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Means Test Policy
Department of Social Services

By email: retirementincomestreams@dss.gov.au

16 February 2018

Re: Position Paper – Means Test Rules for Lifetime Retirement Income Streams

Dear Sir or Madam,

Industry superannuation funds look after the retirement savings of over half the working population. Industry Super Australia's mission is to maximise the retirement incomes of industry super fund members, and to advocate for public policy and superannuation industry practice consistent with this goal.

We therefore welcome the opportunity to provide preliminary comments on the proposals contained in the Position Paper 'Means Test Rules for Lifetime Retirement Income Streams' ('the Position Paper').

We note that the budget impacts and product modelling used to support the proposals in the Position Paper have not yet been made available. The absence of access to costings and the underlying model prevents a full assessment of the proposals in the Position Paper.

We would strongly encourage the Department to release the costings and modelling as soon as possible so that public discussion can proceed on the basis of a common understanding of the complex consequences and trade-offs that inevitably accompany reform in this policy area. Release of the costings and model would also allow these items to be tested by public scrutiny.

We will therefore limit this submission to highlighting a number of issues and preliminary concerns that the Paper has raised. This will be followed by a discussion of an alternative approach to deciding pension entitlement, one that ISA believes is more efficient for individuals and government, and that creates better incentives to maximise life-long incomes from private resources than the proposed approach.

We would welcome the opportunity to continue to discuss the development of new means test rules with DSS, Treasury and government.

Key Points

The key points made in this submission are as follows:

- The costings and modelling used by DSS to develop the Position Paper's proposals should be made available as soon as possible to assist public understanding and testing of the new rules.
- Any new rules must be demonstrably consistent with targeting public resources to retirees who need them most, not to financial companies who want a more concessional treatment of their products for commercial purposes.
- Greater clarity is needed about how and to what extent the proposed new rules are intended to actively support the government's Comprehensive Income Product for Retirement reform agenda.
- The proposed treatment of lifetime and deferred annuities under the new rules appears arbitrary, and insensitivity to capital access and indexation could create unfairness and undesirable incentives.
- DSS data regarding total income confirms the incoherence of the current Asset Test taper rate, a rate that over time will increasingly negatively impact on those earning average incomes and below. The taper rate should be reduced to $2 per $1000.

Policy and the Purpose of the Means Test

The need for new means testing rules has been stimulated by the government's Comprehensive Income Product for Retirement (CIPR) reform agenda. This gives rise to two concerns.

Firstly, the CIPR agenda envisages the much greater supply of and demand for longevity products, such as life office annuities. It is clear that the government wishes to see markets in these products become much more extensive than at present and this will require for-profit providers such as life offices being willing to offer them on terms that make them simultaneously saleable to retirees and profitable for their business.

How these products interact with means testing will play an important role in deciding their supply, design and distribution.

In this context it is likely DSS and the government will come under pressure from providers to make new means testing rules more concessional to ease the future sale of their products. In the name of helping the government to realise its CIPR policy objectives, parts of the financial industry will, in effect, seek public subsidy to assist their commercial objectives.

Any policy settings that create or increase such subsidies will run counter to the primary objective of any set of means testing rules: to ensure that the maximum amount of available public resources are channelled to those who need them most. Further, the existence of such subsidies will immediately weaken the credibility of the rules, making them an object of public concern, and calling into question their likely long-term sustainability.

The resulting uncertainty will make the emergence of sustainable longevity products less rather than more likely.

Developing rules that cultivate long-term public trust and confidence is therefore an important aspect of the current means testing policy process. Early access to the budgetary impacts of different rule settings would make a significant contribution to achieving this.

Secondly, a related weakness of the Position Paper is a lack of clarity about the extent to which the proposed changes are intended to actively support or merely co-exist with the government's CIPR agenda. In the absence of a clear statement of broader policy objectives that the new rules are intended to satisfy it is difficult to assess if the projected outcomes are intended or otherwise.

