ASFA Submission to the Department of Social Services on the social security means testing of retirement income streams

February 2017

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About ASFA

ASFA is a non-profit, non-political national organisation whose mission is to continuously improve the superannuation system so people can live in retirement with increasing prosperity. We focus on the issues that affect the entire superannuation system. Our membership, which includes corporate, public sector, industry and retail superannuation funds, plus self-managed superannuation funds and small APRA funds through its service provider membership, represent over 90 per cent of the 14.8 million Australians with superannuation.

ASFA welcomes the opportunity to provide a submission in response to the discussion paper that was sent to key peak bodies and stakeholders on 22 December 2016. ASFA agrees that the social security means test treatment of retirement income streams and longevity products is an important issue. Fair treatment and clarity of treatment are required for both existing and any new retirement income products. Given that most retirees will continue to rely on the Age Pension to some degree going forward it is crucial that means testing for social security purposes does not unduly impede the development of innovative retirement income products or their takeup by consumers. Preferably the development of such products should be supported by equitable and administratively feasible means test arrangements.

If the policy intent is that people should spend their savings during retirement (for the benefit of the economy as well as supporting a better standard of living) rather than using it as a tax concessional bequest, then it is important to make sure that the products providing people with the confidence to spend are not impeded by policy. Indeed they may even need to be slightly favoured to encourage their use given the risks involved (for example, receiving relatively few benefits and no return of capital if the product holder passes away before average life expectancy).

In circulating the discussion paper it was noted that this is a complex area. In this context ASFA notes the relatively short time frame for submissions from stakeholders.

As well, the scope of the consultation is relatively broad, including assessing "whether the means test rules for existing types of products are fit for purpose, and address[ing] any weaknesses in the current rules to ensure an effective and appropriate means test treatment for all retirement income streams into the future".

While it is claimed that this latter process will provide certainty for industry, it could be argued that such a review in effect puts under a cloud the future offering of certain types of retirement income products currently in the market. It also generates uncertainty for current holders of certain retirement income products, many of whom may have already been affected by the changes to the asset test that came into effect on 1 January 2017.

ASFA appreciates the desire of government for the new superannuation rules to take effect from 1 July 2017 in order to support the offering of innovative retirement income stream products, including products that could be described as CIPRs or MyRetirement. In that context ASFA has consulted with its members to the extent possible in the time allowed and provides below detailed comments on the material in the consultation paper and responses to the questions posed.

It should be noted that if an unsuitable approach is taken to the means testing of innovative retirement income products the takeup rate for such products might be negligible and having in place by 1 July 2017 rules for their introduction might be largely fruitless.

In this context ASFA would be willing to assist the Department convene a roundtable with stakeholders in order to progress development of appropriate and workable means test settings following the receipt of submissions by the Department.

Objectives of the social security means test

While it would be hard to disagree that the primary policy objective of the means test is to equitably and fairly target income support to those people who are most in need, what this means in terms of actual design and operation is more debatable.

Over the decades the role and structure of the assets test has varied considerably. At times its role has been to require individuals to draw down on assets above a certain amount rather than receiving Age Pension. In other cases the aim has been more to deem income from assets in order to provide equivalent treatment of individuals regardless of how they have decided to invest their assets. Taper rates have at various times been decreased and increased. Thresholds for the asset test have also been substantially revised, both upwards and downwards, over the decades. The asset test has even been discontinued at some points in the past, particularly for older retirees.

International practices also provide limited guidance on optimal means test design, particularly as in most countries government income assistance to the aged is not means tested.

A further issue is in regard to what outcomes would be consistent with fiscal sustainability. Projections, including those in the Intergenerational Report and in OECD international comparisons, show expenditure on the Age Pension in Australia is fairly static in terms of share of GDP. As well, government support for incomes of the aged (both Age Pension expenditure and tax concessions for superannuation) as a percentage of GDP is at one of the lowest levels, if not the lowest level, amongst both developed and developing countries. Fiscal sustainability is not necessarily a compelling argument for any further tightening of the means test for lifetime or term annuities. Takeup rates for new longevity products also are likely to be modest, which would further act to constrain the fiscal impact of any increased Age Pension payments.

