Discussion Paper: Social security means testing of retirement income streams

2 February 2017

AIST Submission

AIST

The Australian Institute of Superannuation Trustees is a national not-for-profit organisation whose membership consists of the trustee directors and staff of industry, corporate and public-sector funds.

As the principal advocate and peak representative body for the $700 billion profit-to-members superannuation sector, AIST plays a key role in policy development and is a leading provider of research.

AIST provides professional training and support for trustees and fund staff to help them meet the challenges of managing superannuation funds and advancing the interests of their fund members. Each year, AIST hosts the Conference of Major Superannuation Funds (CMSF), in addition to numerous other industry conferences and events.

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1 Executive summary

In brief:

AIST considers that the role of social security in prioritising Comprehensive Income Products for Retirement (CIPRs) as recommended by the Financial System Inquiry needs to be addressed in this discussion paper. We believe that the focus on neutrality is not properly reconciled with Government policy and our submission points out that people should be compensated for trading in flexibility.

AIST welcomes this discussion paper from the Department of Social Services which seeks to review means test rules for retirement income streams. We note that this paper takes a principled approach to retirement income streams but has removed Government retirement income policy from the scope of the paper. We believe that this is regrettable, as stakeholders in the financial services industry require the certainty that would be provided by reconciling the principles of neutrality, equity, resilience, integrity, fiscal sustainability and simplicity with the role of social security in achieving the Government's policy on implementing Recommendation 11 of the Financial System Inquiry.

The Government has agreed to implement this recommendation as a pre-selected strategy for retirees. We maintain consistently throughout this submission that where Australians are likely to trade in some flexibility for the enhanced features that newer, innovative income streams will provide, then it is the role of either social security or tax to provide the incentives needed to justify this trade-in. The discussion paper is silent on the role that social security means testing plays in implementing this policy, and we consider that this has reduced its utility. AIST recommends that this role be spelled out to provide certainty for the industry.

AIST is also concerned that some of the proposals in this discussion paper appear to have the unintended consequence of reducing age pension eligibility and points out that we do not support means testing being misapplied to support Budget outcomes.

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2 Introduction

AIST's vision is for a better retirement future for all Australians. The concepts of fairness and adequacy are encompassed within advocating for a 'better retirement future'. To achieve better retirement futures, AIST strongly supports the three pillars of government pensions, mandated superannuation, and voluntary savings. In this respect, a recent comment from the OECD is relevant: "Funded private pension arrangements are complementary to public pensions and not a substitute. The growing importance of funded pension arrangements has been in general to complement PAYG-finance arrangements, becoming a component of overall retirement income."[1]

Given the importance of both the first pillar (government pensions) and the second (mandated superannuation), it is important that all pillars are considered when examining the question of whether the system delivers a good retirement future. The consideration of appropriate means testing needs to balance on a very fine line between policy considerations and priorities on one hand, and appropriate social security treatment of different retirement products on the other. Government policy, which is to encourage retirees into innovative new retirement income products must be balanced against an accounting-like commitment to means testing neutrality so as to ensure that access to the age pension is reserved for those who need it.

The context of this discussion paper is Recommendation 11 from the Financial System Inquiry, which the Government supported. Recommendation 11, which required trustees to pre-select a comprehensive income product for members' retirement (CIPR), was agreed to by the Government, together with a commitment to reduce impediments to product development. In this case, products being developed are aimed at better protecting members from longevity risk, as well as other risks.

When examining the concept of a CIPR, AIST strongly advocates the following:

- All pillars must be taken into account.
- The concept of fairness must also be taken into account, including the possibility for social security arbitrage.
- Members have different retirement needs, and accordingly both superannuation funds and members must have flexibility so that products may be developed to match member demographics and needs.

[1] OECD (2016), *OECD Pension Outlook 2016*, page 33.

