SMSF
Owners'
Alliance

Limited ABN 96 161 052 464
Not-for-profit public company

SUBMISSION ON THE DISCUSSION PAPER ENTITLED "REVIEW OF RETIREMENT INCOME STREAM REGULATION"

5 September 2014

Introduction

The SMSF Owners' Alliance Limited (SMSFOA) is a not-for-profit organisation set up with one purpose in mind – to speak for the interests of over one million Australians who have chosen to strive for financial independence in retirement through a self-managed superannuation fund. Our web-site www.smsfoa.org.au has further background on the organisation.

We note the volume of superannuation savings held in SMSFs outweighs that held in either industry or retail managed funds. This submission has been prepared in response to the publication by Minister Cormann on 21 July 2014 of the Discussion Paper entitled "Review of retirement income stream regulation" (Paper) and his invitation to lodge a written submission on the issues raised. We note that the Paper also canvasses a review of the minimum mandatory withdrawal amounts for account-based superannuation funds. Given our membership, this submission focusses on these issues from the point of view of SMSF owners.

Firstly we commend the Minister for setting out clearly the Government's commitment to the three-pillar retirement system, including the concepts that:

a. the Age Pension is there as a 'safety net'; and

b. the Government encourages as many Australians as possible to actively plan and save for their self-funded retirement.

The rationale for encouraging retirement savings with tax incentives was well expressed in Henry's 'Australia's Future Tax System' review:

"The essential reason for treating lifetime, long term savings more favourably is that income taxation creates a bias against savings, particularly long-term savings. Taxes on savings income, including the taxation of inflationary gains, can discriminate against taxpayers who choose to defer consumption and save. The longer the person saves and reinvests, the greater the implicit tax on future consumption….These individuals pay a higher lifetime tax bill than people with similar earnings who choose to save less."

We support these views and also support any genuine moves to simplify regulation within the Australian financial system.

We would be happy to meet with the Minister, Treasury officials or other parties tasked with assessing submissions to discuss this submission, its implications and any other related area of interest. Furthermore, we would be willing to share the detailed results of our modelling used to develop some of the views in this submission.

Disclaimer and Information

This submission uses results from the "Pension Sustainability Computer Model" created and owned by Harlestone Pty Ltd based upon certain assumptions. The contents of this paper and the results from the Pension Sustainability Model should not be construed as the provision of financial advice as we disclaim all liability in this respect. The views expressed in this paper, including the assumptions and computations used in the Pension Sustainability Model, are the personal views of the authors and should not be relied upon by any party.

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1 Regulatory arrangements for term, lifetime and deferred lifetime annuities

We note that the Paper reports that "account-based products are the dominant income stream product in Australia" and that their relative popularity is likely to reflect the following factors:

i. flexibility of account-based superannuation and the control they provide people of their capital;
ii. estate planning advantages;
iii. ability of holders to select their preferred risk/return profile;
iv. they are simple and transparent;
v. they are less costly than guaranteed income streams.

On the other hand the paper points out that the holder of account-based products bears the full extent of risks – both investment and longevity – in relation to the superannuation income stream.

From the point of view of SMSFs, we strongly agree that flexibility, control, simplicity and low cost are four key attributes that attract Australians to establish SMSFs to provide account-based pension streams. Although APRA-regulated funds are not constrained by regulation or tax from providing clients with an account with the same characteristics as an SMSF, they choose not to do so for their business and administrative convenience. In theory the economies secured by pooling in APRA funds were expected to offset any disadvantages, though this does not appear to have occurred in practice as, on average, APRA-regulated funds have not performed markedly better than SMSFs and their costs are higher, except in the case of relatively small SMSF balances.