Fiscal sustainability also essentially is a long term issue. Policy measures which might lead to slightly higher Age Pension expenditures in the near future but lead to lower Age Pension expenditures in the decades ahead, when there will be increased pressures from an ageing population structure, could be seen as being more fiscally sustainable than policies aimed solely at reducing expenditures over the current Forward Estimates period.

ASFA considers that it would be desirable for the overall framework of the means test for the Age Pension to be comprehensively reviewed, preferably in the context of the next Intergenerational Report. Prior to the completion of such a comprehensive and holistic review there should not be further adverse changes to the asset test treatment of retirement income products.

Performance of the current means test rules

ASFA agrees with the consultation paper statement at paragraph 27 that the current means test settings for account based income streams are broadly appropriate. However, there can be debate about whether both the threshold for the asset test and the taper rate for reducing the Age Pension are appropriate given the impact they have on the incentive to save for retirement.

ASFA does not accept the assertion in the paper that the current assets test assessment of lifetime income streams (lifetime annuities) is highly concessional beyond life expectancy.

There are a number of problems with the comparisons made in Chart 1.

A major limitation of the comparison is that the assumed investment earnings rate is a steady 6.6 per cent a year compared to an implicit rate of investment return for annuities of less than 3 per cent a year. The comparisons also assume very different patterns of drawdown. The assumed payment rate for a life annuity is also low relative to current market rates. A current purchaser of an indexed life annuity who is male and is aged 65 can receive a payment of $5,004 in the first year for an inflation indexed life annuity.

If a proper comparison were made using comparable investment returns and drawdown rates, the assessable asset value of the account based income stream would drop consistently from year one onwards and would be likely to be mostly exhausted by the time the account holder was in their 90s. Assessable income also would fall from year one onwards. This would be particularly the case if the account holder were subject to very low or negative investment returns in the early years of their retirement.

Clearly, if an account holder could receive a guaranteed rate of return for an account based product of 6.6 per cent a year there would be much lower demand for life or term annuities with a much lower implicit rate of return. However, one of the main points of purchasing a life or term annuity is to lock in a set investment return, albeit one that might be lower than that could be obtained from a more volatile investment portfolio with a higher rate of return on average.

If the amount of income generated and capital drawdown for each type of product is added up for each of the examples and compared to the assessed amounts in each case for the Age Pension it can be seen that current means test treatment of the various products is broadly comparable. The fact that the holder of the account based income stream receives less Age Pension at various stages is a function of the assumed higher investment return for that product and the slower drawdown of capital that is assumed. As a result, in Chart 1 in the paper the holder of the account based income stream is a net saver until age 80.

Apart from the shortcomings of the comparison between various product types made in Chart 1, the paper also confuses the average treatment of holders of lifetime income streams with the outcome for certain (but not all) outliers in terms of payments received. The paper adopts what is in effect a "heads I win, tails you lose" approach.

For males currently aged 65 only 4 per cent will reach age 98 while for females the figure is 8 per cent. On the other hand, for those currently aged 65 by age 70 some 6 per cent of males and 4 per cent of females can be expected to have passed away. In these latter cases the amount able to be claimed as drawdown of capital will be far less than the purchase price of a life annuity. If the claim at paragraph 31 that the treatment of those who live beyond life expectancy is very concessional is accepted, the counterpoint is that the treatment of those who do not live to life expectancy is punitive and should be fixed. However, as a pooled product the drawdown amount for a lifetime annuity can only be assessed on the basis of the applicable average life expectancy. An individual does not know and cannot know what their lifespan will be at a given age, such as age 65.

The comparison made between the drawdown rates for a term annuity with a term around life expectancy and what in the example is a pure life annuity without a death benefit or other residual value is similarly misleading. If a holder of a term annuity dies prior to their life expectancy payments will continue to the estate of the product holder. In the case of the life annuity described payments cease on death.

It also should be noted that if the objective of the asset test is that people with substantial assets use these to meet their day-to-day living expenses, this objective is well met by both term and lifetime annuities which require a drawdown of assets.