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We noted in submissions to Treasury as part of the retirement incomes review, that the desire for flexibility represented for the most part, an aversion by investors to mortality and liquidity risk, as well as awareness of consumers' rights to change providers or exit entirely. A policy consideration would be to ensure that investors are therefore properly compensated for trading in part or all of this flexibility. Such compensation could come through the tax system, the social security system or through product features themselves. We are mindful that this discussion paper is limited to social security solutions only.

However we are also mindful of the requirement to ensure that different retirement options are treated appropriately in order to reflect the paper's focus on neutrality. AIST applauds the focus on neutrality: we believe that it is essential to avoid "social security arbitrage", where products or individuals are able to game the social security system.

We are not necessarily convinced that this paper has succeeded in drawing these two competing aims together well. Although we would agree that there is scope to ensure that these principles could be modified to allow for policy priorities, it needs to be spelled out what form this will take on. This should also be the case, even if this is out of scope of the discussion paper: For example, if it were the case that the changes to the taxation integrity approach to retirement income streams was the only way these products were to be prioritised (and not through social security means), this should be stated.

In addition, we believe that considerable attention needs to be paid to the behavioural outcomes that the treatment of retirement income will deliver. We are already aware of research that indicates that the value of eligibility for the age pension appears to be considerably more than its actual monetary value, due in part to additional benefits derived such as health care cards and concessional public transport, but no doubt also the provision of the peace of mind that the age pension provides.

Changes to the means test treatment for the age pension will almost certainly affect the take-up (or otherwise) of different retirement income products, and this must be considered. If it were the case that means testing product neutrality were to have the effect of driving consumers towards inferior products, then this must be re-thought. We would also urge policymakers to more strongly consider the strength that age pension eligibility plays as a policy lever: our general impression is that this has been underestimated in compiling this discussion paper.

In its response to the Financial System Inquiry, the Government agreed that it would facilitate trustees in pre-selecting CIPRS for their members. Noting that a one-size-fits-all approach would not be appropriate for all members, this approach means that a pre-selected option could be built

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that would satisfy the bulk of members' needs. However, even this act of pre-selection will drive member behaviour and for an expected minority of members, this may be into an option which is sub-optimal for a number of reasons. AIST makes this comment in passing, and are not aware of any potential solutions to this problem.

A final comment regards the notion of "diminishing (or declining) capital access schedule". Regulations defining how this notion is to work have not yet been issued, and therefore, there will be times in this submission where our best guess has been applied in responding to questions. It is hypothetically possible that once this term has been formalised, our responses may be different, and we would recommend that an additional round of consultation be undertaken in order to ensure that erroneous assumptions are properly dealt with in a timely fashion.

Having said that, we believe that we are in a position to respond to most of the questions asked in the discussion paper.

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3 Response to discussion paper questions

3.1 Part E: The current approach to means testing retirement income streams

Question 1: *Given the shortcomings identified above, what changes should be made to improve the means test rules for existing income stream products to ensure that they meet the policy principles of neutrality, equity, resilience, integrity, fiscal sustainability and simplicity?*

The paper notes that the existing treatment of account-based pensions is appropriate. We agree with this assessment, noting that there is little difference functionally between an account-based pension and a non-super equivalent such as managed investment funds. However, we point out that this treatment should be considered a baseline for alternative treatments, rather than a re-imagining of different retirement income features and benefits.

The central premise of paragraphs 30-32 is that the assets test assessment of lifetime income streams is highly concessional beyond life expectancy. This does not recognise that half the population are not expected to reach this point and will never receive the benefit of this concessional treatment. Nor does it consider that up to the point of life expectancy, the population who outlive life expectancy have not yet received this additional concessionality. Finally, it fails to consider that at the point of life expectancy, the population who continue living are statistically only likely to live on for a relatively short time. We do not agree that a sustainable case has been made to reduce the concessionality of benefits for this part of the population.

