19 February 2018
Paul McBride
Department of Social Services
Canberra ACT 2900

Dear Paul,

MEANS TEST RULES FOR LIFETIME RETIREMENT INCOME STREAM PRODUCTS

Thank you for the opportunity to provide a submission on the Means Test Rules for Lifetime Retirement Income Stream Products.

The means test rules of lifetime income stream products carry significant implications for broader retirement incomes policy, with the potential to help address the challenges of population aging.

Policy Context

Getting the policy settings of the retirement phase of the system right is critically important to ensuring that Australia meets the challenge of an aging population and the sustainability of the superannuation system is maintained for generations to come. The Murray Inquiry noted that incomes from longevity solutions could significantly increase incomes in retirement while providing retirees with security of income for life, leading to significant benefits for the economy and taxpayers.

The willingness of retirees to take up products to help them manage longevity risk is critically dependent on what it means for their pension entitlement. Reaching a landing on appropriate means test rules is a highly complex issue that requires a balancing of conflicting policy considerations and a clear recognition of the problem that we are seeking to solve.

System Wide Issues

The strength of Australia's retirement income system relies at its core on a government provided age pension system that is targeted to those with the greatest need, combined with a fully funded compulsory and voluntary superannuation system that is designed to provide additional income in retirement to supplement and substitute the age pension.

Comparisons with weaker overseas retirement income systems may lead to a sense of complacency and a willingness to accept outcomes in retirement for many retirees that are far from ideal. Notwithstanding the strengths of the Australian retirement income system, its design has resulted in certain unintended consequences.

First it has encouraged excessive risk-taking in the allocation of superannuation funds because the Commonwealth, in its provision of the age pension, is effectively underwriting investment risk.

Second, the creation of superannuation as a defined contribution system has placed the emphasis on maximising the pot at retirement rather than the income generated. This structure encourages retirees to view their superannuation as an investment to be preserved rather than income for retirement and to rank accessibility of capital above security of income. This has profound implications for the way retirees manage their savings.

In this context, there is currently little scope for the financial services industry to step up and provide solutions that would enable a more efficient management of longevity risk and reduce the burden on the Commonwealth. If the private sector could do more to pick up the burden of managing longevity risk, this

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would help address the sustainability of the budget and improve the welfare of people in retirement with broader benefits to the economy.

The academic research lends strong support for the use of deferred products as cost-effective means of managing longevity for several reasons. First, the information asymmetry between product providers and retirees concerning the circumstances of most retirees projected 20 or 25 years into the future is limited at the point of retirement. Second, the mortality bonus inherent in a deferred annuity purchased at retirement and payable at a later stage (such as age 85) would potentially make the product more affordable. Third, the investment risk associated with the timing of product purchases is able to be reduced by setting up deferred annuity purchases as a stream of annual payments either before or after retirement.

A precondition for longevity product solutions is that the age pension means test would need to ensure neutral (or slightly favourable) means test treatment of longevity products compared with current account based pensions (ABPs) that currently constitute almost the total market.

DSS Proposal

The CSRI concurs with the DSS view that the lifetime nature of retirement income stream products means that the focus should be on the cumulative effect of the rules over time. An excessive focus on targeting payments at a point in time may have the undesired effect of encouraging dependency on the public purse. Weight should be given to encouraging people to manage their super savings to provide secure lifetime income and reduce their reliance on income support from the Commonwealth over their lifetime. Relying on senior Australians to live frugally in retirement for fear of outliving their savings is not an adequate response to managing longevity risk.

While the DSS proposal has gone some way towards designing simple means test rules for longevity products that balance these conflicting considerations, its effectiveness in meeting its desired outcome is hamstrung by existing rules for ABPs. The treatment of ABPs under the deeming arrangements would continue to be more attractive and would thus remain as an impediment to the take up of longevity products.

The appropriate basis for assessing the proposal is to take into account total retirement outcomes including death benefits and bequests given that retirees/members clearly place a value on these and superannuation trustees are required to act in the members' best interests.

The penalty of taking up longevity products is evident for retirees with lower superannuation balances (in the DSS cameos, these are single homeowners with $300,000 in superannuation, homeowner couples with $400,000 in superannuation, and single non-homeowners with $400,000 in superannuation). This outcome is particularly problematic because these represent the largest retiree cohorts by number and those for whom pooled products are likely to provide an important supplement to their age pension entitlement.

Consideration should be given to the best way to address the favourable treatment of ABPs in the means test rules to ensure that longevity products are treated neutrally, or slightly favourably, so that retirement income policy objectives may be met.

The other aspect that should be reviewed is the proposed assets for deferred longevity products. Asset testing an amount greater than the death benefit and surrender value during the deferral period when no income from the product will be received, and when the excess above the death and surrender value cannot be accessed under any circumstances, will be perceived as a penalty and likely present a significant barrier to acceptance of deferred longevity products. Consideration should be given to applying no assets test in the deferral period (beyond the death benefit and surrender value) and then applying a much higher assets test at the point that payments start so as to maintain neutrality with immediate annuities. This could involve applying 70% of the original purchase price increased by inflation measured from the date that the payments commence, with the 70% reducing to 35% at the expectation of life.

I look forward to hearing further about the outcome of DSS's deliberations on this matter.

Yours sincerely,

Patricia Pascuzzo
Founder and Executive Director
Committee for Sustainable Retirement Incomes

About the Committee for Sustainable Retirement Incomes

The Committee for Sustainable Retirement Income (CSRI) is an independent, non-partisan, non-profit think tank whose mission is to progress the development and implementation of policies to further the goal of encouraging "*adequate incomes through all the years of retirement for all Australians on a fair and fiscally sustainable basis"*.

It pursues its mission by acting as a catalyst for the development of evidence-based policy and engaging widely with stakeholder groups to reach common ground on policy positions in the community interest.

With a focus on the development of thought leadership and public policy, the CSRI brings together multi-disciplinary and diverse perspectives (including academics, superannuation fund providers, investment managers, life companies, financial planners, federal government representatives and importantly consumer advocacy groups).

Recognising that the effectiveness of the retirement income system is undermined by lack of clarity about purpose, the CSRI injects an integrated and longer-term perspective in policy deliberations and seeks to build consensus on a reform programme.

CSRI takes a holistic view of income and needs in retirement, including the aged pension, superannuation benefits, housing, health care and aged care.