A suitable approach would be to regard the calculated return of capital amount in the asset test for life annuities as being fair on average, neither concessional or non-concessional. Purchasers of life annuities know the characteristics of the product and are willing to balance possible “poor value” if they do not live long with possible very good value if they live to an advanced age. ASFA suggests that a similar approach be taken to the return of capital calculation in the means test for life annuities. However, as indicated in the answer to Question 2 in the consultation paper, there may be a case for making use of life expectancy figures which are relevant to purchasers of annuities in the calculation of return of capital amounts.

The principles of neutrality and equity support the assessment of drawdown of capital being based on average life expectancy of annuity purchasers rather than the relatively long period that a small minority of product holders will live. Integrity of the social security system is maintained as product purchasers do not know how long they will live.

Should the capital reduction rules for the assessable value of income streams be on a straight line basis?

It is a generally accepted principle for social security means testing and taxation treatment of income stream products that allowance needs to be made for the part of payments to the product holder that relate to the return of the original capital investment. In a similar way, a bank account does not retain its original account value if a withdrawal is made which is greater than the interest earned in the relevant period.

Important considerations should include striking an acceptable balance between simplicity and accuracy, and consistency with taxation relating to taxable income stream payments.

The illustration of an alternative approach at paragraph 36 of the paper is both much more complex and more inaccurate than the current straight line approach.

As explained earlier in this submission, the appropriate period for adjusting the purchase price is the relevant estimate of life expectancy. Life expectancy at age 90 is much less than 10 years. As well, in a low interest rate environment a reduction of only 1/55 of the purchase price in the first year would be very inaccurate. The formula suggested appears designed to artificially load any reductions in capital value to the out years. Reversing a formula that could be used for accelerated depreciation in essence introduces a penalty or disincentive. No policy reason is put forward for why the capital reduction should be artificially reduced in the early years of the term of an annuity or like financial product:

- It would be counter to the principles of neutrality, equity and simplicity put forward in the paper.
- It would also be counter to fiscal sustainability as it would lead to higher Age Pension payments in future decades when there will be increased pressures on the Budget from an ageing population structure.

The alternative suggested, requiring product providers to produce an ongoing actuarial valuation of income stream products would be complex and expensive and would introduce inconsistencies between tax and social security arrangements. ASFA is not aware of any other jurisdiction to adopt such an approach, which ASFA suggests is because of good reasons not to (added complexity, potentially less scalable solutions, difficult for consumers to understand etc).

Current definitions used by the assets test and product characteristics such as death benefits

The consultation paper at paragraph 39 asserts but does not demonstrate that the current definitions used to assess residual capital value may not fully capture amounts characterised as death benefits or other insurance-like features.

ASFA considers that definitions should be suitably broad in order to support product innovation rather than being resilient to future product innovation.

Residual capital value, as defined by the Social Security Act s9(1), "means the capital amount payable on the *termination* [italics added] of the income stream." The consultation paper contends that such definitions may be too narrow, and may create opportunities to arbitrage the rules to maximise income support. ASFA would support inclusion of a commutation or capital value for non-account based income streams where this would be available prior to termination of the income stream (or life expectancy in the case of income streams that do not contract for a Residual Capital Value (RCV) on expiration). However, if the payout value of an insurance-like feature of a retirement income stream product was to be included as an asset value for the means test, the principles of equity and neutrality would require the payout value of all life insurance policies held by an individual to be included as an asset. Therefore, including a contingent payout for an insurance product is not a sensible approach.

Income test deduction amounts for return of capital for non-account income stream products

As previously demonstrated in this submission, it is appropriate to apportion the initial purchase price over either the fixed term of the product or relevant life expectancy. While some individuals will live beyond the relevant life expectancy, an equal number will die before the average life expectancy for a person with their age at the time of the purchase of the product. The latter group by definition never fully deduct the capital value of the income stream product.

The current treatment accordingly is fair, equitable and neutral, not a weakness. The proposal to cap the maximum aggregate value of deductible amounts at the nominal value of the purchase price means that on average the initial value of life annuities would never be fully deducted across the holders of such products. In effect, on average the purchasers of non-account income streams would be penalised relative to other income stream products.

There is a policy case for consistently aligning the reduction of the assessable value for the assets test and deduction amounts for the income test. However, this should not be done, as proposed in the consultation paper, to consistently penalise holders of non-account income stream products.