The discussion paper points out (in paragraphs 33-37) that, for term annuity products, the existing straight line deduction of the purchase price is slightly generous – particularly for inflation indexed annuities. This is because on an amortisation schedule, capital is repaid less in the early years rather than the later years. We agree that this is technically correct but consider that the existing method should be retained because of its simplicity and intuitive appeal. We further note that in taking out a product of this nature, an investor has traded in flexibility for a regular fixed income payment schedule. Finally, we note that treatment along these lines would result in a higher aggregate asset test withdrawal rate over the population over the same period. AIST does not support the social security system being misapplied by Government in order to balance the Budget.

We note that paragraph 38 considers the problem of measuring the value of non-account-based income streams and provides an alternative method, based on net present value. We are

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concerned that multiple values (and unfamiliar terminology) will confuse consumers and increase their reluctance to use products which can help manage longevity, market and adequacy risks. In addition, we note that for some income streams, the use of a new figure to derive a value for means testing purposes has the net result of inflating interest rate risk, particularly if such an approach results in new values whenever the appropriate reference rate is reset. Whilst we would prefer the one value to be set as at the end of the year when members provide information to Centrelink or the Department of Veterans Affairs, we doubt whether the costs and confusion associated with such a change would provide the benefits associated with the present system. Further, any method based on net present value is likely to be non-transparent and non-intuitive.

Similarly, in light of the confusion outlined above in the previous paragraph, we agree that a review of terminology is prudent. However, as discussed above, we are uncertain as to whether we can fully comment on terms such as "residual capital value" in the absence of regulations which specify the "diminishing capital access schedule". We believe that the proposal to broaden definitions as discussed in paragraph 39 should be re-addressed once regulations are available to better enable judgement.

Finally, we note the proposal in paragraphs 40-41 which would increase the amount of income over time from non-account-based income streams to reflect a reducing capital value in income payments. Our position on this is similar to our response to paragraphs 33-37, noting that there would clearly be an increase in assessed income across the board. AIST re-iterates our opposition to means testing being misapplied in order to achieve Budget outcomes.

Question 2: *What changes, if any, are necessary to ensure a sound foundation for new rules to assess innovative income streams?*

AIST urges Government to undertake consultation on regulations outlining the "diminishing capital access schedule" as this is necessary to ensure appropriate consideration of policy with respect to innovative income streams.

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3.2 Part F: Possible directions for means test rules to assess new products

3.2.1 Assessment once a deferred product commences making payments

***Question 3:** What approach is most appropriate to income and assets testing for income streams **during the deferral period would best meet the policy principles** of neutrality, resilience, integrity, fiscal sustainability and simplicity?*

As we indicated in our introduction, this discussion paper needs to state the role of social security in meeting the Government's intended policy position on Recommendation 11 of the Financial System Inquiry.

During the deferral period of a deferred annuity, a member does not have access to the account (above any applicable withdrawal benefit) nor is there a benefit payable on death (above any death benefit). We note that in social security law, the proceeds of insurance policies are not generally assessable until they are actually paid.

This provides a valuable template for how the income or assets test might work. We would therefore agree generally with the sentiments illustrated in paragraphs 49-50 where the investments are treated like insurance. There may be, however complications in that products may, in the future, cater to their members' desire for flexibility by offering withdrawal and/or death benefits payable during the deferral period prior to vesting.

We would recommend that to the extent that withdrawal and/or death benefits are available during the deferral period, ordinary means testing should apply. This should be assessed at the greater of these benefits, if they are of different values.

However compensation to the member for lack of flexibility and quarantined capital/deferred consumption, could come in the form of a concession or an exemption to the extent that there is no withdrawal benefit or death benefit payable during the deferral period. This could be based on a variety of methods, where examples might include concessions or exemptions which could apply depending upon, for example:

- How much of the product remains unavailable until vesting;
- The first $50-$100,000 of the purchase price; or
- A partial amount corresponding to half the unavailable portion, shading out along a straight line to zero when fully vested.