For example, the proposed Income Test rules for immediate lifetime products replace the existing deduction amount approach with one that assesses 70 per cent of product payments. The return of capital, previously allowed for by a deduction based on a division of the product price by life expectancy or specified term, is now recognised by assessing payments at a constant rate of 70 per cent.

However, the 70 per cent rule is less concessional than the deduction amount approach. It will likely result in many future retirees whose pension entitlement is decided by the Income Test losing more of their pension than if the current deduction method was retained. This will be particularly important in a context where a new retiree considers a choice between a pooled product (such as the 100 per cent lifetime annuity scenario modelled in the Position Paper) and an allocated pension assessed on the basis of current deeming rates. In this context, the allocated pension will likely offer a lower assessable amount, as well as full and unconditional liquidity.

In short, if an aim of the new rules is to promote the government's policy of encouraging a greater take-up of pooled longevity products, where a decision is between an allocated pension and a likely longevity product it appears unlikely the new Income Test will contribute to this take-up. It is not clear if this is an intentional or unintentional outcome, and how it fits with the broader CIPR agenda.

It would assist public understanding if DSS made clear how and to what extent it views the proposed reform of means testing rules as supporting or co-existing with stated government policy. At present there appear to be a series of tensions which make it difficult to assess why some proposals are being made and whether the consequential outcomes are intended.

Particular Rule Concerns

In addition to the broad matters of principle and policy discussed above we have a number of concerns with how the new rules propose to treat certain products and how they will impact on incentives to save.

a) The treatment of annuities (Lifetime and Deferred) seems arbitrary and the insensitivity to capital access and indexation could create unfairness and undesirable incentives

The new Assets Test for lifetime and deferred annuities proposes to assess 70 per cent of the nominal purchase price until life expectancy, followed by an immediate drop to 35 per cent.

It is not clear why this approach has been proposed and why alternative scenarios, such as a stepped-reduction to 25 per cent by age 95, have been rejected. Again, access to DSS budgetary impacts and models would have helped to clarify these issues at an early stage.

A move away from zero assessability is welcome. But at present, the 70/35 per cent assessment rule appears arbitrary. The sustainability of new means testing rules will turn on the extent to which they are anchored by a broadly agreed policy objective, and efficiently and effectively advance that objective.

Moreover, it is not clear why this rule is appropriate to particular annuity products. For example, a fully indexed lifetime annuity owned by a retiree with a life expectancy to age 85 would be assessed at 70 per cent at age 84, and then 35 per cent the following year. The real value of the annuity asset to the retiree has not changed. However, halving the assessment rate may mean a pension entitlement begins or increases.

In addition, it is not clear if or how the proposed rules intend to take account of annuity products that offer differential access to capital, death benefits and indexation. It would appear that an annuity that is not indexed at all will be treated similarly to one that is fully indexed – despite the very different income consequences for those who own them and their capacity to fund their own retirement.

In relation to Deferred Life Annuities (DLAs), the new Asset Test rules propose to apply the same treatment as lifetime annuities during deferral. However, under the new Income Test a DLA will not be assessed until vesting begins. The Position Paper does not discuss the potential budgetary and behavioural impacts of this approach. And yet it is a significant departure from the existing practice of deeming during deferral.

Deeming is justified on the basis that not applying some form of assessment will cultivate the gaming of bequests. Furthermore, allocating additional pension resources to those who could otherwise better support themselves if they invested in an immediate income stream is not consistent with maintaining the integrity of the means testing system and its aspiration to horizontal equity and product neutrality.

The Position Paper does not explain why these arguments for assessment during deferral under the Income Test are no longer relevant.

