FINANCIAL PLANNING
ASSOCIATION *of* AUSTRALIA

# Retirement Income Stream Review

**FPA SUBMISSION | 05 September 2014**

General Manager
Personal and Retirement Income Division
The Treasury
Langton Crescent
PARKES ACT 2600

**By email:** superannuation@treasury.gov.au

5 September 2014

**RE: Review of Retirement Income Stream Regulation – Discussion Paper July 2014**

Dear Sir/Madam,

The Financial Planning Association of Australia (FPA) welcomes the opportunity to respond to the Treasury's *Review of Retirement Income Stream Regulation* discussion paper.

The FPA considers that the retirement income system needs a lifetime view as saving for retirement should start at a young age and continue throughout working ages and into retirement. Flexibility needs to be in-built to allow for the needs at various life stages.

Our submission addresses the sixteen discussion questions in the discussion paper, and raises general observations regarding the pension phase of Australia's superannuation system.

If you have any questions, please do not hesitate to contact me on 02 9220 4500 or dante.degori@fpa.asn.au.

Yours sincerely,

**Dante De Gori**
General Manager Policy and Conduct
Financial Planning Association of Australia

## 1. The regulatory arrangements for superannuation income streams

### 1.1 – General observations

While the regulatory settings identified in the discussion paper do interfere with some longevity risk products, there are issues in policy and in the market which are far greater impediments to a flourishing market for private longevity risk insurance.

The existing tax-free environment for income generated by pension products in the pension stage has caused significant difficulties for the government and the private sector. This creates potentially conflicting objectives for financial advisers where the most effective advice for providing a consistent retirement income that is protected against longevity risk may be different to the most tax-effective solution.

In part, the difficulties that stem from the tax-free pension phase are connected to the conflicting purposes of the superannuation system. The stated objectives of the client with respect to their superannuation assets and retirement outcomes complicate the issue further. If the superannuation system is designed to compel individuals to adopt a retirement income strategy, then the adviser has a justification for recommending products and strategies with respect to superannuation assets which are less optimal from a tax perspective but offer a secure retirement income strategy. The ability to prepare retirement income strategies which are designed to deliver a tax-effective benefit to beneficiaries potentially conflicts with the intended purpose of the superannuation system.

The FPA believes that weak consumer demand for longevity risk products significantly reduces the availability of relevant and appropriate products. This is partly due to the effectiveness of account-based pensions (ABPs) and good financial advice, but also due to the function of the age pension as a form of public longevity insurance. Financial planners who advise on retirement strategy always advise clients about how their assets can best be organised in order to maximise access to the age pension if possible, and this usually involves structuring the client's superannuation assets in order to be tax-effective and to be exempt from social security asset tests. As long as these strategies remain useful for clients, it will be difficult to justify specific longevity risk products in many cases.

Lastly, there have been high-level policy discussions regarding mandatory or default products for the pension phase of retirement. The FPA strongly disagrees with policy settings that prescribe a mandatory or default product for the pension phase, but it is important to note that any outcomes from these discussions would have an important impact on the availability, competitiveness, and innovation of longevity risk products.

### 1.2 – Discussion questions

**Question 1:** What types of income stream products would enable retirees to better manage risk in the retirement phase (in particular longevity risk and investment risk)?

In theory, any account-based pension can manage investment risk reasonably well. There are ABPs that offer long-term volatility solutions that mitigate investment risk, as well as short-term volatility risk solutions through term deposits and fixed funds. However, the FPA's view is that if the objective of the superannuation system is to provide a retirement income, then longevity risk is best managed by products in the form of insurance, rather than a variation of the ABP structure.

Hybrid products have the advantage that they could be structured to satisfy the minimum drawdown requirement while still offering longevity risk insurance. Notwithstanding that these products do offer a way to address longevity risk without changing existing policy settings, the market would be better served by changing regulatory settings in order to facilitate competitive, standalone longevity risk products that offer an alternative to the age pension.

**Question 2:** Do the annuity and pension rules constitute an impediment to the development of new products and if so, what features of the rules are of most concern from a product innovation perspective?

**Question 3:** What changes could be made to the annuity and pension rules to accommodate a wider range of income stream products while having regard to the need to protect against abuse of the earnings tax exemption and to promote appropriate and prudent retirement income objectives?

**Question 4:** Would the proposed changes to the annuity and pension rules lead to new products being brought onto the market?

A person entering retirement currently has very little choice in income stream design, with a current choice of only an account-based income stream, a lifetime guaranteed or a fixed-term guaranteed income stream. It should be noted, that only a very small percentage of retirees use lifetime or fixed-term income streams, so the current choice is largely limited to an account-based income stream.

This current range does not cater well for the risks of longevity. The longevity of an account-based income stream depends on the balance, earnings rate and amount of withdrawals each year.

