



# Treasury laws amendment

**(Innovative Superannuation Income Streams) Regulations 2017**

Mine Wealth + Wellbeing Submission

April 2017



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## About Mine Wealth + Wellbeing (Mine)

The Mine Wealth + Wellbeing Superannuation Fund (Mine) is a profit to members, public offer fund dedicated to serving the retirement needs of all Australians. Its enduring purpose is to deliver an exceptional retirement for members which achieves peace of mind along the way.

Mine employs over 200 staff and manages over \$10 billion in funds for approximately 66,000 members.

In addition to superannuation and pension products, Mine offers its members insurance, financial advice and banking products.

Mine has been recognised by research company SuperRatings with a 10 year Platinum rating for its pension product and a 9 year Platinum rating for its super product. It has also received Chant West Five Apples rating for super and pension in 2017, and was a finalist for the 2016 Chant West Specialist Fund of the Year.

## Introduction

This paper represents our response to the Treasury Laws Amendment (Innovative Superannuation Income Streams) Regulations 2017. Overall we congratulate policymakers for navigating a complex array of legislation to suggest changes which will enable super funds to develop innovative retirement income solutions which will improve member outcomes.

We make a small number of recommended modifications to the Exposure Draft and the Explanatory Statement. These recommendations are based primarily on two themes: (1) simplicity and fairness, and (2) increasing flexibility to enable the consideration of innovative solutions which may experience greater acceptance amongst the population.

Please note that Mine's Retirement Outcomes Modelling team, consisting of Dr Adam Shao and Estelle Liu, along with Chief Investment Officer David Bell, are the primary authors of this paper. Dr Shao, Ms Liu and Mr Bell are available for further discussion on any of the issues raised below.

## Recommended modifications to the Exposure Draft and Explanatory Statement

### Item 1

Specifically, new paragraph 1.06A(3)(c) of the Regulations applies the following factors to determine whether there is any unreasonable deferral of benefit payments – reference to document: top of page 5 of Explanatory Statement.

### Recommendation 1.1

We recommend (for clarity) an additional dot point:

- Realised mortality experience of the beneficiaries.



## Recommendation 1.2

We believe the overall guidelines may benefit from having some firm rules. We note that the guidelines are currently left open to interpretation, as illustrated by the example (middle of page 5 of Explanatory Statement). We recommend the following rules:

- Maximum deferral age (for the first payment to be made) of life expectancy + 5yrs.
- A 95% degree of confidence that, once payments have begun, year-on-year payments will not change by more than X%. We suggest that a reasonable suggestion for X would be 15.

We note that this second formal rule will enforce the requirement for advanced modelling and testing in the design of these products. We believe a design based on “in-expectation” assumptions is insufficient.

An illustrated example is provided below.

## Example 1.3

For instance, an “innovative” income stream product pays the expected annual amount of \$20,000, but the exact payment is stochastic (i.e. “to the extent that payments do not depend on returns, age or life expectancies”), as shown in Figure 1.4. Three simulated income paths are included for illustration. In one year the payment can be as low as \$1,000 and in another year the payment can be as high as \$50,000. The relative size of expected total payments from year to year is nil, but the relative sizes of total payments on a confidence interval basis are large. Will this “innovative” income stream product be considered reasonable?