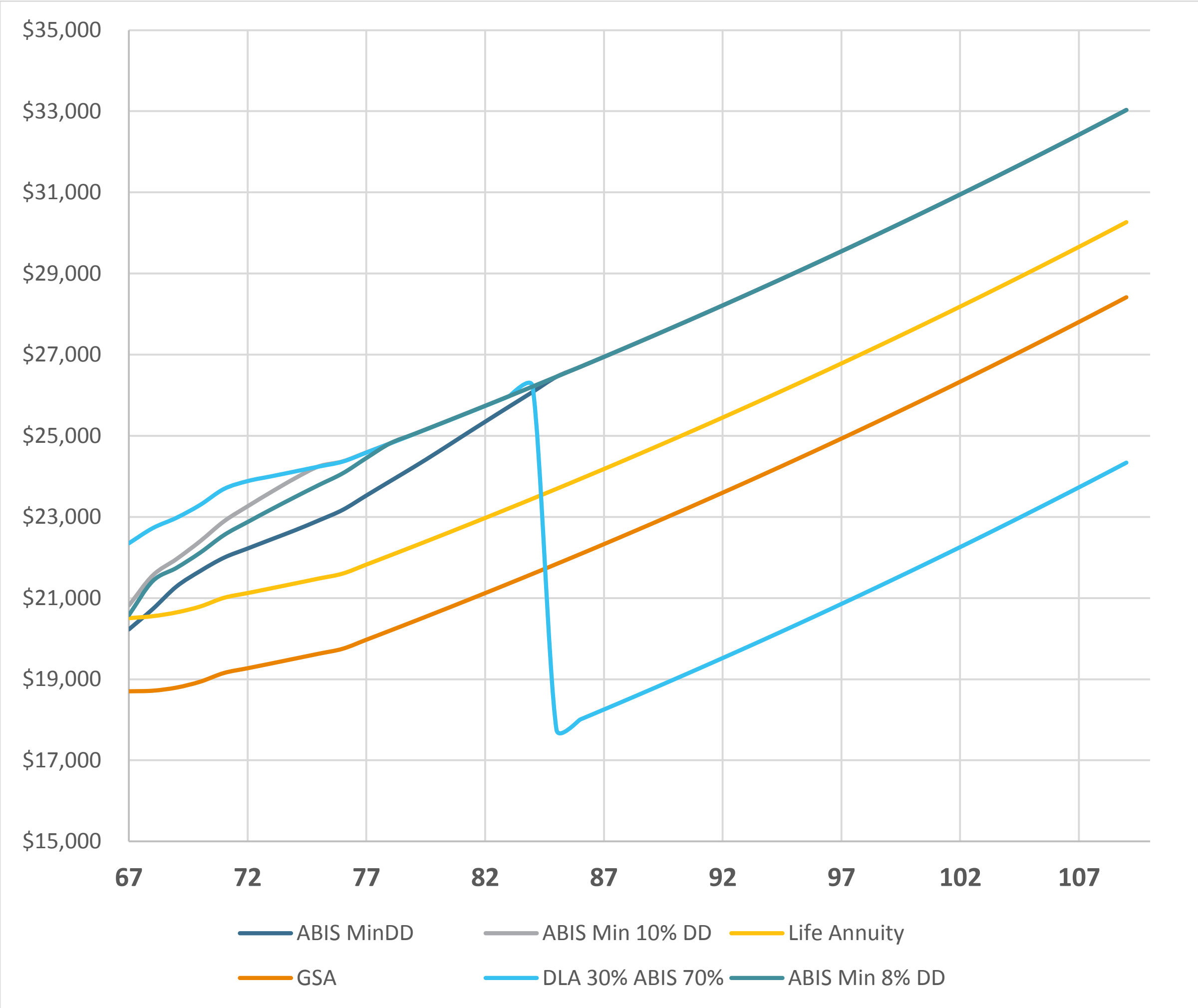
An argument for not assessing a DLA during deferral is that the owner has surrendered access to their capital for perhaps 20 years and therefore deserves some concession for doing so and taking the risk that the higher future income they have purchased will not actually be received. However, the proposed new rules do not distinguish between DLAs that offer no capital access during deferment and those that do.

In addition, it is questionable whether public policy should encourage individuals to “make bets” for or against their longevity by offering them concessions to do so.

