16 February 2018

Department of Social Services – by email

Means Test Rules for Lifetime Retirement Income Streams

The Financial Services Council (FSC) welcomes the opportunity to make submissions to the Department of Social Services (DSS) on the position paper on Means Test Rules for Lifetime Retirement Income Streams.

The FSC has over 100 members representing Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advisory networks and licensed trustee companies. The industry is responsible for investing more than $2.7 trillion on behalf of 13 million Australians. The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange and is the fourth largest pool of managed funds in the world.

We thank the DSS for developing this proposal for the means test for lifetime retirement income streams (henceforth lifetime products). We are supportive of the process for developing these new rules, and support the relative simplicity of the proposals compared to other approaches. Nevertheless, we are concerned that in some cases the proposals are likely to result in a reduced take up of pooled lifetime products, and as such the proposal may not be consistent with the Government's stated objective of facilitating the introduction of retirement income products.

This submission should be read in conjunction with the FSC submission on the earlier DSS consultation on means testing of lifetime products (Attached). Unless stated otherwise, the FSC comments apply equally for both guaranteed annuities and GSAs (or group self-annuitisation products).

Overall comments

The FSC broadly supports the principles stated in the DSS paper on pages 5 and 6 as being sensible and appropriate.

We note these principles do not include the importance of consistency with other government policy goals. DSS has acknowledged the importance of alignment with CIPR reforms (see page 6), so it appears consistency is being used as an implicit principle. We also note that DSS does not indicate their proposals align with the proposed objective of superannuation.

The link between the DSS policy principles and the DSS proposals is unclear, as the current or proposed approach is not evaluated against the principles. Similarly, we have not been informed how DSS used the principles to reach its preferred outcomes. For example:

- We do not know why the proposal to include 70% of asset values in the assets test is the best way to meet the principles. What alternatives were considered, and why were they rejected?

- It is unclear how the proposals meet the stated principle of resilience — are the proposals robust to product innovation, and if so how?

Comments on modelled outcomes

FSC also has concerns about the modelled outcomes of the proposal (we have separate comments about the modelling itself, discussed below). Specifically, the DSS proposal appears to have significantly adverse pension impacts for retirees with lower super balances who use lifetime products. This is shown in the modelling results on pages 15, 24 and 30 — the Age Pension payments are almost always lower for retirees using immediate lifetime products compared to account based products:

- In the scenario on page 15, pension payments for an individual are lower at every age after about 67 if they are 100% invested in immediate lifetime products. The total retirement outcomes, including bequests, on page 16 show a similar outcome.
    - While it is unlikely that retirees with less than $300,000 will invest 100% in a lifetime product, the scenarios on this page suggest the pension falls as more is invested in a lifetime product.
- On page 24, pension payments for a couple are lower at every age after 65 if they are 100% invested in immediate lifetime products (see also the total retirement outcomes, including bequests, on page 25). There are similar results for a single non-homeowner shown on page 30 and following.

These results also suggest the pension payments decrease as the level of risk pooling increases. Therefore, the proposal effectively results in a 'tax' on lifetime risk pooling or insurance.

We also note:

- The disadvantage for immediate lifetime products appears to be smaller for those with higher super balances (see for example page 21). Therefore the DSS proposal appears to be more disadvantageous for those on lower incomes during their working life, or who had broken work patterns, and would therefore have lower super balances. By contrast, there is a smaller disadvantage for lifetime products at higher balances.
- The proposals appear to discourage deferred lifetime products, based on the DSS modelling. The decline in Age Pension after the deferral period ends is quite substantial in the results on page 16. Similar to concerns the immediate lifetime products, the disadvantage appears to be more substantial for those with lower balances — and this will be the situation for most retirees.
    - If a retiree purchases a lifetime product with 10 year deferral period and no death benefit, they will have the assets test applied and (potentially) have their pension reduced every year during that 10 year period. If this retiree dies after 9 years they will have lost pension every year, their estate would receive no death benefit, and the entire value of their product would be absorbed into the pool and provide benefits to others. This appears a quite punitive result.

Overall it seems reasonable to conclude, based on the points above, that we would expect to see a decline in take up of pooled lifetime products (from already low levels). This would be an unhelpful outcome given the lower Age Pension costs to the government from these products in many cases, and the lower financial risks faced by retirees using the products.

One option to address the points raised above would be to have an assets test that was 60%/30% rather than 70%/35%; and an income test that steps down at some point.

Comment on principles of proposal

The FSC has several in-principle concerns with the proposal.