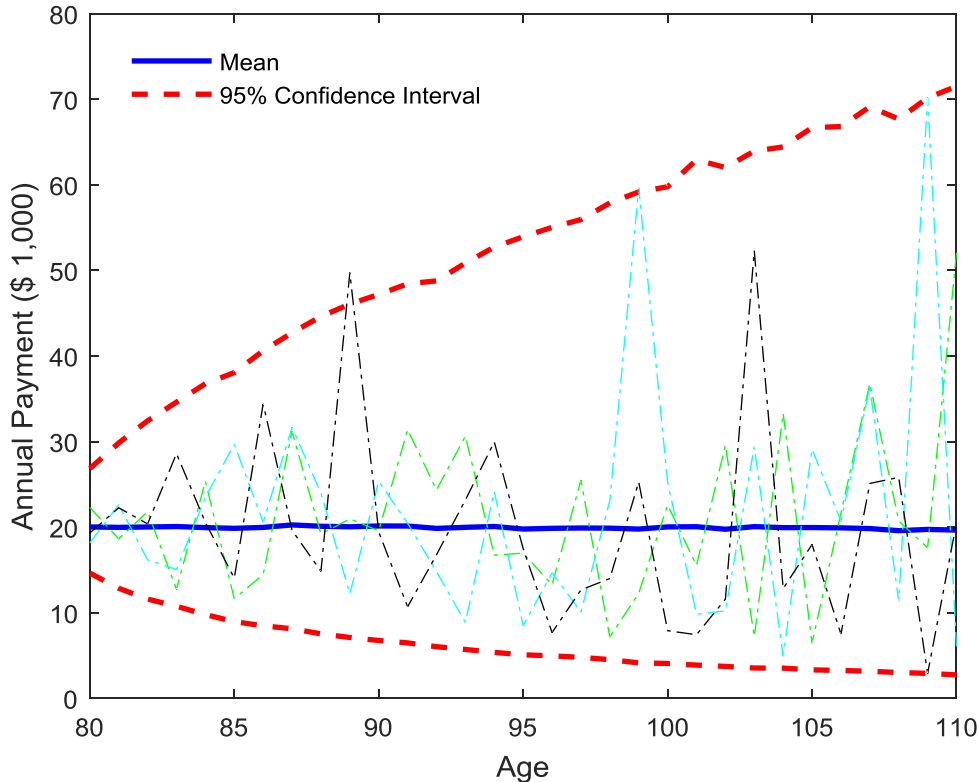


Figure 1.4 – Simulated income paths for a candidate deferred group self-annuitisation.

## Item 2

Restrictions on accessing capital supporting the income stream – reference to document: bottom of page 5 of Explanatory Statement.

In this section we will discuss the Treasury’s proposed maximum commutation amount (MCA) and some of its implications on product design.

We used Examples 1.1 and 1.2 in the “Exposure Draft - Explanatory Statement” for illustration purposes.

We recognise one of the major reasons to set a maximum limit on the allowable commutation amount is to ensure the products have a focus on income rather than capital preservation. We also recognise that when setting such maximum limits it is preferable to allow for some flexibility in product design (this has benefits with respect to product acceptance).

### Analysis of Example 1.1 from Exposure Draft

Maximum commutation amount – income stream purchase by a single payment.

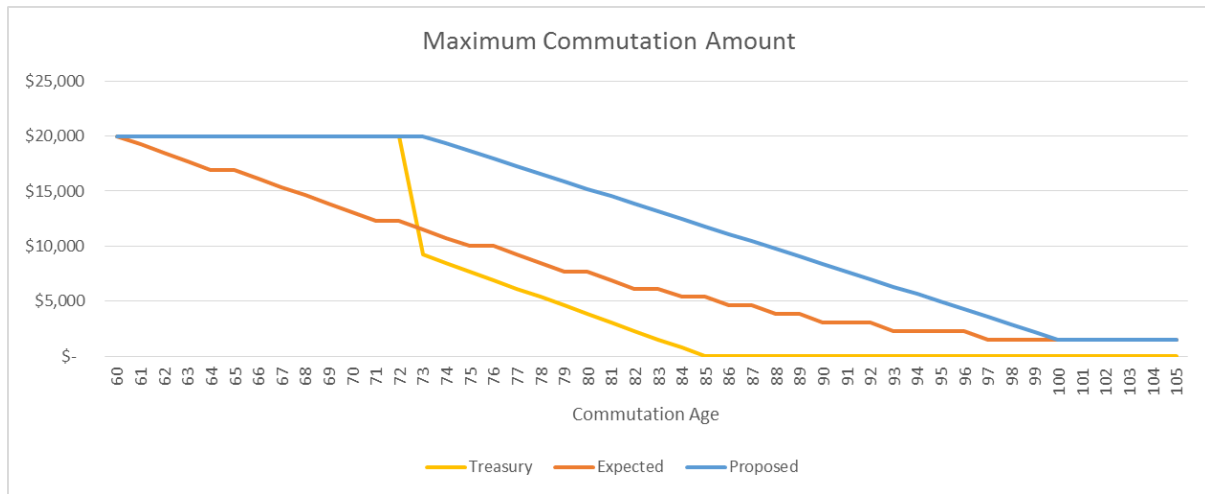


Figure 2.1 – Comparison of alternative models for Maximum Commutation Amount.