In the absence of supporting arguments and modelling evidence the proposed Income Test treatment of DLAs appears excessively concessional and skewed to favouring a particular product. This interpretation is supported by Charts 1 and 2.

Chart 1 shows the pension income attracted by various income products, including a DLA/ABIS product in which the Account Based Income Stream (ABIS) component is exhausted by age 84. Because pre-vesting pension entitlement is decided on the basis of the ABIS, pension payments are higher for the DLA than any other income stream.

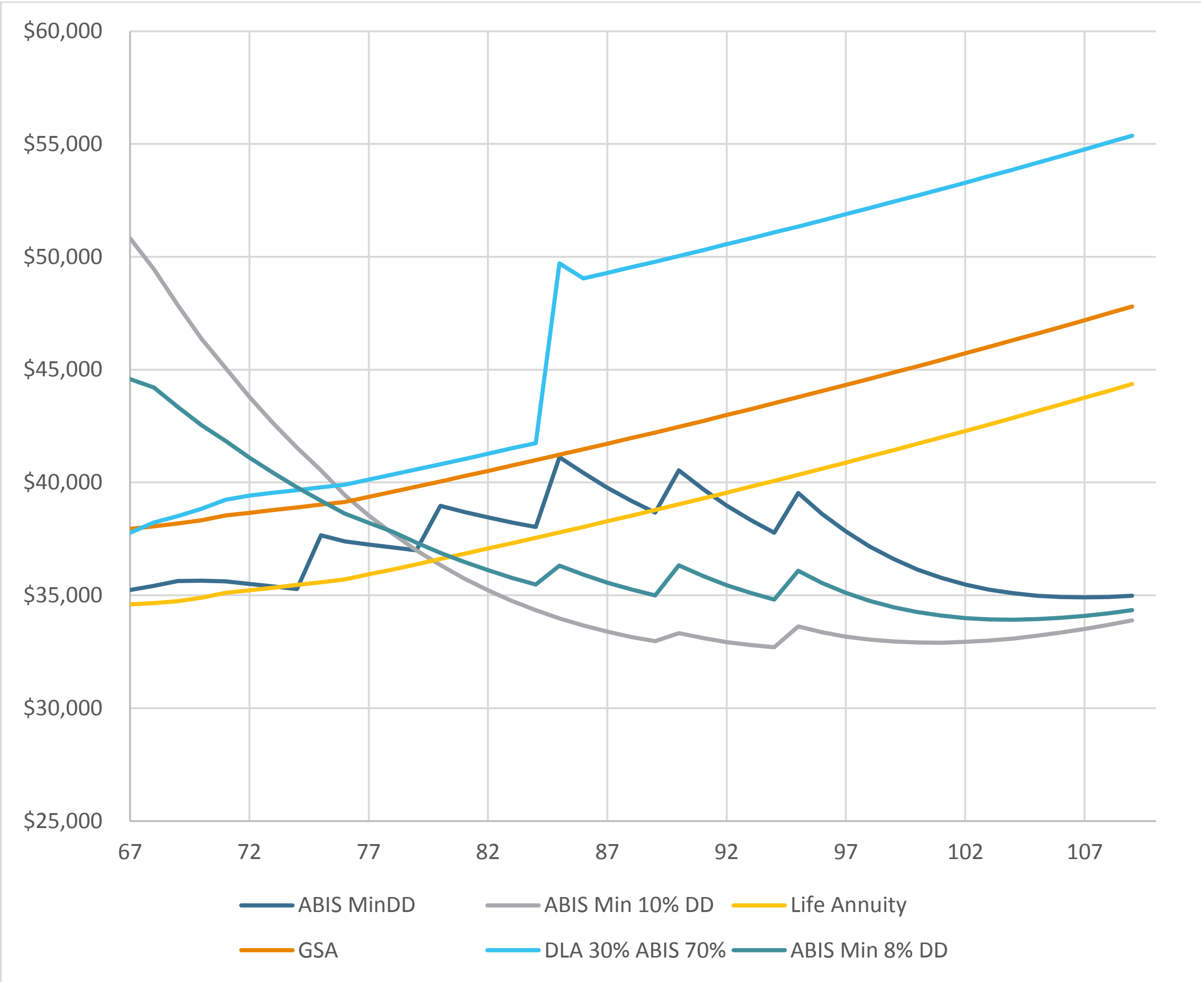
Chart 1: Age Pension paid ($300k purchase price, single homeowner, no other assets or income)



