MERCER
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Mercer (Australia) Pty Ltd
ABN 32 005 315 917
Collins Square
727 Collins Street Melbourne VIC 3008
GPO Box 9946 Melbourne VIC 3001
+61 3 9623 5464
Fax +61 3 8640 0800
david.knox@mercer.com
www.mercer.com.au

RetirementIncomeStreams@dss.gov.au
Department of Social Services

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Subject: Means Test Rules for Lifetime Retirement Income Streams

Mercer welcomes the opportunity to make a submission on the Department of Social Services' Position Paper *Means Test Rules for Lifetime Retirement Income Streams* dated January 2018.

Broadly speaking we welcome this paper for the following reasons:

- It is a necessary step in the development of Comprehensive Income Products for Retirement (CIPRs) as recommended by the Financial System Inquiry (FSI)
- The proposed new means test rules for pooled lifetime income streams are simple to understand and a step in the right direction
- The proposed rules are broadly product neutral between different longevity products which should encourage a broader range of products

We would also recommend that a revised policy should form part of the forthcoming Budget with an ideal starting date of 1 July 2018, subject to the necessary legislation. This action would highlight the Government's commitment to the development of a market of longevity products and a more efficacious superannuation system.

Notwithstanding our general support, we have several concerns and suggestions which we believe will encourage the further development of lifetime income streams and a more efficient retirement system.

An incentive is necessary

Our first concern is that the results from the modelling show that present value of the outcomes for retirees are broadly similar whether an individual or a couple takes an account-based pension (with minimum drawdowns), a longevity product or a hybrid product combining the two.

Such an outcome will not encourage the take up of longevity products. Most retirees do not look beyond the next five or ten years. They do not expect to need longevity products. Hence, if the outcomes are similar and the benefits of a longevity product are more than 15 years away, these products are unlikely to be chosen by many retirees. This outcome will run counter to the FSI's desire and recommendation.

For example, page 26 of the updated position paper shows virtually no increase in the total income in the first 15 years for a couple with $400,000 in superannuation. As this represents a very common situation, this result highlights the lack of an incentive under the current proposals for many retirees.

Whilst discussing the modelling results, we believe that the use of 100% Account-based income stream (ABIS) with minimum drawdown represents a very conservative benchmark. Although we recognise that many retirees follow the minimum drawdown, it is equally true that many retirees withdraw at a faster rate, particular in the earlier years of retirement. Such action leads to a faster reduction in assets and therefore higher age pension payments than shown in the modelling. Indeed, it is likely that a CIPR will also lead to a faster drawdown than the current minima.

It should also be noted that longevity products limit the retiree's access to their capital during their retirement. This is not taken into account in the modelling. Hence we disagree with the neutrality principle on page 5 that the "means test assessment should not advantage a particular type of product".

Our recommendation is that there needs to be a slight bias in favour of longevity products to encourage their take up and to compensate for the reducing access to capital. This outcome could be achieved by reducing the asset test for pooled lifetime income streams from 70 per cent and 35 per cent to 60 per cent and 30 per cent respectively.

We recognise this weaker test would increase age pension payments and therefore be more expensive. However we believe that if a more realistic ABIS benchmark was adopted, the increase in age pension costs over the longer term would be limited, if present at all.

A single product is necessary

Our second concern relates to the following statement on page 12 of the updated paper:

> "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."

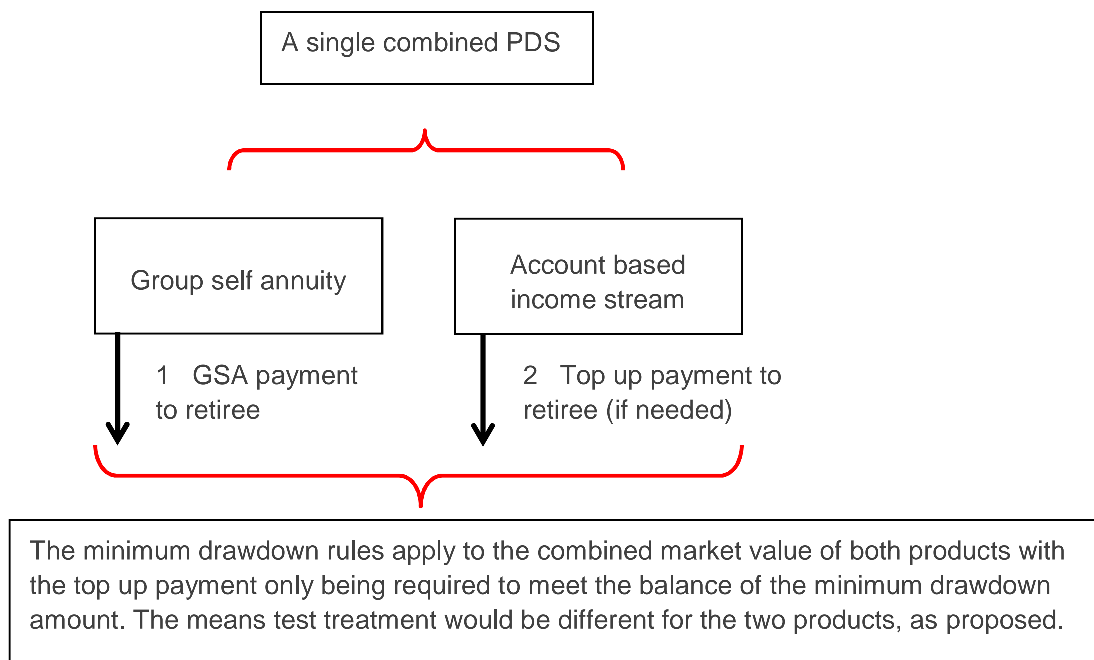
We understand that this position has been driven by the current definitions within the relevant Act and the definition of an ABIS within the SIS regulations.

