In a SMSF the persons charged with the responsibility of managing risk on behalf of members are also the members.

When managing investment risk, trustees are required to develop a strategy and clearly communicate that strategy to all fund members. These rules apply across all superannuation funds. In the case of account based pensions (allocated and term allocated), the member bears the mortality risk.

Where a self-managed superannuation fund provides a defined benefit pension, the members effectively carry the mortality risk. The choices (given that the full range of superannuation pensions remains available to all superannuation entities) for SMSF members will be between a term allocated pension where they run the risk of being one of the 40% who will outlive their pension, and lifetime pension where they could outlive their pension because of difficulties in managing mortality risk. Provided these risks are documented, there is no difference in principle between a requirement to have an investment risk management plan and a mortality risk management plan.

Therefore there is no logical reason for denying SMSF members the opportunity to manage these risks via the use of a term allocated pension or a defined benefit solution. As many of the earlier submissions noted, defined benefit pensions have a legitimate role in the retirement income plans of many Australians and many Australians. By establishing a self-managed superannuation fund, have decided to take control of the risk management of their affairs. Provided the risks are understood and communicated, members should be free to make a choice as to who will manage mortality risk. They already do so when choosing between pension alternatives anyway. SMSFs may have to manage mortality risk differently to large funds where mortality risk can be pooled, but they can manage it. Just as there are some rules relating to managing investment risk (in-house assets and the need to consider diversification for example), there may need to be some guidelines for managing mortality risk.

The suggestion from ASFA that limits on the probability levels applied to defined benefit pensions from small funds has some merit if estate planning issues remain a concern. However, reconsidering the taxation of transfers from reserves to member accounts will probably provide a more efficient and equitable outcome.

**Final Comments**

Australian society operates under a system that encourages individuals to take responsibility for their own actions and the outcomes they achieve in life. Clearly each member of our society is also encouraged to think of the society as a whole as they make their choices and decisions to achieve their individual goals. In presenting the discussion paper, Treasury has flagged an area of our society where some individuals are making personal choices that detrimentally impact upon the rest of society (ie they depriving our government of revenue or becoming entitled to government support that they ought not to be entitled to). The problem is that the vast majority of the individuals that Treasury is targeting had no knowledge that by applying the laws as the existed they were guilty of this "anti-social behaviour".

Furthermore, Treasury has offered very little by way of data quantifying the extent of the detriment to government resources arising from the concerns they have expressed. There is a substantial body of data available from professional practices around the country supporting the fact that the changes proposed by Treasury will have substantial detrimental and retrospective impact upon ordinary Australians who were simply trying to take responsibility for their own retirement income by applying the laws of the land. The submission by Dr Ben Korman is one case of thousands highlighting the fact that the proposed changes will penalize ordinary Australians for doing what every Australian ought to be doing – taking responsibility for their own circumstances whilst abiding by the laws of the land.

Several of the submissions on this issue made in 2004 highlight the concerns of some that somehow Treasury and the ATO have an agenda to make life hard for SMSFs. The implication they make is that Treasury and the ATO view SMSFs as a sinister means by some (now many) Australian's to some how rort the system. Clearly this is not the actual view of either Treasury or the ATO. Indeed, many of the senior officials of both organizations run their own superannuation funds, and like most SMSF members and trustees they do so because it is their retirement savings vehicle of choice. However, the method by which the proposed changes were developed and delivered does open the door to those who would hold an alternative view of the Treasury and ATO position.

The clarification of superannuation laws and regulations since the introduction of SIS in 1984 is to be both applauded and welcomed. Every effort has been made by regulators to ensure that the retrospective impact of changes to legislation was minimized – at least up until 11 May 2004. The balancing of the need to protect members whilst minimizing costs has been difficult but in general well managed.

Treasury and ATO should continue to support the role of the self-managed fund in the Australian retirement landscape. It is no more in the interests of the country to have the retirement savings of the country managed by a few large institutions than it is to have the nations productive resources controlled by a few large multinationals, or the labour resources controlled by a few large labour organizations. SMSFs provide a means by which ordinary Australians can control the allocation of some our investment resources and plug gaps left by large institutions.

Treasury is to be encouraged to plug gaps in the revenue net in a manner consistent with the objectives outlined in this submission. That will require a continuation of the ability of SMSF members to control their own destiny by managing contributions, benefit payments and risk management under the same legislation applying to all superannuation funds, perhaps with some guidance via the regulators in relation to risk management for the protection of member benefits and government revenue.

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