Source: Modelling by Industry Super Australia. Supporting spreadsheets available on request.

Chart 2 further confirms the apparent preference to the DLA in a total spending context. Under the proposed new rules the DLA offers the highest income for most of the retirement period, supported partly by no Income Test assessment in deferral and a highly concessional Asset Test treatment after vesting despite an exponential increase in mortality credits.

Chart 2: Total Real Spending ($300k purchase price, single homeowner, no other assets or income)



Source: Modelling by Industry Super Australia. Supporting spreadsheets available on request.

ISA has modelled similar outcomes for $400k and $600k single homeowner scenarios.

In practice, the proposed treatment of DLAs appears likely to result in more public resources being used to fund the retirement of those relatively wealthy long-lived retirees who will tend to favour and actually benefit from deferred products.

b) The DSS data regarding total income confirms the incoherence of the current Asset Test taper rate

The Asset Test taper rate introduced in January 2017 has long been criticised because it would appear to result in *decreased* total income in retirement as an individual's savings *increased.* In other words, for middle income earners with enough superannuation to trigger a part pension, they *lose* retirement income the more they save.

Table 1 shows what happens to incomes when an extra $300,000 is saved and then invested into three different retirement income products. The yellow cells highlight that at age 65 the impact of the taper rate is to reduce the incomes across all three products. In the case of the ABIS, increased savings of $300,000 lead to lower incomes for the first years of retirement.

Table 1: Impact of the Asset Test taper rate on incomes when an extra $300k is saved

		Age at Payment		
Product	**Purchase Price ($)**	**65**	**75**	**85**
ABIS min DD	300K	34,601	36,862	38,327
	600K	29,917	36,070	49,462
30% LA / 70%ABIS	300K	35,567	36,645	38,437
	600K	29,917	39,291	48,683
50% GSA/50% ABIS	300K	36,158	37,199	38,827
	600K	34,515	43,590	48,937

For example, an extra $300,000 in savings results in about $5,000 less annual income because of the Asset Test taper rate.

Source: extracted from the live plotting points in the revised DSS Position Paper, February 2018

The DSS figures confirm the irrational impact of the taper rate on the incentive to save. Over time, the rate will increasingly negatively impact incentives and outcomes for those on mid-decile incomes. Analysis by ISA and Rice Warner has previously established that the longer the $3 rate remains unchanged, the more it will negatively impact on those earning average incomes and below who retire in 2035 and 2055.[1]

In the interests of neutrality, fairness and rational retirement policy design, the taper rate should be reduced from the current $3 rate to a $2 per fortnight reduction per $1000 of assets over the limit. We would welcome further discussion on this issue.

<u>A Better Approach</u>

The approach to means testing for pension entitlement that has become ingrained in Australian public policy is problematic – increasingly so in the context of the significant growth in private superannuation assets over the past quarter-century.

[1] See Figure 16 in Industry Super Australia (2015) *Off Target: Current Tax and Transfer Settings Do Not Achieve Retirement Security*.

Superannuation is substantially universal and as the SG increases, a growing proportion of lower and middle income people will become subject to a means testing regime that applies its test frequently – every year – and is complex. This is not necessarily efficient, particularly in the context of retirees whose means are most unlikely to increase in the future – after all, they have stopped working.

On the one hand, it is an understandable attempt to ensure that limited public resources are targeted to those retirees who need them most. On the other, guaranteeing a means tested life-long pension that increases the more that retirees fall below certain asset and income thresholds creates perverse incentives for both retirees and income product providers.