However, in reality it must be recognised that most retirees are looking for a single package and that the CIPR proposal envisaged a superannuation fund offering a single product to their members comprising both an income stream and a longevity product. Having two separate products will not be a simple outcome and therefore is unlikely to achieve the FSI's objective of improved efficiency. The comment that

a pooled lifetime product cannot avail itself of the new rules, if it is held within an ABIS, is a severe limitation on the development and marketability of these products.

We also highlight the tension between the desire for a level real income (part of the CIPR's objectives), the minimum drawdown rules and the fact that income from a longevity product will not necessarily be constant, particularly if it is a Group Self Annuity (GSA) where payments are likely to be subject to some variation depending on the actual experience.

A solution to this tension is to enable an account-based income stream and a GSA to be combined into a single product offering by a provider and for the minimum drawdown rules to apply to the combined product. The following diagram illustrates how this could work.



It is important to note that the GSA payment to the retiree is determined by the operations of the GSA and cannot be determined by the individual, unlike the payment from an ABIS.

Consideration of unitised pooled products is necessary

Our third concern relates to the non-workability of the current rules relating to unitised Group Self Annuities. This is described in more detail in Attachment 1. Our recommendations are:

1. For a pooled longevity product where the investment (or purchase price) is not determined by an individual's age, the starting age for the capital access schedule should be permitted to be determined by the average starting age of those who invested in the pool during a specified period, such as the designated financial year.
2. For the purposes of the capital access schedule, the "Retirement phase start day" as defined in the SIS Regulations needs to be a single date for all individuals within a group of investors into a GSA. We suggest the midpoint of the financial year (ie 1 January) during which the investments were made, given that the group is formed from all investors (or all investors of that gender in a particular age group) during the designated financial year.

The income test

The proposed income test is 70 per cent of all product payments. In some circumstances this makes it harsher than the current application of the deeming rules and will make longevity products less attractive, especially at the older ages. This is particularly relevant as the income test will cut in sooner due to the reduction in the assets test from life expectancy. Hence, there are two problems with the proposed income test:

1. The use of actual payments and not deemed income
2. The absence of any reduction from the life expectancy age, unlike the proposed assets test.

We therefore recommend that either the deeming rules be used for the income test (where a market value is available) or that the income test be halved (like the assets test) from life expectancy or a specified age.

Some further simplifications are necessary

The use of an individual's life expectancy in the calculation of the age when the assets test is reduced is an unnecessary complexity. It would be simpler for everyone if this is a fixed age, such as age 85 or 20 years above the age pension eligibility age.

The paper uses several expressions meaning the same thing ranging from lifetime products through to pooled lifetime retirement income stream products. It would be simpler if a single expression or acronym was used, perhaps pooled lifetime income products.

Who is Mercer?

Mercer is one of the world's leading firms for superannuation, investments, health and human resources consulting and products. Across the Pacific, leading organisations look to Mercer for global insights, thought leadership and product innovation to help transform and grow their businesses. Supported by our global team of 22,000, we help our clients challenge conventional thinking to create solutions that drive business results and make a difference in the lives of millions of people every day.

As well as consulting services and investment advice and solutions, Mercer Australia provides customised administration, technology and total benefits outsourcing solutions to a large number of employer clients and superannuation funds (including industry funds, master trusts and employer sponsored superannuation funds). We have over $150 billion in funds under administration locally and provide services to over 2.4 million superannuation members and 15,000 private clients. Our own master trust in Australia, the Mercer Super Trust, has around 230 participating employers, 220,000 members and $22 billion in assets under management.

We would be delighted to discuss the above matters with you. Please don't hesitate to contact me on (03) 9623 5464.

Yours sincerely,

Dr David Knox
Senior Partner

Attachment 1

Pooled longevity products

The Financial System Inquiry (FSI) discussed two types of longevity products that could form part of a Comprehensive Income Product for Retirement (CIPR), namely annuities which are offered by life insurance companies and Group Self Annuities (GSAs), which represent an effective pooling of longevity risk across individuals. In each case, payments from these longevity products could commence immediately or be deferred until a later age.

The FSI recommended the development of CIPRs and noted that “the greater use of longevity risk pooling at retirement could significantly improve the superannuation systems’ efficiency”. The Government accepted this recommendation and has subsequently introduced legislation supporting innovative income streams.

However the offering of new types of retirement benefits by the superannuation industry has been rather limited due to a number of factors, including the lack of clear guidance relating to CIPRs.