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Whilst we agree with the general sentiments of paragraphs 54 and 55, if appropriate compensation is not provided for limiting flexibility, investors may consider these limitations sufficiently unattractive to prevent purchase and usage. We take this opportunity to note that opportunities to use tax as an incentive are not available, and we are not presently able to say whether product features will be mandated that act as incentives, implying social security is the only policy lever available.

In this context, we would recommend that such incentives be capped at a set dollar figure so as to limit misuse by wealthier retirees, financial planners or financial product manufacturers and agree fully with the integrity and equity principles as proposed on page 3 of the discussion paper.

Question 4: *On what basis should deferred income stream products be assessed* ***once they have commenced providing payments****?*

a. Which approach to establishing an assessable asset value best meets the policy principles of neutrality, equity, resilience, integrity, fiscal sustainability and simplicity?
b. How should income be assessed?

We believe that these products may be assessed similarly to existing products once payments have commenced for both assets and income purposes. Products should be relatively easy to classify as account-based or non-account-based products for the purposes of assessment, noting that an imputed purchase price at the commencement of payments for deferred life annuities would be conceptually similar to current treatment of immediate life annuities involving the purchase price.

Question 5: *Are there other approaches or issues regarding the assessment of income streams with a deferral period that have not been canvassed above that it is important to consider?*

AIST makes no comments in direct response to this question, however takes the opportunity to remind the Department that the Government's response to Recommendation 11 of the Financial System Inquiry was designed to guide members of super funds into products that would better manage risks in retirement, including longevity risk.

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3.2.2 Assessing complex and hybrid products

Question 6: *Does assessing the actuarial value of complex and hybrid income stream products provide the most suitable approach to ensuring that the rules for these products satisfy the policy principles of neutrality, equity, resilience, integrity, fiscal sustainability and simplicity?*

In our response to Question 1, we considered actuarial valuations such as net present value, noting that a variable reference rate (e.g. bond rate, RBA cash rate, BBSW etc) may generate frequent revaluations and have the effect of magnifying interest rate risk. This volatility could mislead consumers who would likely have chosen regular, predictable payments in preference to such volatility. We also note a preference for implementing simple valuation processes which help funds achieve economies of scale.

Question 7: *Would assessing these products in terms of their individual components better achieve these objectives? Are there circumstances in which this approach would be problematic?*

AIST would support deconstruction of complex products into simpler products wherever possible in the interests of simplicity, transparency and means test parsimony. Where products are unable to be broken down, an actuarial valuation may be the only available option, however we believe that these will be exceptions as components should be able to be described in broad enough terms to be assessed separately.

Question 8: *Is there a need for a determination process to provide binding advice on the treatment of particular income stream products? Would this assist in the development of innovative retirement income products?*

AIST believes that determinations of products should only be used as a last resort. Appropriately drafted policy should negate the need for binding advice, however we support the certainty that binding product rulings provide to providers and consumers alike.

Question 9: *Are there other approaches or issues not canvassed above that it is important to consider?*

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AIST makes no comments in direct response to this question.

3.2.3 Ensuring definitions adequately capture product complexity

Question 10: *Are there current legislated definitions relating to income stream products that create ambiguity regarding means test treatments?*

We believe that the definitions associated with the current rules are adequate.

3.2.4 Interactions with the targeting of other social policy systems including residential aged care

Question 11: *To what extent are interactions with means testing for other social policy systems, such as residential aged care important to the development of retirement income products?*

We believe that the development of retirement income products is likely to have positive interaction with aged-care support programs (e.g. lump sums for home improvements to enable continued living in home, additional income to pay for regular assistance) rather than residential aged-care facilities primarily because the latter usually requires very large sums that may only be funded personally.

AIST considers that any changes made to social security treatment of income streams needs to consider the impact it would have on aged care fee calculations. Additionally, where funds cannot be accessed during deferral periods, the impact on Australians who need to move into an aged care facility must also be considered. Finally, as well as funds being available on death could they become available to purchase a Refundable Accommodation Deposit into an aged care facility?

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