Questions for discussion posed in the paper

Question 1

ASFA does not accept that shortcomings of the means testing of term and life annuities were identified by the paper. As explained above, in ASFA's view the analysis in the paper contains a number of errors and incorrect assumptions. Current means test parameters are broadly appropriate in terms of neutrality, equity, resilience and integrity and are fiscally sustainable. Proposals for change in the paper generally do not meet either one or all of the policy principles of neutrality, equity, resilience, integrity and simplicity. The proposed changes also would have a substantial detrimental impact on the attractiveness of annuity and other longevity products.

Question 2

While not specifically canvassed in the paper, one change that would help provide a sure foundation for new rules to assess innovative income streams would be to adopt life expectancy figures for annuity purchasers, rather than for the population generally.

Individuals who know they have a low life expectancy because of medical or like reasons generally will not purchase annuity products. Using a longer life expectancy figure would slightly reduce the capital deduction or return of capital amounts in the means test calculations for annuity products.

Care should be taken that equivalent treatment is given to like products. For instance, the means test treatment of an individual who has an interest in a group self annuitisation product should be the same as that for an individual with a deferred annuity with equivalent key product features.

Possible directions for means test rules to assess new products

At paragraph 43 the paper notes that the new superannuation rules will aim to encourage innovative retirement products to be brought to market, providing more options for retirees.

It would be unfortunate if means test settings for the Age Pension rendered some or all innovative retirement products relatively unattractive or not viable. Many potential purchasers of innovative products which deal with the financial consequences of longevity are likely to be in asset or income bands to which the means test for the Age Pension applies. In contrast, those with low retirement savings are likely to rely on the Age Pension to deal with longevity while those with substantial financial assets are likely to be more interested in estate planning than dealing with longevity through purchasing a financial product with insurance or risk sharing characteristics.

It will be important for the special characteristics of any innovative products to be taken into account, especially when there is no or limited access to capital during the term of the period. Applying an approach supposedly equivalent to that for account based income streams is punitive when it is not possible to draw down on capital to meet short term income needs.

The discussion paper falls into error at paragraph 49 where it is asserted that insurance bonds have similar characteristics to deferred annuities and like products. Insurance bonds if not accessed until their full term have special taxation treatment but capital access is possible at any stage. This will not generally be the case with deferred annuities with the proposed rules for such products not allowing any commutation beyond the life expectancy of the purchaser. Accordingly, the means test treatment of insurance bonds should not be the benchmark for the treatment of deferred annuities.

Similarly, the argument at paragraph 54 that there is a risk that individuals could use the mechanism of deferred annuities to fund bequests is very strained. It is difficult to think of a product less suited to maximising bequests than a life or deferred annuity.

The lack of access to capital is a very relevant consideration in regard to the appropriate asset test treatment of a retirement product. Defined benefit pensions, which are paid to hundreds of thousands of individuals who are currently retired are income rather asset tested for this very reason, not because as suggested by the discussion paper defined benefit funds are largely closed to new employees.

The current quite high rate of reduction of Age Pension once the applicable assessed asset threshold is reached is posited on the individuals affected being able to draw down on capital to make up for the foregone Age Pension. This is not possible when the product concerned is not commutable. There is a strong argument that the asset test treatment of deferred annuities and defined benefit pensions should be equivalent.

Paragraph 55 is also misleading in asserting that an exemption from the asset test necessarily detracts from the equity, neutrality and integrity of the means test. What is important is whether an exemption is appropriate in the context of the characteristics of the financial product concerned. Public sector defined benefit pensions are exempt from the asset test and this does not necessarily detract from the equity, neutrality and integrity of the means test.

In the context of the argument in paragraph 56, ASFA agrees that it is important to recall the fundamental policy objective of the means test, which is to assess a person’s overall capacity for self-support and target social security expenditure according to need. Where there is no access to capital and no death benefit, the means test treatment should not be designed to supposedly require the product holder to draw down capital from the product to meet living expenses.