Figure 2.1 is a visualisation of the MCA for Example 1.1 assuming Hector (the beneficiary) died (commuted) at different ages. The orange line is the Treasury’s MCA.

We agree with Treasury that the MCA should be a decreasing function over the life of the beneficiary to reflect reducing capital through income streams payments over time.

In order to examine whether the level set for MCA is appropriate or not, we first worked out what should be the expected commutation amount (ECA) when Hector died at different ages (marked in dark orange). ECA is the commutation amount Hector is expected to receive if he died. To make it actuarially fair, ECA at a particular time can be calculated as the expected value of the future income streams received by Hector if he did not die at that time.

ECA is calculated using a modified version of the formulae in new subregulation 1.06B(2) of the SISR 1994.

$$\left( \frac{\text{Access amount for the income stream at the time of the commutation}}{\text{Life expectancy period on the income stream start day}} \times \text{Life expectancy at the time of commutation} \right) - \text{Previously commuted amount}$$

Note that before the income stream start day, the expected commutation amount (ECA) is equal to the access amount which is the accumulated amount of consideration paid to date.

It is natural to think that MCA should be set at least higher than ECA. One example is when designing a pooling solution based on a lifetable that is different from the prescribed Government Actuary lifetable. The MCA should be set higher to allow for the different underlying mortality assumptions.

The Treasury’s MCA allows the full access amount to be paid as a commutation amount if the income stream is commuted on the death of the beneficiary within the first half of the life

expectancy period. We acknowledge the flexibility allowed here in product design. For example, a product can offer liquidity option so the beneficiary can choose to withdraw the purchase within the first half of the life expectancy period.

The flexibility allowed in the Treasury's MCA seems to be limited post the first half of the life expectancy as it first drops sharply and then linearly decreases to zero at the life expectancy age.

We believe forcing the MCA to be zero after the beneficiary reaches his/her life expectancy at retirement may not be desirable. There are many product-based reasons why a non-zero MCA may be desirable and lead to greater acceptance of innovative retirement income stream products. One argument is the peace of mind that the beneficiary might lose when the contract does not have any commutation value at all.

Since MCA is setting a maximum cap for the commutation amount, we believe it should allow some room for flexibility in product design. This would be very helpful especially in managing a mortality pooling product structure and allowing for some positive commutation amount when the beneficiary dies after their life expectancy.

## Recommendation 2.2

We propose a more appropriate MCA (marked in blue) as shown in Figure 2.1.

We pick a senior age 100 and set the MCA beyond age 100 to be constant and equal to the ECA of age 100. MCA is then linearly decreasing between the age after pasting the first half of the life expectancy and age 100.

Note that, our proposed MCA has one extra year of full access amount compared to the Treasury's MCA. This is intentionally allowed for to ensure MCA is always above ECA. As suggested from the ECA formulae, ECA will be equal to the full access amount in the first year after the income stream payments start since life expectancy period on the income stream start day = life expectancy at the time of commutation. As a result, under our proposed rule, the full access amount is allowed to be paid as a commutation amount if the income stream is commuted on the death of the beneficiary within the first half of the life expectancy period (inclusive of the year when the beneficiary just reaches his first half).

Our proposed MCA can then be defined using a simple piecewise linear function. It incorporates the following important features:

- Acknowledges decreasing pattern over the life of the beneficiary.
- Is set higher than the expected commutation amount, but not unreasonably high.
- Allows for full access amount to be paid as commutation amount in the first half of the life expectancy period.
- Allows for full access amount to be paid before the income stream payments start.
- Allows positive commutation amount at all ages.

### Analysis of Example 1.2 from Exposure Draft

Maximum commutation amount – income stream purchased by instalments.