SMSFs have been successful largely because of the above-mentioned factors. In particular, SMSFs have a substantially greater proportion of their assets in 'simple' Australian equities, cash and term deposits than do APRA-regulated funds. The fundamental source of investment income is business in the form of rent, interest or dividends. 'Packaging' of such simple dividend/interest streams into more complex products does not add fundamental value and always involves some party taking a fee. The investment profile of SMSFs suggests many of their owners agree that it is preferable to acquire such income stream (dividends, interest or coupon) as close to the source as possible and minimise 'packaged' products with associated costs.

Given that under the current system the Government underwrites the risk that someone's superannuation will not last until death – by providing the Age Pension if it doesn't – then we acknowledge Government has an interest in ensuring the risk taken on by superannuation funds is within reasonable bounds.

However, the Government also has a strong interest in ensuring superannuation monies are invested efficiently and effectively to minimise the risk that superannuation returns will be inadequate to fund a pension that will keep the taxpayer off the Age Pension and so defeat the purpose of the superannuation system.

In this context, we are confused as to why the Paper appears to take a narrow view that term, lifetime or deferred annuities <u>must</u> be currently regulated as "*superannuation income streams"* under Regulations 1.05 and 1.06 in Part 1A of the Superannuation Industry (Supervision) Regulations 1994*.*

We understand that some product providers would prefer to be able to provide a product classified as a 'superannuation income product' regulated under SIS, with its inherent tax advantages, but it is incorrect to suggest, as the Paper appears to, that this is the only way that term, lifetime or deferred annuities can be made available.

Surely such products can also be available for purchase by SMSFs or APRA-regulated funds (or indeed by individuals outside the superannuation system if they so wish) in the same way as all superannuation funds can purchase shares, bonds and other investment products that are NOT regulated as "*superannuation income streams".*

This approach in the Paper appears to be unnecessarily complicating a system which we all acknowledge has advantages in simplicity.

The problems identified in the Paper in relation to "*superannuation income products"* include:

a. the need to design various rules around income stream products to constrain the earnings tax exemption available in pension phase;

b. The need for such a product to provide a minimum annual payment; and

c. Restrictions over variations in annual payments, residual capital value and commutation value.

The reference to designing rules around income stream products and to "constrain" the earnings tax exemption in order to facilitate the introduction of such products is alarming. It can be read as suggesting that Treasury is trying to build a case for removing or modifying the tax exemption on earnings in the pension phase. If this is the case it would be a major change of Government policy that, we suggest, is outside the scope of this Paper. It would be better looked at in the forthcoming Tax White Paper or in a separate review of the superannuation system.

The Interim Report of the Financial System Inquiry points strongly to the need for policy stability, noting that ad hoc changes to superannuation undermine confidence in superannuation as a long term savings vehicle. We have been arguing for a thorough review because we believe that the effectiveness of the current system can be improved. However, such review should be transparent, objective and rationally based with the system's long-term sustainability as a core objective.

The Paper also sets out on a complex and, in our opinion, unnecessary, discourse on how to provide for deferred annuities and what restrictions there should be on these. This further suggests that Treasury has an interest in controlling and prescribing the products in which superannuation in pension phase can invest.

We believe that the Government should place no more restrictions on term, lifetime or deferred annuities products available for investment by SMSFs and APRA-regulated funds than exist for other investment products such as shares and managed investment schemes..

Simply put – KEEP IT SIMPLE.

Further, we are strongly opposed to creating another privileged market for financial product providers in the pension phase. The Financial System Inquiry's Interim Report focussed on the lack of competition and relatively high cost of the APRA-regulated funds which benefit from compulsory superannuation contributions which for many Australian workers simply go into a default industry fund. A similar mandated market should not be created in the pension phase where there is currently an even lesser degree of competition and product choice. Government meddling in product design and regulation only adds to investment costs.

Therefore our answers to the first 11 questions in the Paper would be:

Q1: What types of income stream products would enable retirees to better manage risk in the retirement phase (in particular longevity risk and investment risk)?

