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First State Super – Submission

Social security means testing of retirement income streams

Department of Social Services Discussion paper, published December 2016

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1. Introduction

As one of Australia's largest superannuation and retirement incomes funds, First State Super is responsible for the accumulation and pension savings of over 770,000 members, managing $78 billion in funds (including StatePlus) of which $22 billion are retirement assets. On 6 June 2016 First State Super successfully acquired StatePlus; the combined group has over 200 financial planners.

We naturally have a strong interest in the financial future of our members, the people whose lives are often dedicated to helping others – nurses, teachers, emergency services workers and public servants. First State Super is committed to its member community and to the national interest as we believe both are intrinsically linked.

2. Design principles

We support the Department of Social Services' focus on the social security rules being guided by its six principles of neutrality, equity, resilience, integrity, fiscal sustainability and simplicity. We acknowledge that in practice these principles are often in tension and the task of designing means testing involves seeking an acceptable balance between competing considerations.

We submit that the process of finding the acceptable balance, and making the necessary trade-offs, is meaningfully and helpfully informed by placing it in the context of the broader retirement incomes system.

3. Relevance of incentives in superannuation and retirement

The superannuation and retirement system

We note that Australia's population is living longer, which is a great achievement of economic, health and social policy; however, increased longevity also presents significant social and economic challenges. This is especially the case with respect to public expenditure on the Age Pension, health care and aged care over coming decades when relatively fewer people will be working and contributing to government revenue through taxes, increasing financial pressure on the national economy.

As Australia's retirement income system matures, it will be based increasingly upon individuals' long term savings and superannuation, which already bear market, inflation and longevity risks. We acknowledge that many Australians, including a large majority of our members, will continue to rely to some degree on the Age Pension. Our communications are increasingly designed to encourage members to take up income streams, as even a small income stream added to the Age Pension improves an individual's standard of living.

Members' needs and attitudes

Good outcomes for individuals and the economy will rely to a degree on appropriate product design by funds (and to a degree by regulators) and on sound decision-making by individuals. Product development and innovation is essential to ensure there is a range of products to assist retirees in managing these risks, while catering for their different needs and preferences. The design of these products, their interaction with the social security system, and how they are communicated to retirees (and understood) are important considerations in facilitating sound decision making.

Our long term relationship with our members in both accumulation and pension decumulation phases has allowed us to gain insights into people's behaviour and personal and financial concerns. These include the fear of outliving savings, concern about health, the desire to be debt-free, and for families, the desire to assist the next generation. We have also seen the power of communicating the difference between lump sums and defined benefit income streams versus lump sums in encouraging 'automatic' take up of income streams, noting that DB pensions, often tied to final salary levels, are more generous than most people's savings will support. We observe that for the past 25 years, superannuation has been promoted to members as 'your money' which makes it difficult to introduce the notion of giving up a portion of savings to purchase a longevity component which may never be realised.

By supporting members with products that increase the potential for producing consistent and predictable income streams for retirement, and by communicating the benefits of income streams with longevity components, members will be better able to plan their retirement and smooth their income over retirement years.

Appropriate use of incentives

For these reasons, we consider that a 'greater good' perspective needs to be taken, rather than an approach of accounting exactly to the individual balance sheet. We acknowledge that means testing is designed to balance competing considerations across income groups in the community; similarly, trade-offs apply to the design of the broader retirement income system.

- For individuals, the balance is between pre-retirement and post-retirement incomes; and for allocating sufficient funds for (potentially) very old age.
- For the government and economy more generally, it is balancing post-retirement standards of living and fiscal sustainability (reflecting intergenerational equity).

Where incentives in the system are applied, ideally they should align with the objective of the system. For the superannuation retirement system, tax incentives have been used to promote higher savings levels, which should ultimately translate to higher standards of living for Australians in retirement and lower reliance on the aged pension. Similarly, means testing incentives may encourage more people to adopt CIPRs as a core pension product, accepting trade-offs between present and deferred consumption, and in the case of death before life expectancy or product term, completely foregone consumption. We see the introduction of CIPRs as the next step in ensuring more consistent take up of income streams, smoothing consumption, and in the long term limiting reliance on the Age Pension.

Hence we support Department of Social Services in adopting treatment of innovative retirement products that either does not impede or may slightly favour their development and take-up by retirees. We are concerned that, in the absence of incentives, retirees will avoid CIPRs and limit their ability to manage longevity. At the same time, we acknowledge that the treatment of new products should not be overly generous or artificially create a demand based on "social security arbitrage".

4. Response to questions

We have grouped and summarised the questions for discussion in our response below.

Q1 and Q2: These two questions ask whether changes should be made to the existing income stream products.

We agree with the discussion paper's assessment that the existing treatment of account based pensions is appropriate.