- We do not consider adequate justification has been provided for applying the asset test to products with no surrender value or death benefit. The DSS should consider the alternative of applying the assets test to the product's surrender value/death value, given that a pensioner would not be able to access the value of a lifetime product other than its surrender value. We recommend the DSS assess this different approach to the assets test against the principles and conduct modelling of this approach (noting our comments elsewhere on the DSS principles and modelling).
    - We also note that for products with no surrender value or death benefit there is no asset value attributable to the individual, yet the proposal is to apply an asset test to the individual.
    - FSC has previously argued that products with no access to capital should be exempt from the assets test (see our Attached previous submission on this issue at page 4).
- The proposal applies the assets test to the greater of surrender value, highest death benefit and 70% of purchase price (before life expectancy). This means a product with surrender value at 70% of purchase price is treated for the assets test identically to a product with a 0% surrender value (before life expectancy). Similarly, a product with death benefit equal to 70% of purchase price is treated identically for the asset test to a product with a 0% death benefit.
    - This approach appears to be disadvantageous to products with lower surrender/death value; these products provide more pooling and insurance yet are treated identically (for the asset test) to products with reduced pooling and insurance components.
- For lifetime products, it is not clear that including 70% of income and 70% of nominal purchase price (before life expectancy) in the relevant means tests results in full adjustment for the impacts of *all* of the following factors: the return of capital, the implied lifetime insurance, the lack of access to capital, and any deferral period. The proportion included in means tests needs to be adjusted downwards to reflect *all* of these factors simultaneously — otherwise there will be a penalty applied to lifetime products.
- Preliminary analysis by FSC members indicates the proposed income test implies an unrealistically slow rate of capital return — in some cases the test implies that capital will be returned up to an age of 136. This argues for a reduction in the percentage of income included in the income test (see the alternative option raised above).
- There is an apparent inconsistency in the DSS proposals. Treasury has indicated the capital access amount but the DSS proposal will involve a different asset value. This is inequitable, given customers can't access capital above that level, and confusing, as two different measures of capital value are being used.
    - This is also on face value an inconsistency with the CIPRS reforms despite the arguments of DSS that the two processes are in alignment (page 6).
- While in most cases the DSS proposal will make the application of the means test simpler, there are cases where it will be complicated. The proposal for a step down in the asset test percentage may be complicated to implement where a retiree purchases multiple lifetime products on different dates (this strategy is sometimes known as 'averaging in'). On each purchase date, the retiree's life expectancy will be different, so the step down in asset test will probably occur on different dates for different lifetime products. One way to address

this issue is to have only one step down date per individual, no matter how many lifetime products they purchase.

    - If this issue is not addressed, it may mean the proposals are less resilient to innovation.

Comments on modelling

The position paper usefully includes the results from modelling of the proposal. This is helpful in evaluating the proposal.

We have several comments on this modelling:

- The modelling does not include the impact of uncertainty or randomness. As a broad statement, individuals in account based pensions would face higher risks than lifetime products.
    - The modelling is comparing risky products (account based products) with less risky products (lifetime products); as a result omitting risk means the comparisons are incomplete.
- It would be beneficial for there to be modelling using different assumptions, including different deeming rates or market returns. The results may be quite sensitive to these assumptions.
- The modelling assumes that individuals in account based pensions only make minimum withdrawals. While many retirees do make minimum withdrawals, other options should be explored as this assumption may have significant impact on the results. In particular, the assumption of minimum withdrawal results in lower disposable income and Age Pension costs — so an assumption of higher withdrawal will increase Age Pension costs and increase retirement incomes.
- The modelling does not include scenarios involving people retiring after 65. The outcomes for later retirees could be quite different from the modelling results provided.
- We also note there is no modelling of 'averaging in', the ongoing purchase of lifetime products over several years (see discussion above on the policy issues relating to this practice).

Given the concerns above, the FSC proposes that we work with the government, particularly the Australian Government Actuary (AGA), to consider a broader range of policy and modelling options. This would assist gaining industry support for recommendations.

Other comments

The FSC makes the following additional comments:

- Given the inconsistencies in treatment raised in this submission, product providers could construct products or strategies to arbitrage or game the new rules.
- Clarification is requested for this statement: "Pooled lifetime products can be held as an investment inside an account-based income stream. Where this occurs, the value of the lifetime product would continue to be assessed as account balance" (page 11).
- The two above points also relate to product neutrality. Neutrality is not achieved where an account based pension and life annuity with the same attributes are assessed on a different basis.
- It is recommended that the rules allow for CIPR requirements, to avoid the need for future changes to meet the needs of a CIPR.

- We request that the final proposal should include an appropriate level of grandfathering for existing products that would otherwise be disadvantaged by a rule change, and an adequate implementation timeframe for new products.

Please contact me with any questions in relation to this submission on (02) 9299 3022.

Yours sincerely,

[signed]

Michael Potter
Senior Policy Manager