Longevity risk can be managed using lifetime income streams. However, these are largely unpopular in their current format due to several reasons:

- Cultural aversion to locking money away;
- Low levels of retirement savings and the need to maintain flexibility;
- Low rates of return due to the conservative pricing and capital reserve policies; and
- The potential for a loss of capital.

Creative product development in this area is currently stifled by a combination of consumer demand (with average super account balances less than $100,000 then consumer power for choice is limited) and legislative restrictions and as a result there has been very little development in products that effectively deal with longevity risk.

To date, much of the product development in this area has focussed on providing guarantees on returns or capital values to protect against market volatility. But these options do not guarantee the longevity or adequacy of income for the duration of retirement. Periods of extreme market volatility have also highlighted how an economic downturn can cause significant increase in the cost of offering these product features for providers, with costs passed onto consumers to impact negatively on retirement savings.

A major inhibitor to the development of products is the wording of the Superannuation Industry (Supervisions) legislation that determines what is defined as “an income stream” to be eligible for the tax exemption on current pension assets. This limits creative product development.

The Government needs to implement further change to create a legislative environment that promotes product development that caters for longevity risk and the diverse consumer needs in retirement, within a level playing field for providers.

Having regard to our general observations on the state of the pension system in Australia, the minimum drawdown and the different taxation between accumulation and pension phases are significant impediments to the adoption of new products by Australian retirees. However, our view is that it is easy enough to facilitate product innovation under the current regulatory settings, but without consumer demand for these products there will be little reason to innovate. The primary concerns from the market are that longevity risk products are unattractive from a tax perspective, and the benefit of private longevity insurance over reliance on the age pension is not clear.

There are some annuity and pension rules which could be changed to facilitate product innovation within existing products. For example, ABPs need to be recommenced in order to add to the income stream via a contribution or rollover, rather than just being able to add to the ABP. Furthermore, the current requirement to lock in indexation at the commencement of an annuity is inflexible.

However, many of the changes which would facilitate a deeper and more diverse market for longevity risk products (as well as other pension products) have been explained above in our general observations. While those are observations that are outside of the scope of the discussion paper, our view is that more fundamental changes need to occur at the pension stage of superannuation before fine-tuning of the regulations will result in successful policy.

Implementing these changes would facilitate some demand for the kinds of products which already exist, as well as encouraging innovation.

The FPA recommends industry consultation to rewrite the superannuation legislation definition of an income stream so that it is not an inhibitor to creative product development by allowing more flexibility in the variation of income each year, and still qualify for the tax exemptions on current pension assets

## 2. Deferred lifetime annuities

### 2.1 – Discussion questions

**Question 5:** Should people only be able to purchase a DLA with superannuation money?

In principle, this is the best outcome. However, it is not strictly necessary to implement a rule to that effect. The DLA could be purchased outside super if the income generated by the DLA was taxed in the same way as if the money had been invested outside super. That said, this policy setting would provide a prohibitive disincentive to purchasing the DLA outside of superannuation, and create complexity with respect to commutability (i.e. why should a DLA purchased outside of superannuation be non-commutable if the tax treatment is identical to another investment?)

**Question 6:** Should people only be able to purchase a DLA for an up-front premium or should other purchase options also be allowed? If an annual premium approach is allowed, what should be the consequences if the premium payments cease?

More options than an up-front premium should be allowed, including an option to contribute prior to meeting a condition of release. Where an annual premium approach is used and payments cease, there should be a reduce benefit paid to the individual as an annuity, subject to thresholds. Whether this option is available may also depend on how long the individual had been paying premiums before payments ceased.

**Question 7:** Should there be an upper limit on the amount that can be invested in a deferred lifetime annuity?

In principle, as a DLA is a longevity risk insurance product, there should be an upper limit on how much any individual could reasonably require per year. However, there are so many complicating factors involved in establishing the limit that the more practical answer (and the one that should be adopted by the Treasury) is that that there should be no upper limit on the amount invested in a DLA, and the Treasury should address any potential misuse of DLAs through non-commutability and death benefit restrictions.

**Question 8:** Should there be a minimum deferral period for a DLA? If so, what would determine the period?

Yes. The period should be based on actuarial tables for the life expectancy of that individual at the pension age.

**Question 9:** Should there be a maximum deferral age or period? If so, what should it be?

If policy settings are implemented to create a disincentive to use DLAs as a form of tax-free investment, then there is no need for a maximum deferral age. If there is a choice between implementing non-commutability and restricting death benefits or a maximum deferral age, the more principled measure would be implementing non-commutability and restricting death benefits, but the more politically successful measure would be a max deferral age.

**Question 10:** Do the payment features described in paragraphs 51 and 52 strike the right balance in allowing people to insure against longevity risk while avoiding unnecessary restrictions on product development?