SMSFOA: This question is wongly based and misleading. The words "*income stream"* should be removed from the question and then we would say that term, lifetime and deferred annuity products would be valuable in managing longevity risk. Management of investment risk is a very different question and is not the main focus of this Paper. However, our guiding principle would generally be that there is little need for new "products" which inevitably incur another layer of cost thus depressing returns, since sensible investment diversification provides a much better result.

Q2: 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?

SMSFOA: They may impede development of products regulated by SIS but do not as far as we are aware impede the development of such products to be universally available for investment by super funds and individuals. There are other more significant issues to be addressed regarding the development of such products as canvassed by the Financial System Inquiry (FSI). (See SMSFOS Submission to FSI Interim Report dated 26 August 2014)

Q3: 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?

SMSFOA: None as we do not see a need to accommodate a wider range of "*income stream products"* which seems a distraction given the growing significance of account-based superannuation funds. It is already open to the market providers to make a wider stream of retirement income products available to investors to complement account-based pensions. We are not sure what Treasury has in mind when referring to "abuse of the earnings tax exemption". The rules about access to tax-free pensions are clear and, if abuse is identified, the abusers should be dealt with under existing penalty regimes.

We certainly would be strongly against any Government rules being introduced that attempt to prescribe *"appropriate and prudent investment"* since Governments have not had a good track record in mandating investment strategies.

Q4: Would such changes lead to new products being brought onto the market?

SMSFOA: Not necessarily. It is up to providers to design and deliver products that they believe will cover any gaps in the market. We have discussed more significant issues in relation to the development of such products in our response to FSI Interim Report dated 26 August 2014 and would be happy to provide an extract.

Q5:Should people only be able to purchase a deferred lifetime annuity (DLA) with superannuation money?

SMSFOA: No, on the assumption it can be purchased by an SMSF, APRA-regulated fund or an individual. But neither should such a product have any special tax treatment beyond taxation rules applying to any investment product.

Q6: 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?

SMSFOA: The Government should not mandate how such products are structured or paid for. The consequences upon any cessation of premium payment is up to the market to determine and not for the Government to mandate.

Q7: Q8: Q9: Q10: Q11:

SMSFOA: No. See answer to Q6.

2 Minimum payment amounts for account-based income streams.

The following are the objectives of the minimum payment rules set out in paragraph 64 of the Paper:

a. To ensure account-based product is being used to provide an income stream in retirement;

b. Facilitate the provision of a steady level of income over time; and

c. Ensure funds are withdrawn from the concessionally taxed superannuation environment over time. That is, the minimum drawdown represents a minimum rate at which money held in an account-based product must be transferred out of the superannuation system either to be consumed or re-invested.

We understand (a) and (b) above which essentially cover the same point, though we point out that the current minimum withdrawal rules also apply to fund balances that have been accumulated as a result of <u>non-concessional</u> contributions and that this anomaly should be corrected, if possible.

With regard to (b), we do not see that it should be an objective of Government to mandate a steady level of income for a retiree over time. Government should not in principle interfere with people's lives unnecessarily and there may be many reasons people wish to have a more 'lumpy' withdrawal pattern. They should be allowed to do so within the overall concept that superannuation monies should be used to provide an income in retirement. It may be that, rather than an annual limit, a rolling limit of, say, three years would provide more flexibility for superannuants whilst retaining the overall objective that superannuation is paid out over the retirement period.

The charts are interesting but given the major assumption that *no allowance has been made for any offsetting rebound in equity prices after a GFC*, we see little added value in Chart 2 and it should not be used to direct any policy decisions.

Indeed, we have extensively modelled the impact of GFC on superannuation and believe that its impact has been dramatically overestimated by Government and the media.

The Paper may be falling into the trap of suggesting that short-term volatility in share prices has a significant impact on a retiree's income. In the context of the span of a retirement income scheme over the accumulation and drawdown stages, the duration of a GFC and its aftermath is comparatively short term so long as a fund has sufficient cash reserves to cover any dip in fund earnings.

