Australian Institute of Superannuation Trustees

12 April 2014

Manager
Retirement Benefits Unit
Retirement Income Policy Division
The Treasury
Langton Crescent
PARKES ACT 2600

Email: superannuation@treasury.gov.au

Dear sir/madam

Re: Treasury Laws Amendment (Innovative Superannuation Income Streams) Regulations 2017

In brief:
AIST welcomes the certainty that these regulations will bring for providers of innovative income streams. These draft regulations would be improved through limitations on unreasonably long deferral periods, better disclosure of pricing methodologies and better strategy with regards to the declining capital access schedule. However the rules around distributing excess cash from group self-annuitisation arrangements works against members of profit-to-member funds.

Thank you for the opportunity to respond with respect to these draft regulations. AIST welcomes these regulations which provide certainty with respect to how the tax integrity rules are to be changed to ensure that income streams are allowed to develop innovative features and benefits, whilst at the same time maintaining a reasonable set of trade-offs to ensure both viability and fairness. Our comments in this submission may not address all parts of the draft regulations.

The new standards

AIST welcomes the provisions in this schedule, which is designed to insert a new series of rules for income streams which do not fall under the definitions of regulations 1.05 or 1.06 of the *Superannuation Industry (Supervision) Regulations 1994* ("the SIS Regulations", SISR).

We note that the draft regulations insert new requirements (at regulation 307-205.02D(3)(b) of the *Income Tax Assessment Regulations 1997* (ITAR) or at SISR 1.06A(3)(b)) which would require benefits to be payable throughout the life of the beneficiary. These new regulations apply to guaranteed income streams such as annuities (immediate or deferred), but would also apply to non-guaranteed income streams such as collective defined contribution scheme income streams. We recommend that this be reworded to reflect the application of this section to non-guaranteed incomes streams such as these, along the lines of (example using text from the proposed SISR 1.06A(3)(b)):

> *… the benefit is **designed to be** payable throughout the life of the beneficiary (primary or reversionary)…*

Our proposed additions being the text in bold above.

Unreasonable deferral

The standards prohibit an unreasonable deferral of benefits paid from the income stream at the proposed SISR 1.06A(3)(c). AIST welcomes this, however we believe that by limiting the scope of this proposal to income streams which have already commenced, there is a possibility that income streams which themselves have unreasonably long deferral periods may be sold to retirees.

We believe that a considerable part of the value proposition of these investments will be the pricing that they are able to be listed at for the benefits of retirees, and note that the longer the deferral period, the more attractive the pricing will be able to be provided. This has a number of disadvantages:

- ***1. Long deferral periods***

The formula specified at Item 11 of Schedule 1 of the draft regulations which determines the declining capital access schedule is reliant on a denominator being the life expectancy as at the retirement phase start date. For long deferral periods, there is the possibility that nil death benefits (or any payments at all) are payable for a period up to where a deferred income stream would otherwise commence. Unusually, this would include the period of one full year prior to the pre-determined life expectancy.

For example, if Suzie, referred to in Example 1.2 of the Explanatory Statement, had instead purchased a deferred annuity payable from age 86 and had died at age 85, her death benefit would be a multiple of 26 – (86 – 60) – 1 = $0. If she had died at age 84, her death benefit would be the grand total of $769, raising the real question of whether there are real benefits to such lengthy deferral periods.

- ***2. Hybrid products with contingent terms of payment***

In our initial submission[1] to the retirement incomes review of 2014, we wrote about a then-new hybrid product which we had modelled. Under relatively conservative modelling, we showed

[1] AIST, (2014). *Response to Treasury: Review of retirement income stream regulation*. AIST Submission. [online] Melbourne: Australian Institute of Superannuation Trustees, p.30, Appendix B. Available at: http://tinyurl.com/ogwso8m [Accessed 12 Apr. 2017].

that the product's guaranteed income was unlikely to commence payment until the retiree turned 109. We further showed[2] that it would be only around this point that the income paid out by this product overtook the minimum income from an equivalent account-based pension. It should be noted that after fees, the income payable from that hybrid would be less than the account-based pension from commencement.

- ***3. Behavioural economics and the need for advice***

It has been long known that the way information is framed affects the consumption of products in a market economy. It has also been the case that consumers require additional disclosure in order to appropriately assess value, which in some cases has been required by law. For example:

- Products in supermarkets now have a per-unit cost disclosed next to the price, where goods in different sized quantities are sold such as (for example) 1.25L bottles of soft drink next to 2L bottles; and
- Home loans are required to disclose comparison rates which take into account the effect of establishment fees, loan maintenance fees and early refinance and switching fees.

On the other hand, we note that term deposit rate sheets, whilst generally noting the different terms and payment frequency arrangements (e.g. annual, monthly, compounding, deferred etc.), do not, unlike home loans, disclose effective rates of return and disclose actual rates payable instead. This may mask the actual value implied by the rates in such a table.

Where there is a real risk that investors will not live long enough to realise any benefits from products with a lengthy deferral period, we believe this this is considerably more serious than the examples cited above. Particularly if pricing is provided in such a way that provokes spurious comparisons.

AIST has concerns that the pricing of long deferral periods may therefore be likely to be picked up by "rate-chasers" who may fail to appreciate that the likelihood of outliving their life expectancy is not generally great. We recommend that deferral periods be limited in order to ensure that retirees are not mislead by attractive pricing.