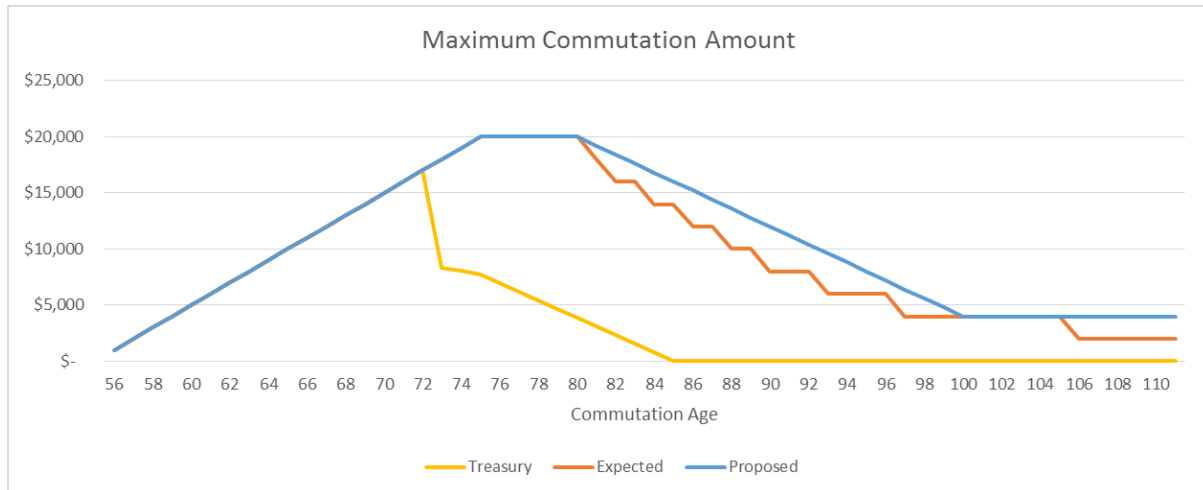


Figure 2.3 – Comparison of alternative models for Maximum Commutation Amount – case of income stream purchased by instalments.

Example 1.2 is slight more complex than Example 1.1 with the purchase being made with instalments. The Treasury’s MCA, ECA and our proposed MCA are shown in Figure 2.3.

We agree with the Treasury that the MCA before the income streams kick in should be equal to the access amount which is the accumulated amount of consideration paid. As shown in Figure 2.3, the Treasury’s MCA is equal to the full access amount until Suzie passes her first half of her life expectancy at retirement even she is still paying the instalments and the income streams have not started yet.

### Recommendation 2.4

We believe when considering commutation amount with payment by instalments and deferral of income streams, life expectancy at retirement is not the most relevant factor of this problem. The more relevant factor is the life expectancy on the income stream start day.

The full access amount is allowed to be paid as a commutation amount if the income stream is commuted on the death of the beneficiary within the first half of the life expectancy period, or before the income stream start day, whichever is later. The ECA and our proposed MCA at later ages are worked out similarly to Example 1.1.

Our proposed MCA helps address a potential problem from the Treasury’s MCA when the deferral period is longer than the beneficiary’s life expectancy at retirement. For example, if the deferred annuity only starts to be payable from age 85. Under the Treasury’s rule, MCA would be zero before the first income stream kicks in. Under our proposed rule (Figure 2.5), MCA would only start to drop from the full Access amount after the income stream starts.



Again, we believe the flexibility to allow for greater than zero commutation amount should be considered in MCA.