For most retirees there is an incentive to deplete their private savings to meet thresholds, and to game how they allocate those savings between assets and family members in the run-up to and during retirement. For income product providers, because maximising income from private assets is penalised by the means testing system, there are weak incentives to offer highly income-efficient income streams that may contribute to a disproportionately lower pension entitlement.

Maximising income from private resources should be the obvious rational basis for how retirees organise their financial affairs. However, such a basis is rendered irrational by the incentive to not exceed entitlement thresholds.

Means testing should incentivise retirees to maximise the income from their assets for the full duration of their retirement. This could be achieved as follows.

At the point of retirement, a projection of the private income for life that a retiree’s assessable assets could reasonably be expected to generate is made pursuant to an Australian Government Actuary estimate. All assessable assets, regardless of the form of the product, would be included.[2]

This estimate would be the “means” against which pension entitlement is tested.

Pension entitlements would not fall during the subsequent period of retirement, even if actual retirement income received from the assets exceeded the estimate. The estimate of private income would not subsequently be revised downward to the detriment of the retiree.

The retiree would be entitled to keep all income above the projected estimate during their retirement, providing a strong incentive to manage their private assets in a manner conducive to maximising their private income over the long term.

If a retiree’s actual income falls below the projected estimate, they could apply for a higher pension entitlement to meet some or all of the shortfall. This preserves the fundamental safety net aspect

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[2] Products without a purchase price or account balance would receive a fair actuarial value.

of the pension. However, because the incentives to enter into superior products that generate reliable retirement income are strong, current concerns about the inefficient use of assets to access more pension will be reduced.[3]

Variations on this model are possible, including sharing above-projected income gains between the retiree and government on the basis of ratios that maintain incentives while avoiding paying an unreasonable pension entitlement in a context of unexpected or windfall gains.

The key is to lock-in a benchmark lifetime income stream from assessable assets, so that individuals will have appropriate incentives to use their private resources as efficiently as possible.

A potential concern with this proposal is that locking-in a minimum pension entitlement at the point of retirement would prove too expensive and, ultimately, fiscally unsustainable. This need not be the case for two reasons.

Firstly, under this proposal significant upside changes to retirees' incomes because of windfall events would lead to a reappraisal of assets, with a consequent reduction in pension entitlement. This reduction would be sustained for a period of time equivalent to an estimate of what long-term income would be expected if the windfall were efficiently invested. This will prevent windfall gains being rapidly exhausted in order to regain the prior Pension entitlement.

Secondly, under present means testing arrangements, how common is it for pension entitlements decided at the point of retirement to then be reduced because of significant increases to retirees' private financial circumstances?

This is a question that can be resolved empirically by DSS. However, while windfall events certainly do take place, we suspect that they are rare and that the pension entitlement determined at retirement is not subsequently reduced in most cases.

The advantages of this proposal include:

- Superior incentives.
- Simplicity: the retiree knows their long term pension entitlement at the time they retire barring some extraordinary event; the pension won't go up or down based on annual investment market volatility, deeming rate decisions by policy makers, or interest rates.
- Lower administrative burdens on individuals and Centrelink – annual assessments would generally not be required.
- Budget savings due to greater administrative simplicity.

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[3] If a retiree received new assets, such as an inheritance, this new asset would be subject to a similar annual retirement income projection pursuant to the Australian Government Actuary approach, and included in the means test (but the prior estimate of the income other assets would not be revisited). Alternatively, these windfalls could be taxed as income.

- Potential budget savings due to behavioural effects: if trustees develop and offer optimal retirement income products, and individuals join them, the propensity for those in these products to call on the pension later in retirement will be reduced.
- Product neutrality, as the income stream producing capacity does not give regard to the product.
- Consistency with the effort to transition superannuation into a retirement income system.

If you have questions about any of the issues and evidence presented in this submission, please do not hesitate to contact me at [redacted].

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