We also note that whilst the use of Australian Life Tables appears to be well-founded, the reality is that products aimed at protecting against longevity will be themselves, the subject of significant anti-selection. A significant portion of retirees will diagnose themselves not in need of longevity protection due to hereditary and non-hereditary factors and, even allowing for errors in those diagnoses, this would leave longevity products more likely to be utilised by retirees with longer life expectancies.

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[2] AIST (2014) as referenced in previous footnote, at Appendix C

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This naturally means that the life tables themselves will not resemble the cohort who eventually use these products nor the longevity assumptions used to price the products. Although we are unable to offer suggestions, the methodology which ends up being used by providers for pricing must be disclosed to members in the interests of transparency. AIST strongly supports the *G20 High-Level Principles on Financial Consumer Protection*[3] and pointed out in our submission[4] in response to the Financial System Inquiry interim report that such disclosure should form part of operational principles for effective disclosure.

Inappropriate design issues

AIST is particularly concerned regarding the design of the declining capital access schedule where at various points, products are unable to pass cost savings back to members. AIST's members operate in the profit-to-member space, where savings created through appropriate pricing of benefits to members are passed back to members. The profit-to-member ethos would see funds operating pooled products being able to ensure that members were able to benefit from situations where there were excess funds in pools. In its purest form this would see members directly benefit where they can be matched with savings individually.

The model proposed in these draft regulations raises very serious questions about how to appropriately allocate funds remaining in pooled products where the members have died prior to life expectancy. Where can these excess funds go? In the most straightforward scenarios:

- Members who pre-decease their life expectancy are limited to amounts specified by the formula. Any excess funds in the pool are unable to be allocated to them.
- Members who pre-decease their life expectancy by a year are (as previously discussed) unable to be allocated anything;
- Members who are in receipt of deferred income are unable to have their income increased in the payment phase as this would ostensibly form a breach of the unreasonable deferral of income prohibition; and
- The last member in a closed pool would be unable to be paid anything over and above their maximum death benefit, leaving the remaining portion unable to be paid anywhere.

AIST believes that excess funds in pooled products must be allowed to improve the benefits payable to members in superannuation funds for two reasons:

1. Where payments are made from product manufacturers to fiduciaries, including commissions, volume-based payments and shelf-space fees, AIST maintained that these

[3] OECD, (2011). *G20 High-Level Principles on Financial Consumer Protection*. Paris: Organisation for Economic Co-operation and Development. Available at: http://www.oecd.org/daf/fin/financial-markets/48892010.pdf [Accessed 12 Apr 2017].
[4] AIST, (2014a). *Response to the Financial System Inquiry Interim Report*. AIST Submission. [online] Melbourne: Australian Institute of Superannuation Trustees, pp.51-52. Available at: http://tinyurl.com/n4ozc4l [Accessed 12 Apr. 2017].

should be in turn, paid to the benefit of members and campaigned for this outcome during the consultations on the Future of Financial Advice (FoFA) reforms.

2. The Financial System Inquiry noted as a policy objective that the pooling of benefits would provide higher income to retirees, whilst insuring against longevity risk.

Moral hazard issues

The issues regarding benefits payable on death to third (and in some cases, ancillary parties) have long dogged the design of funds of various natures historically. Various lengths have been taken by policy-makers and others to ensure that earlier than normal death does not provide a financial incentive, such as the banning of tontines, the high levels of security around the identities of lives insured in the traded life policy market and benefit design in term life policies generally.

We are concerned that the formula prescribing the capital access schedule, being stepped, may inadvertently provide situations such as where a member who may have been diagnosed as being terminally ill, may conspire with their next of kin (who may stand to benefit financially) to accelerate or to engineer an earlier death. The incentive would be further pronounced where a member commences later in life, thus incurring a sharper declining capital access schedule. The stepping of the schedule means that it is possible that the maximum capital access may decline by a material portion in one day, going from one year to the next, where the date in question is either 15 days after the retirement phase start date/commencement date or the anniversary date.

Although a schedule that steps down may have some parsimonious advantages over a steadier decline such as a daily schedule, we believe that this threat would be greatly reduced by such a measure.

Another option that could be considered might be to extend the available death benefit of 100% throughout the first half of one's life expectancy, then declining in a straight line to life expectancy, plus a margin of (for example) five years to encompass future increases in longevity, as well as the cohort of members likely to use these products.

Please contact Richard Webb, Policy & Regulatory Analyst on 03 8677 3835 or at rwebb@aist.asn.au should you wish to discuss our submission further.

Yours sincerely,

Eva Scheerlinck
Chief Executive Officer

The Australian Institute of Superannuation Trustees is a national not-for-profit organisation whose membership consists of the trustee directors and staff of industry, corporate and public-sector funds.

As the principal advocate and peak representative body for the $700 billion profit-to-members superannuation sector, AIST plays a key role in policy development and is a leading provider of research.

AIST provides professional training and support for trustees and fund staff to help them meet the challenges of managing superannuation funds and advancing the interests of their fund members. Each year, AIST hosts the Conference of Major Superannuation Funds (CMSF), in addition to numerous other industry conferences and events.