Means Test Rules for Lifetime Retirement Income Streams

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New Regulations

New superannuation regulations relating to pooled lifetime products took effect on 1 July 2017. Although these new rules are separate from the new means test rules, the two are inter-related. It is stated that these new rules will “address issues that restricted the ability of retirement income providers to develop and bring new retirement income stream products to market”.

This is not true.

The new rules will accommodate a widening of the range of products that is acceptable under the rules, to include products that have already been developed or are being considered for potential development. But they will **not** encourage further innovation or the development of new products in this area.

Rather, as new products are developed (or considered for development), they will face similar barriers to previous products. They will be excluded under the rules until such time as the rules are further changed to accommodate them. Furthermore, product design will become a matter of meeting the rules, rather than actually meeting the objectives that the Government is trying to achieve.

What is needed is a set of **principles**, consistent with the aims of the Government. These principles will provide a framework within which innovation can truly take place.

This is the case with all rules. It applies not only to the new regulations, but also to the means testing of social services.

Finally, whether rules or principles, they should be applied to the vehicle which, in substance, is providing the total income to the retiree. In this case it will be the Comprehensive Income Product for Retirement (CIPR), proposed by the FSI, and recently consulted on by the Government. If individually applied to the individual products which, in form, go to make up the CIPR then each product will need to comply or the CIPR will fail. This is the case, even though the CIPR as a whole may clearly meet the rules or principles imposed.

Defining Longevity Risk

Throughout the position paper the word “lifetime” is used, as if to imply that longevity can only be solved by guaranteeing that an income will continue for life. This has been a feature of the products developed, and permitted, to date.

Actually, longevity is simply “survival” for a number of periods, and survival is “not dying”. Thus, longevity is simply not dying over a specified (perhaps indefinite) long period.

The current view of longevity is that the problem can only totally be solved (i.e. forever) and that anything less does not solve the problem at all (and is consequently disallowed). Partial solutions are not to be considered, even though they may result in a reduced reliance on Government support (any increase in retirement income, or payment for a longer period, reduces the need for income to be augmented by the Government).

Taking an alternative view of longevity widens the potential range of solutions to the problem – “pooled” products (whether pooling consists of a group of individuals, or is provided indirectly via a life company) only need to provide a benefit on survival (which might be used to provide further longevity protection subsequently). Whether this benefit is in the form of an income guaranteed for life, or some other form (e.g. a lump sum), the benefit is in any case funded by those in the pool who forfeit some or all of their capital on death.

Regardless of the nature of the benefit, it is the source of funding (i.e. from those who die to those who survive) which categorises the product as addressing the longevity problem.

Funding Longevity Benefits

As noted above, meeting longevity risk depends on the amount of forfeiture – the more that is forfeited (i.e. the lower the death benefit) the more that is available to provide a benefit on longevity. Traditional products (like immediate annuities with no short term guarantee, or deferred annuities with no benefit on death during the deferral period) provide the maximum benefit on longevity, and so are able to guarantee the full income for life. Other products, which provide some level of death benefit, are not able to provide the full benefit on longevity, and so cannot guarantee the full income for life (unless the extra benefit is charged for, which makes the product more expensive, or a lower income is provided throughout).

Accordingly, it is the treatment of sums that are available for bequest (i.e. that are not forfeited on death) that is really needed to address the longevity problem.

In other words, rather than encouraging products that address the longevity issue (notwithstanding that the Position Paper talks about "neutrality") the means test, or equivalent taxation, needs to **discourage** the use of superannuation money for providing bequests, contrary to the stated purpose of superannuation (to provide an income in retirement).

(One simple solution might be to include money taken out of the superannuation system in assessable income – and allow the progressive tax system to tax larger amounts (bequests) at a higher rate – of course, the political aversion to "death duties" would need to be addressed.)

The Proposed Means Test

As noted above, different products provide different levels of longevity protection. And yet, they are all to be treated the same under the new means test rules.

Furthermore, the proposal is that such products be included in the income or assets test to the tune of 70% (or less for the assets test, if past the expectation of life). This is despite the references in the Position Paper to “neutrality” (as noted above).

I also note that the Position Paper refers to “access to capital” – retirees are assumed to relinquish their access to capital when they purchase a “pooled lifetime product”. And yet, the above shows that this need not be the case – there is a range of levels of access to capital (i.e. death benefits) just as there is a range of products available. Accordingly, applying a “one-size-fits-all” percentage of 70% to all such products is unlikely to be appropriate.

Furthermore, all retirement income products (including Account Based Pensions) include some capital drawdown in the income that they provide – if the retirement income was purely sourced from investment income then the assets would last indefinitely. Inclusion of some of the original capital in income should, not therefore be the basis for any differentiation in treatment.

The difference between an ABP and a pooled lifetime product is not, therefore, in the amount of income produced (assuming the ABP is drawn down at more than the minimum rate), but rather how long it lasts. Both an ABP and a pooled lifetime product could produce the same income, but without forfeiture, and the guarantee, the ABP may well be exhausted if the retiree lives long enough.

Alternative Means Test

Accordingly, if the concept of fairness and neutrality is to be truly complied with (rather than actively seeking to encourage pooled lifetime products) the full income (i.e. 100%) should be included in the income test until an advanced age (e.g. the expectation of life). If the retiree lives beyond that age then income sourced from an ABP (or similar non-longevity protected vehicle) should continue to be fully (i.e.100%) included in the incomes test. However, income sourced from a pooled lifetime product might be included at some lower percentage (e.g. 50% or less), recognising that the capital supporting that income would have potentially been forfeited on earlier death – i.e. it is a “reward” for the potential forfeiture that the retiree faced.

(The actual percentage beyond the advanced age would need to balance the need for an incentive to invest in pooled lifetime products with the need to prevent social service pensions being used as a “fall-back” should superannuation savings be exhausted – **there is no point in encouraging pooled lifetime products in order to reduce reliance on social service pensions if such pensions are to be paid anyway**.)

The same approach could be used for the assets test – it would not be necessary to have two separate sets of figures.

One difference would be that the advanced age would be the same for all people (of the same gender) – e.g. based on life expectancy at birth (say 80 for males and 85 for females, to make it even simpler). All income from a pooled lifetime product would be treated the same way (which is a lot easier than keeping track of when a product was purchased, such that income or assets may be treated differently depending on which product it was sourced from and when the product was purchased).

Advantages

This alternative approach would have the following advantages:

- It would be consistent with the principle of **neutrality**, treating all sources of income the same;
- It would be consistent with the principle of **equity** (applying the same formula to all retirees, regardless of their means);
- It would be consistent with the principle of **resilience** (applying to all products, regardless of when they were written) – similarly, such rules would apply equally to any new, innovative products developed;
- It would retain the **integrity** of the social security system, being fair to all retirees;
- It would better retain the **fiscal sustainability** of the social security system – for people who invest in pooled lifetime products, the cost of the social security system would only be increased in respect of those at advanced ages, compared with increasing the cost at all ages under the proposal in the Position Paper;
- It would be **simpler** than the proposal in the Position Paper;
- It would not require identification of each separate product, and the income produced by it, but would simply look at the income (and its source) available in each year;
- It would not require consideration of a separate life expectancy associated with each product, but would just consider one advanced age for all retirees of a particular gender; and
- Pooled lifetime products would still be favoured by concessional treatment at advanced ages, where the need for longevity protection exists – this alternative proposal would focus on the true area of difference between an ABP and a pooled lifetime product.