File Name:

16 March 2005

The Manager
Retirement Income and General Rules Unit
Superannuation, Retirement and Savings Division
The Treasury
Langton Crescent
Parkes ACT 2600

SUBMISSION: Review of the provision of pensions in small superannuation funds

The Association of Superannuation Funds of Australia (ASFA) would like to make the following comments in response to the Government's Discussion Paper *Review of the provision of pensions in small superannuation funds*.

As the Discussion Paper, in Section 4, provides an overview of the key issues under discussion there is no need to revisit those findings in any great detail. However, attached for your information is a worked example showing the operation of both a market linked income stream and a defined benefit pension within an SMSF. It serves to illustrate what SMSFs are attempting to achieve in the provision of a defined benefit pension.

The Discussion Paper notes that the interaction of the various superannuation rules combined with the close relationship between the member and the trustee in small funds creates an opportunity for a member of a small fund to achieve results that are not entirely consistent with the Government's retirement policy objectives.

As a general principal ASFA has a concern where government policy and the policy implementation are not in harmony as this generally leads to confusion and disruption.

The Association also does not support rules that potentially allow unintended access to tax minimisation and estate planning strategies as this puts at risk the retirement income system.

In addition, we do not judge it as good public policy to have a retirement income regime that potentially creates different tax opportunities and benefits for some sections of that regime and not others.

Federal Secretariat

Level 19
Piccadilly Tower
133 Castlereagh St
Sydney NSW 2000

PO Box 1485
Sydney NSW 2001
Tel: (02) 9264 9300
Fax: (02) 9264 8824

ASFA also believes that income streams should be 'true to label'. Some small funds are using the existing rules to create products that purport to guarantee an income stream when it is widely acknowledged that no such guarantee exists. ASFA notes that the defined benefit pension rules used by small funds were designed in an era where accumulation funds generally only provided a lump sum benefit on retirement and defined benefit pensions were only provided by defined benefit funds and life companies where there was a pooling of lives and the backing of a sponsoring employer or financial institution. However in the intervening years the regulator has permitted small funds to also issue these products, but in the absence of these features.

The desire by small funds to issue defined benefit pensions, even in the absence of a guarantee, is, however, understandable and arises from a mixture of the needs of certain small fund members to access an income stream for their lifetime, a perception that the commercially available products are poor value and a desire to retain control of their assets in the pension phase and should they die early. These competing needs highlight what many see as a deficiency of both the allocated and market linked income stream products. Both products are generally targeted at about average life expectancy and do not necessarily meet the needs of members requiring an income stream for their lifetime.

ASFA therefore supports the removal of the concepts of guarantee and defined benefit in relation to lifetime and life expectance in pensions provided by small funds and the establishment of a lifetime market linked pension, available to all funds, that caters for pensioners that live beyond their life expectancy and which allows a smoothing of income payments.

We also recommend the updating of out dated pension valuation factors in the SIS regulations to more accurately reflect the value of a pension purchased and provide parity of valuation between income streams

Following are ASFA’s comments on specific issues raised within the paper.

Defined benefit pensions in funds with fewer than five members (SMSFs and SAFs)

ASFA supports continuation of the prohibition on small funds being able to issue income-guaranteed lifetime and life expectancy pensions, as currently set out in SIS, unless those pensions are supported by some form of longevity insurance.

ASFA does not consider it appropriate that a fund should be able to issue a pension product that purports to be guaranteed when the product issuer is aware that no such guarantee exists.

Federal Secretariat

Level 19
Piccadilly Tower
133 Castlereagh St
Sydney NSW 2000

PO Box 1485
Sydney NSW 2001
Tel: (02) 9264 9300
Fax: (02) 9264 8824

Defined benefit pensions in non SMSF / SAF arrangements

As a general principle, ASFA considers that funds, other than SMSFs and SAFs, should be able to offer life pensions and defined benefits provided they satisfy the relevant accounting and actuarial solvency standards on an ongoing basis and have access to guaranteed funding such as through a sponsoring employer.

This concept is supported by the provision for an arms length DB fund to approach the regulator for relief from the operating standard.

Note should be taken of the role that the access to defined benefits plays in employee remuneration. For some employers, the capacity to offer a defined benefit on retirement has been an important part of their remuneration package to attract and retain key employees. Many of these benefits are provided through funds backed by a company with sufficient financial capacity to ensure that benefit liabilities are met.