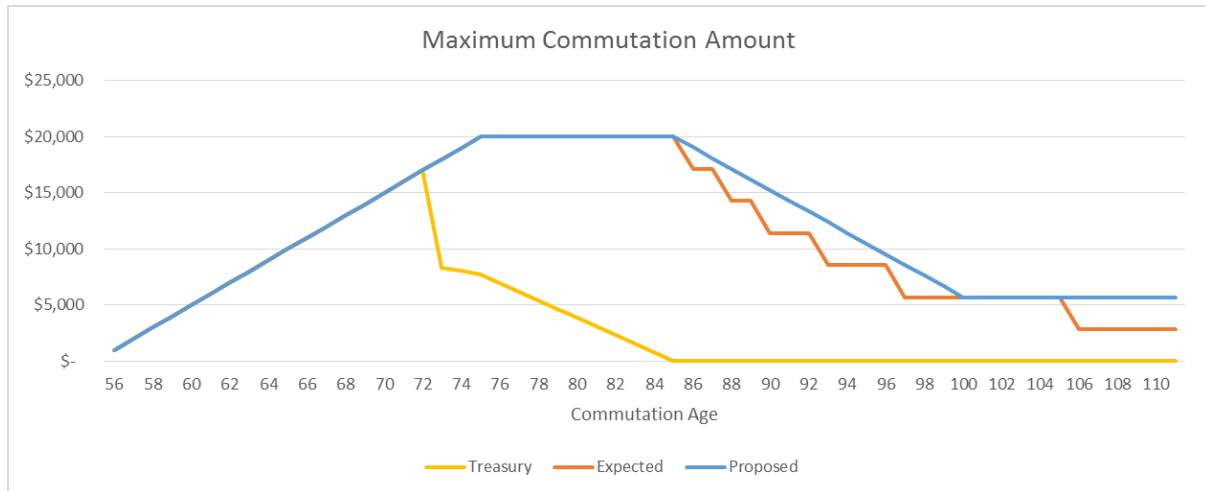


Figure 2.5 – Comparison of alternative models for Maximum Commutation Amount – case of income stream purchased by instalments, deferral period is greater than beneficiary’s life expectancy at retirement.

### Item 3

Hybrid Income Streams– reference to document: middle of page 8 of Explanatory Statement.

#### Clarification 3.1

We would like to request a clarification on the second paragraph in “Hybrid income streams” in the “Exposure Draft – Explanatory Statement”. The last sentence reads “As the deferred annuity would be held as an investment of the fund, it would not count towards a member’s transfer balance account balance.”

We believe the value of the deferred annuity has been counted towards the member’s transfer balance account balance. We believe the purchase of a deferred annuity via pension account does not change the member’s transfer balance account balance.

### Item 4

Valuation for Total Superannuation Balance Purposes– reference to document: top of page 12 of Explanatory Statement.

#### Clarification 4.1

There is one part of this section that we think further clarification is required. It is the first sentence in the second paragraph under “Valuation for Total Superannuation Balance Purposes”.

It relates to determining the accumulation phase value of an individual’s superannuation interest. This section explains “the default rule” and the rule applied “otherwise”. The former determines the value assuming if the individual voluntarily ceased the interest. This will then exclude the commutation value when the beneficiary dies. The latter specifies it is equal to the value of the superannuation interest which is calculated as the accumulated amount of considerations paid to date. Further explanation will be needed to clarify which rule is applied. Otherwise, one implication under “the default rule” is to encourage beneficiaries to purchase deferred income streams in accumulation phase to reduce their total superannuation balance that counts towards the \$1.6 million transfer cap.

#### Item 5

Implication of Tax Exemption - reference to document: bottom of Page 1 of Explanatory Statement.

#### Issue 5.1

The last sentence of this section mentions that a tax exemption will apply to the new income streams product when individuals have reached retirement. The exact quote is “Superannuation funds and life insurance companies will receive a tax exemption on income from assets supporting these new income stream products provided they are currently payable, or in the case of deferred products, held for an individual that has reached retirement”.

There are potentially significant administrative challenges arising from innovative income stream product members (i.e. members of a cohort) having different taxation status (retired and not retired).

For example, a pooling solution allows members to join in the pool at accumulation phase. Assuming members join as a single cohort at the age of 40, the investment of the pool would be taxed the same as other investments in accumulation phase. 25 years later, some members start to retire while others may continue to work. Under the tax exemption rule, these retired members would not need to pay tax on their share of investment anymore. Over time, more members of the pool would become eligible for a tax exemption at different times.

If the tax liability is met through fund redemptions then this has important ramifications:

- Parallel accounting and management for two sets of pool members per cohort (taxed and non-taxed) – at least two sets of unit prices per cohort.



- If the commutation penalty of a particular design is greater than zero from age 65 then redemption to meet tax requirements is undertaken at unattractive levels, creating an unattractive scenario for members.

This could be a large operational deterrent to establishing innovative longevity solutions. The most plausible solution is for the tax rate to be zero for all cohort members at legislated retirement age. We also observe the further problem that there will always be a range of ages within a cohort (e.g. a cohort may contain people within, say, 3 years of age). This means that the outlined problem will occur regardless.

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