With this in mind, we thought it appropriate to share with you our experience relating to Mercer LifetimePlus, which we believe continues to be the only GSA offered to individual retirees in the world. It is clearly an innovative product.

As noted above, a GSA is a pooled longevity product where individual investors agree to invest in the pool and share the experience of the pool with the other investors. In a pure GSA, there are no guarantees and therefore no capital is required to support the product which, in turn, reduces the cost to investors. The investment and mortality experiences of the pool drive the outcomes received by the investors. In most cases, it would be expected that the investors who live the longest will receive the greatest benefits whereas those who die earlier receive lower benefits and generally give up some of their capital to support those who live longer.

Mercer LifetimePlus is a fully distributing unit trust with distributions every six months representing

- The investment earnings received (ie interest, dividends, rentals, realised capital gains/losses)
- Capital payments representing a gradual repayment of the investment, commencing after 12 years
- Living bonuses (or mortality credits) representing the capital left in the pool from those who exit, either voluntarily or by death.

An important characteristic of a longevity pool is that every investor within a particular group of investors (with the same or similar characteristics) receives the same outcome at each distribution date. Otherwise

we know from experience it becomes impossible to administer and difficult to communicate. In that sense, it is very different from an individually purchased life annuity where the price paid (or investment) depends on the insured person's age and gender. This is not the case with a GSA such as Mercer LifetimePlus. From the retiree's (or financial advisor's) perspective, a GSA may have more similarities with an investment than an insurance product such as an annuity.

Taking into account this reality, it was necessary for Mercer LifetimePlus to be redesigned into a unitised product so that it can be easily administered on the platforms operated by most of the industry. That is, financial advisors are accustomed to recommending unitised investment products and retirees need to be able to look up the value of all their investments at any time. Without unitisation, we do not believe that GSAs can be successful in the marketplace. For example, the operational re-design cost for just one platform to accommodate a non-unitised GSA was over $1 million. It is not feasible for such costs to be replicated for all platforms for all new products. It should also be noted that most superannuation funds now operate on a unitised basis, including their account based pensions. Hence this leads to the natural development of a CIPR, comprising a unitised account based pension and a unitised longevity product, which may both be incorporated into a CIPR as shown in our diagram on page 3 of this submission.

The need to conform to the actual operating dynamics within the marketplace means that Mercer LifetimePlus is now a unitised product and that all retirees of the same gender who invest within a particular financial year receive the same outcome. For this reason, we recommend that this product should only be adopted by those between the ages of 60 and 70 at the time of investment. This approach maintains some homogeneity within the group who are subject to the same unit price and therefore some equity within the group.

We believe that similar issues are likely to be faced by future providers of GSAs. In short, an individualised approach may not work for many GSAs as the price (or investment) may not be directly related to the individual's age or the purchase date.

In line with the Government's policy to support a greater range of longevity products we recommend that the following two changes should be made to the operation of the capital access schedule and the starting date for a retirement product. These changes are necessary to avoid requiring GSAs to operate with individual investor characteristics rather than an averaged (or pooled) approach.

1. For a pooled longevity product where the investment (or purchase price) is not determined by an individual's age, the starting age for the capital access schedule should be permitted to be determined by the average starting age of a specified group of investors who invested in the pool during a specified period, such as the designated financial year.
2. For the purpose of the capital access schedule, the "Retirement phase start day" as defined in the SIS Regulations needs to be a single date for all individuals within a specified group of investors

into a GSA. For example, the midpoint of the financial year (ie 1 January) during which the investments were made could be used, if the group was formed from all investors (or all investors of that gender in a particular age group) during the designated financial year.

Any averaging, as suggested above, could be required to be signed off by an actuary to ensure it meets any regulations.

The application of such rules will ensure simple and consistent treatment for all GSA investors. For example, these two suggested modifications would enable a single exit unit price to be used for all investors from the same financial year. This outcome is needed by the platforms used by the industry as they can only show two unit prices – the full market value and the exit value. It is not feasible for either of these prices to vary by investor within a particular class of units. For example, it is not feasible for the exit price (which would normally be designed to fall within the capital access schedule to meet the proposed means test rules) to be based on each individual's details. This suggested approach of showing just two unit prices is similar to the buy and sell prices shown for investment products.

Of course, it could be argued that the averaging and simplification suggested could disadvantage certain individuals. For example, a 61 year old investor in a pool where the average age of 65 would be subject to a lower capital access schedule than would occur if their age of 61 was used. On the other hand, this individual is likely to receive a better outcome from the pool as they would be considered to be 4 years older than reality. In short, in all longevity pools there will be swings and roundabouts and nothing is guaranteed.

Our major point is that if the government wants to encourage a broader range of longevity products, the relevant regulations must be simple to understand and facilitate products that are efficient to administer. The use of individual ages and individual starting dates does not lead to easy implementation and, in fact, will likely preclude the development and mass market adoption of GSAs. We believe that the above recommendations will not cost the Government any money (as averages would be used) but would lead to a more pragmatic and efficient outcome for providers, financial advisors and retirees.