Modification of Market linked pension product

ASFA supports the modification of the market linked income stream, in preference to the introduction of a new pension product. The modified MLIS would be available to all funds, would aim to provide a non-guaranteed lifetime income stream and through its name indicate that it does not provide an income guarantee. The basic features would be that the amended product:

- Remains account based,
- Seeks to provide an income beyond a pensioner's life expectancy on commencement date,
- Contains optional rules to facilitate smoothing of annual income during periods of fluctuating investment returns, and
- Would prevent the accumulation of reserves.

Consistent with this, of the options set out in the Discussion Paper, ASFA supports the proposals as outlined at 5.3.1 (extending the term of the market linked pension) and 5.3.3 (a mechanism to allow the smoothing of pension payments) as going some way towards meeting the above needs.

Pension term

There are two possible approaches to addressing the 'length of term' issue.

The first approach would be for the existing market linked income streams to be modified so as to permit the selection of a pension term that would provide a pension to age 95. For a 63 year old male with a 60 year old spouse taking a reversionary pension the available MLIS pension terms would be the existing spread of 21 to 28 eight years, or a new 35 year term (based on the current age of the youngest spouse beneficiary), either with or without income smoothing.

Federal Secretariat

Level 19
Piccadilly Tower
133 Castlereagh St
Sydney NSW 2000

PO Box 1485
Sydney NSW 2001
Tel: (02) 9264 9300
Fax: (02) 9264 8824

The second approach would be to provide a separate single set of pension valuation factors (PVFs) that reflected the pensioner's life expectancy at the commencement of the pension income year. The PVFs would be based on the current Australian Life Table and current interest rates and would be updated in line with changes in those tables and rates. These factors would work similarly to the current allocated pension but with a single annual pension figure, not access to maximum and minimum pension amounts. Each year the pensioner would divide their account balance by the factor relevant to their age on 1 July of the income year to determine the current year pension income amount.

ASFA considers the second approach above preferable to the first, and both approaches to be preferable to the more complicated options put forward in Section 5.4 (Introduce New Pension Products) of the Discussion Paper.

Income smoothing

ASFA recommends that income smoothing be achieved through income averaging and be phased in from commencement of the pension with a maximum permissible smoothing over, say, five years. Smoothing would operate as follows: The notional income for a year would be determined from a pension valuation factor. The actual income for a year would be determined by averaging earlier year(s) actual income with the current years notional income. If the income was averaged over 5 years then in the first six years of the pension the pension would be averaged over 1, then 2, 3, 4 5 and 5 years.

ASFA suggests that pensioners should be required to elect on pension commencement whether or not the pension income is to be smoothed.

Modification of SIS rules

ASFA considers that, as a major priority, the Government should implement the following changes to the superannuation rules to complement the above changes:

> **Valuation of pensions for RBL purposes**
>
> Where a pension is purchased for a lump sum from a third party, or established by book entry within a fund, the value of the pension for RBL purposes is the purchase price or exchanged value less the amount of undeducted contributions.
>
> Where the above method cannot be used, (i.e. where there is no identifiable purchase price) the pension should be valued using pension valuation factors (PVF) as set out in Schedule 1B of the SIS Regulations. It is noted that to achieve equity between pension types, the PVFs in Schedule 1B should be updated using the current Australian Life Tables, and mechanisms put in place to maintain their currency.

Federal Secretariat

Level 19
Piccadilly Tower
133 Castlereagh St
Sydney NSW 2000

PO Box 1485
Sydney NSW 2001
Tel: (02) 9264 9300
Fax: (02) 9264 8824

Estate planning considerations
To minimise estate planning through superannuation funds it is suggested that consideration be given to restricting:

- The class of reversionary pensioners to a spouse, an interdependency relationship or a financial dependant. and
- A lifetime pension to a maximum of two reversions

Consideration could also be given to the creation of rules that would further restrict the reversion to a spouse where the primary pensioner has survived to a set age, say 95.

Allocated Pension Factors
Part of the attraction of defined benefit pensions in small funds arises because the pension valuation factors in SIS are out of date and thus underestimate the value of a lifetime pension. A reverse effect applies with allocated pension. Some of the attraction of these products is lost because the current factors underestimate life expectancy and thus fail to provide a meaningful level of pension for the later years of those who exceed their life expectancy.