We would support both non-commutability and fixed annual payments, but the annuity should be able to be adjusted to avoid difficulties in paying out in the case of increasing overall longevity.

**Question 11:** Should providers of DLAs be able to offer a death benefit? If so, should there be restrictions on the size of the death benefit that could be offered? If so, what restrictions?

The ideal position is that there should be no death benefit, as the product was purchased for longevity insurance not to provide a benefit. In effect, the individual's ability to give a benefit to their family has been counteracted by the long life of the individual. However, there is significant perceived unfairness where an individual and this factor may influence individuals to take up the Age pension as longevity insurance as opposed to purchasing their own.

If DLAs had to provide a death benefit to ensure the policy's political success, and/or to address the perceived unfairness of the product in the case that the client passes away earlier than anticipated, then these products should be designed to provide a death benefit if the annuity fails to pay out at certain percentages of the purchase price. This is similar to the case of other annuity products.

## 3. The minimum payment amounts for account-based income streams

### 3.1 – Discussion questions

**Question 12:** Are the current minimum payment amounts for account-based products appropriate to achieve the objectives outlined above, given financial conditions can change?

**Question 13** Should there be an automatic mechanism for adjusting the minimum drawdown amounts in response to significant adverse investment market performance? If so, what should that mechanism be? How would this also satisfy the rationale for setting minimum payment amounts?

**Question 14:** Should the minimum drawdown amounts also increase in response to very strong market performance? Would the mechanism be similar to that for decreases? Would this satisfy the rationale for setting minimum payment amounts?

**Question 15:** For how long should the change remain in place? Should it be left in place only for the year in which the shock occurs, or until balances have 'recovered' by a particular extent?

**Question 16:** What other issues need to be considered if the minimum drawdown amounts should fluctuate?

The FPA agrees that there needs to be consideration for a more responsive structure that allows investors to have choices when markets suffer unexpected down turns.

One option is to enable the minimum drawdown requirement structured to provide for a total or average drawdown requirement over a set period based on a variety of circumstances, which would allow the market to adjust to economic conditions. This option still allows the Government to implement policies to address extended periods of volatility and/or poor performance, as well as in periods of strong market performance.

In respect to this the FPA proposes an option to consider a minimum draw down provision election over a 5 year period rather than just on an annual basis. This model could operate similar to the 'bring forward provisions' for non-concessional contributions that an investor can make prior to turning aged 65.

For example an ABP purchased for $200,000 by a client aged 65 must take a minimum equal to 5% minimum percentage rate. The proposal would be to allow the client to choose to take less than the minimum in a certain year due to negative market returns, which in turn would trigger a <u>5 year minimum total drawdown provision</u>. It could work the following way:

| | |
|---|---|
| 2014 | Account Balance $200,000 @5% = $10,000 – client takes minimum pension |
| 2015 | Account Balance $190,000 @5% = $9,500 – client takes minimum pension |
| 2016 | Account Balance $150,000 @5% = $7,500 – client decides not to take minimum pension triggering 5 year minimum average drawdown. |

Within the next 5 years the investor is required to take a 5 year minimum total drawdown of $37,500 based on the minimum calculated in the year the client declined to take a minimum pension.

| | |
|---|---|
| 2017 | $5,500 |
| 2018 | $5,500 |
| 2019 | $7,500 |
| 2020 | $7,500 |
| 2021 | $11,500 |

This proposal would allow the market to adjust for shocks and improvements to the market without needing intervention from the Government in most cases. The five-year periods would commence from the point where the investor selects to take less than the prescribed minimum.

Another option could be to allow the five-year periods to commence from the point where the product starts producing payments for the client, where the minimum payment percentage over the five year period is the cumulative total of years in that period spent between different age brackets.

For example, a client whose ABP commences payments at 63 can plan for a minimum drawdown amount of two years at 4% and three years at 5%.

While these policy options would help to achieve the objectives of minimum drawdown payments in a more flexible manner, the core issue of how to decide on the minimum drawdown amounts remains. The current minimum drawdown percentages are arbitrary enough that they interfere with the retirement options of those who are less well-off, but do little to intervene in the ability of wealthier individuals to use their ABP to generate tax-efficient income.

Ideally, minimum payment amounts should be a function of the initial retirement account balance, the existing retirement account balance, the overall performance of the market, and the client's expected longevity in that particular year.

While the data for this function can be collected electronically, it would be quite difficult to produce a benchmark for the overall performance of the market and translate that information into an effective change in the minimum annual drawdown for every pension product.  Furthermore, linking annuity payments or minimum drawdowns to the market is the increased counterparty risk. Fund managers may try to beat the market by exposing the pool to high-risk investments. The FPA therefore recommends that the existing minimum percentage table remains in place until a systemic, client-based solution can be established.