To impose an asset test on assets that, for instance, will never be accessed by up to 50 per cent of the product purchasers (because they do not live beyond the applicable average life expectancy) would detract from the equity and neutrality of the means test. It would also render the sale of such products financially unviable. For instance, the purchase by a person aged 65 of a deferred annuity at a cost of $100,000 would lead to a reduction in Age Pension payments of $7,900 a year initially, with further substantial reductions (depending on the capital reduction method adopted) for a period of nearly 20 years under most of the options canvassed in the discussion paper.

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

An approach which would balance the various policy principles might be along the following lines.

Asset test treatment

If an income stream product has a period during which income is deferred the capital value for means test purposes should be the upper of the commutation value offered or death benefit. If, like a defined benefit life pension, there is no ability to access the capital behind the product, then that amount of capital should not be assessed in the means test. The principle put forward in the discussion paper is that the asset test is designed to encourage individuals to draw down on their capital when it is above a specified amount. This principle should be applied as uniformly as possible. This means that where access to capital is not possible the product should not fall within the net of the asset test.

By definition, if capital cannot be accessed by commutation or by a death benefit then the product's capital is not being used for estate planning purposes.

Income test treatment

During the deferral period by definition no income stream is being received by the product holder.

The discussion paper suggests that the Department is not necessarily convinced that a complete exemption is appropriate. If there is any proposal to income test a longevity income stream product during the deferral stage ASFA suggests that such a suggestion should be tested by an industry consultation group along the lines suggested earlier in this submission.

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?

The appropriate approach to assessing income stream products once they have commenced providing payments will necessarily depend on the approach taken before they have commenced payments.

On the basis that a deferred income stream product was not asset or income tested prior to the income stream being paid (other than in regard to any commutation or death benefit value), ASFA considers that the means testing can in effect start anew. That is, there should be an asset valuation of the income stream as at the date of its commencement. This might require an actuarial valuation but the alternative would be to assign a value that equals the market price for purchasing an immediate life annuity or other equivalent income stream to that provided by the product once payments commence.

Deductions from capital value to reflect reduction of capital and from benefit payments to reflect return of capital could then be made in accordance with the applicable life expectancy of the product holder at the time the benefit began to be paid.

Rather than a host of new rules being needed, in effect only a new valuation would be needed at the commencement date for the benefit.

It also would mean that the total amount of capital reductions and returns that were made use of would equal the capital value of the product over its life, rather than being more or less.

This method would also take into account the increase in the value of the capital backing for the product due to investment returns and the “mortality dividend” from individuals who pass away before the qualifying age or other qualifying circumstance for a benefit payment.

If a product were asset tested from the date of its purchase it would be inappropriate to set a new higher asset value at the date deferred benefits began to be paid. More specifically, if the capital value of the product had been reduced to zero over the deferral period a zero capital value would be appropriate when income payments to the product holder commenced. This would not be a concession, rather an acknowledgement that the Age Pension for product holders during the deferral period had been substantially reduced by the asset test.

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?

ASFA does not wish to raise any issues in addition to those that have been raised above in this submission.

Assessing complex and hybrid products – questions 6 to 9

ASFA would support a principles based approach in which income streams generally would be accounted for in terms of their individual components, but which offers the option for providers to seek agreement to a comprehensive annual actuarial evaluation of the product where they believe that this would better reflect the nature of the product. It should be left to product providers to decide what would be the most cost effective and appropriate approach for each particular product.

A determination approach to provide binding advice on the treatment of particular income stream products, with appropriate avenues for review, could be of assistance to product providers in terms of providing greater certainty. However, it should be left to product providers to decide whether to apply for such a determination.

A public register of any determinations might assist the overall development of innovative retirement income streams in terms of supporting competition and also providing an indication of the likely treatment of products similar to those which have already received the benefit of a determination.

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

ASFA considers that the main source of current ambiguity regarding the means test treatment of products with deferred benefits is that there is not currently specific recognition in the means test for deferred annuities, group self annuitisation, and like products. If means test provisions along the lines suggested above by ASFA were introduced then the current ambiguities would be largely removed or would be inconsequential.

Question 11

ASFA agrees that interactions with means testing for other social policy systems, such as residential aged care, are important for the development of retirement income products.

This will especially be the case with products designed to deal with the financial consequences of longevity. Typically, takeup of residential aged care increases markedly for persons in their 80s or 90s.