ASFA suggests that the allocated pension factors in schedule 1A of the SIS Regulations be updated in line with the change in the Australian Life Tables that have occurred since allocated pensions were introduced in 1994. Some consideration may be required to a permissible phasing in period so as to not disadvantage those pensioners currently drawing down the maximum amount (as the changes in the Australian Life Tables will result in higher PVF's and thus lower maximum draw down amounts.)

There is one final issue that was not addressed in the discussion paper that may be worthwhile considering as part of this process – the 50/50 rule that applies to concessional taxation treatment once the person has benefits that exceed their lump sum RBL amount. It appears anomalous that while a person with an accumulated balance of $619,223 can take the entire amount as a concessionally taxed lump sum benefit, a person with a balance of $620,000 must take at least $310,000 as a pension to achieve similar full tax concessionality. ASFA believes that the opportunity should be taken to consider changing the way the 50/50 rule works and will be happy to consult on how this may be achieved.

Yours sincerely,

Dr Michaela Anderson
Director Policy and Research

Federal Secretariat

Level 19
Piccadilly Tower
133 Castlereagh St
Sydney NSW 2000

PO Box 1485
Sydney NSW 2001
Tel: (02) 9264 9300
Fax: (02) 9264 8824

ASFA The Voice of Super

Review of provision of pensions in small funds

Indicative Pension Illustrations

Indicative Pension Illustrations

per $1,000,000 consideration

Market Linked Income Stream				Lifetime Pension		
	Remaining Assets @ 7% Investment earnings	MLIS Factors Term 25	MLIS Pension p.a.		Remaining Assets @ 7% Investment earnings	Pension @5% p.a. Increase
Age				Age		
65	$1,000,000	16.48	$60,680	65	$1,000,000	$50,000
66	$1,007,233	16.06	$62,717	66	$1,018,280	$52,500
67	$1,012,864	15.62	$64,844	67	$1,035,253	$55,125
68	$1,016,689	15.17	$67,020	68	$1,050,699	$57,881
69	$1,018,532	14.70	$69,288	69	$1,064,375	$60,775
70	$1,018,157	14.21	$71,651	70	$1,076,015	$63,814
71	$1,015,312	13.71	$74,056	71	$1,085,326	$67,005
72	$1,009,779	13.19	$76,556	72	$1,091,988	$70,355
73	$1,001,273	12.65	$79,152	73	$1,095,652	$73,873
74	$989,487	12.09	$81,843	74	$1,095,933	$77,566
75	$974,092	11.52	$84,557	75	$1,092,413	$81,445
76	$954,812	10.92	$87,437	76	$1,084,634	$85,517
77	$931,203	10.30	$90,408	77	$1,072,099	$89,793
78	$902,869	9.66	$93,465	78	$1,054,264	$94,282
79	$869,389	9.00	$96,599	79	$1,030,536	$98,997
80	$830,324	8.32	$99,799	80	$1,000,271	$103,946
81	$785,214	7.61	$103,182	81	$962,767	$103,946
82	$733,447	6.87	$106,761	82	$922,637	$103,946
83	$674,354	6.11	$110,369	83	$879,699	$103,946
84	$607,392	5.33	$113,957	84	$833,755	$103,946
85	$532,031	4.52	$117,706	85	$784,595	$103,946
86	$447,517	3.67	$121,939	86	$731,993	$103,946
87	$352,709	2.80	$125,967	87	$675,710	$103,946
88	$247,096	1.90	$130,051	88	$615,486	$103,946
89	$129,868	1.00	$129,868	89	$551,047	$103,946
90				90	$482,098	$103,946
91				91	$408,321	$103,946
92				92	$329,381	$103,946
93				93	$244,915	$103,946
94				94	$154,536	$103,946
95				95	$57,830	$57,830

Note: The 25 year term of the MLIS is achieved by using the life expectancy of a 60 year old female.

Federal Secretariat

Level 19
Piccadilly Tower
133 Castlereagh St
Sydney NSW 2000

PO Box 1485
Sydney NSW 2001
Tel: (02) 9264 9300
Fax: (02) 9264 8824