In relation to term annuity products, the discussion paper notes the existing straight line deduction of the purchase price is slightly generous, particularly for inflation indexed annuities. This is because with an amortisation schedule, capital is repaid less in the early years rather than the later years. While this is technically correct, we submit that the existing method should be retained because the value of its simplicity and intuitive appeal in facilitating sound decision-making outweighs any slight discrepancy in relation to some annuity products.

In relation to life-time annuities, we agree that the existing treatment can appear highly concessional when considering an individual who lives well beyond the “expectation of life”. This is because the purchase price is deducted on a straight line, based on the insured’s expectation of life at commencement. It is also important to appreciate the alternative scenario where a member dies well before the expectation of life. In this scenario the individual is disadvantaged by the current method. This is expected to be the case for 50% of members who take up these products. Our modelling suggests that some concession is involved with the current method, but not by an overly significant margin. On the basis of this broader consideration, we submit that the current method is appropriate in relation to the principles and should be retained.

Our observation is that, if the income test was applied beyond life expectancy and amended to permit identical treatment of a defined benefit pension, a deferred annuity and an immediate annuity, this would harmonise and simplify the assessment principles and make them more easy to communicate.

There is a case perhaps for changing the expectation of life to be set to take into account annuity mortality rates rather than population mortality. Given the trends in mortality improvements, we also support that the expectation of life should be regularly reviewed.

Q3. What approach is most appropriate to income and assets testing for income streams in the deferral period?

We agree with the discussion paper’s recommendation that the greater of the death benefit and commutation value *during the deferral period* should be included in the assets test. This means that a deferred annuity with no death benefit payable or commutation value would have a deemed asset value of zero.

The greater of the death benefit payable and commutation value *in the deferral period* should be included in the assets test to avoid the possibility of assets being sheltered from the means test. Also, this treatment is consistent with the treatment of Account Based Pensions.

Where there is no death benefit or commutation during the deferral period, we submit that there should be no additional amount included in means testing since the member cannot access any further amount nor is any further amount available for a bequest on death. That is, our proposal aligns the operation of the means test with the **payment** profile of the product.

We consider that this treatment (i.e. no inclusion in the assets test beyond the death benefit or commuted value) as consistent with the treatment of defined benefit pensions, where there is no inclusion in the assets test until pension commences. Because these products are intended to provide more consistent income streams, while mitigating longevity risks, there should be a recognition that such products are intended to improve the retirement outcomes for people.

Since no income is being derived in the deferral period, it might be reasonable to have no income test applying. Alternatively, deemed income (1.75% to the applicable threshold and 3.25% thereafter) could be applied to the assets level (i.e. greater of death benefit and commuted value).

There is little incentive for an individual or their advisers to ‘game’ this position. An individual who over-allocates to a deferred annuity in order to qualify for or increase their age pension at retirement is taking a huge gamble on their own life expectancy. If the annuitant dies before reaching life expectancy, their capital would not form part of a bequest, rather it would be used to support the retirement incomes of surviving product holders. We submit that this acts a deterrent to gaming behaviour.

Q4. On what basis should deferred income stream products be assessed once they have commenced providing pensions?

We consider that at the point of commencement, an imputed purchase price should be calculated in respect of the future annuity payments. This imputed price is the amount of the premium for an immediate annuity on that date. The assets and income tests are then applied as for immediate life annuities.

This approach ensures consistency with the treatment of existing income streams, and consistency with the treatment for a person who buys an immediate life time annuity at the point of commencement of the deferred annuity. It is also a reasonable approach in that the imputed purchase price at commencement of the deferred annuity is conceptually equal to the actual price at date of commencement plus investment return plus mortality profit over the deferral period.

Q5. Any other issues regarding deferred annuities?

No comment.

Q6-9. These questions relate to the treatment of complex and hybrid income stream products.

In our view, where possible, is that complex and hybrid income stream products should be deconstructed into simpler products and the means testing should then be applied to those simplified products. For example, a likely popular combination of products will be derived from an account based pension component plus a deferred annuity component. The means test could be readily applied separately to the individual components.

Where the product is too complex for such a deconstruction, we suggest that an actuarial assessment be required.

Q10. Are current legislated definitions ambiguous?

Q11. To what extent is interaction with means testing for other social policy systems, such as residential aged care, important?

No comment.

Other considerations (non-superannuation assets)

We support innovative retirement income products being available for non-superannuation monies. The Social Security treatment should be consistent with that applied on superannuation assets.

5. Summary

In conclusion, we submit that, based on members' best interests, the social security treatment of retirement income products should be aligned with the payment experience of the products. We submit that this is also in the best long term interests of the economy.

We welcome the opportunity to discuss our view further with Social Services in the coming stages of this discussion.