The reality is that income from a diversified portfolio of shares does not fall nearly as much in a GFC as share prices. To manage GFC risk, a portfolio should be structured so that no shares have to be sold during a GFC in order to provide income to a retiree.

Consider, for example, a portfolio earning cash income (interest and grossed-up dividends) of 5% p.a.- that is being paid out to a retiree. In the last GFC income fell about 25%. Say this lasts 5 years before incomes are restored to their former levels. Then, simplistically, a retiree would need to top up his/her withdrawals from cash to avoid selling shares in GFC. The shortfall is 25% of 5% = 1.25%. Times 5 years is 6.25%.

This has been a very simple analysis but orders of magnitude would be correct. It suggests that someone withdrawing 5% p.a. needs to have a cash reserve of just over 6% to cover the impact of a GFC. This ignores any other reasons for holding cash or term deposits.

Another example is someone who only has enough super to last, say 10 years, before he/she has to go onto the Age Pension. Whilst a GFC would impact such persons more than the example above, unless they hold higher levels of cash, the level of the minimum withdrawal will not impact their behaviour. The level of withdrawal as a percentage of opening balance would be much higher than the minimum level specified by the Government, with or without a GFC.

So our view would be that the current minimum withdrawal levels for persons under 75 should not be a problem for a sensibly structured and managed portfolio.

As retirees get older, we understand why the Government has mandated increasing minimum withdrawals in order to maximise the use of superannuation to fund retirement. Theoretically, there should be nothing left in the fund when the beneficiary dies.

For retirees to manage GFC risk as they age, they would need to hold increasing levels of cash and term deposits if they need to continue to pay (a larger) minimum withdrawal without selling shares in a GFC.

Whilst in theory this would reduce returns, we do not believe that the level of cash and term deposits necessary to survive a GFC with higher withdrawals would in virtually all cases be higher than the level of cash and deposits such persons would prudently hold in their portfolio for investment risk reasons.

However, life-expectancy is only an estimate. Some retirees will die earlier and some will live longer.

Those who live longer may find the mandatory drawdowns have depleted their fund to the point where it doesn’t generate sufficient income to support them independent of the age pension, particularly where the cost of care may be higher in the latter stages of life.

There may therefore be a case for ceasing mandatory drawdowns when the assets in the fund have fallen to a certain level. This might be when the fund is reaching the point where it can no longer provide a pension greater than the Age Pension. This is consistent with the view we have previously expressed that lump sum withdrawals should not take the fund below the level where it cannot sustain a private pension equivalent to the publicly funded age pension. A level would be set at which further drawdowns would not be required.

Apart from this proposal and not applying the minimum percentage to funds derived from non-concessional contributions, we believe the current system is reasonable. On balance there are far more pressing issues regarding superannuation that should be addressed.

The other possibility is to perhaps allow funds at their discretion to recalculate the value of their fund balance (upon which such minimums are based) part way through a year, subject to audit, if there has been a dramatic depletion in fund balance (25% or more(?)).

Q12: Are the current minimum payment amounts for account-based products appropriate to achieve the objectives outlined above, given financial conditions can change?

> SMSFOA: Yes, though consideration could be given to have a rolling 3-year minimum rather than an annual limit to provide additional flexibility whilst retaining the need to pay out a minimum over time. Furthermore, it may be in the Government's interests for the minimum withdrawal to not apply if the balance in superannuation is inadequate to fund a pension greater than the Age Pension.

Q13: Should there be an automatic mechanism for adjusting the minimum drawdown amounts in response to significant adverse investment market performance?

> SMSFOA: No, but maybe a superannuant could have the discretion to recompute the fund balance on which the minimum is calculated part way through a year – subject to audit.

Q14: and Q15 - consequential.

Q16: What other issues need to be considered if the minimum drawdown amounts should fluctuate?

> SMSFOA: If possible, the minimum drawdown amount should not apply to funds accumulated from non-concessional contributions and earnings from them.