ARE WE SELLING RETIREMENT INCOMES POLICY SHORT?

After weighing up some of the possible changes to government policy, David Shirlow is left wondering whether developing a universal set of drawdown rules might be better than encouraging or mandating particular retirement income products.

In recent years retirement income products have been a subject of two major reviews: the Cooper review into superannuation (2009-2010) and the Henry review of Australia's tax system (2008-10). Now they are being addressed in two more: the Financial System Inquiry (FSI) and the government's review of retirement income stream regulation. Further, appropriate retirement income regulatory design is very much driven by tax and social security expenditure settings. This means the practical outcomes of these reviews may be dependent on the outcomes of the government's tax white paper proposed for next year.

TAXATION OF SUPER FUND EARNINGS

As Treasury notes in its July 2014 discussion paper on retirement income stream regulation, Henry recommended that super fund earnings be taxed at the same rate (7.5 per cent) in both accumulation and pension phases. This approach would remove the need for the prescriptive rules being examined in the current reviews. So, before we dive into possible refinements to those rules, it is worth briefly exploring the possibility of the white paper recommending tax changes for super fund pension earnings.

In recent years, public debate has intensified around the overall tax revenue cost of superannuation, along with the targeting of its tax concessions. The previous government's proposal to limit concessions for better-funded retirees by imposing pension account earnings tax above a $100,000 threshold has been laid to rest by the current government.

However, as the FSI interim report indicates, given the 2007 removal of benefits tax for those aged 60 or more, there will be ongoing policy focus on the inequity of the distribution of tax advantages.

So, is it likely that a pension earnings tax would be introduced in some shape or form? A uniform rate would certainly remove technical and administrative difficulties relating to the transition from accumulation to pension phase. Prescriptive regulatory descriptions of income streams, such as the minimum drawdown rules, would arguably go out the window. There would be freedom to design innovative pension products – one of the government's review objectives.

But how would the transition be managed? Grandfathering would presumably cover all current super pensioners; but should it not also cover those approaching retirement, who have invested in super in the expectation that

they could start a tax-free pension? And wouldn't, for example, a single person with minimal non-super savings, who was to be subject to the new pension earnings tax, be well advised to withdraw the first $750,000 or more of their benefits and invest it outside super? Assuming the current seniors and pensioners tax offset (SAPTO) and other personal tax settings are not changed – at least, not in the near future – a single person could invest that amount in a typical balanced portfolio earning around 7 per cent (before tax) without exceeding their effective tax-free threshold. Indeed, if the new pensions earnings tax rate was 7.5 per cent, the single person could withdraw and invest $1,000,000 outside of super and have an effective tax rate of less than 7.5 per cent.

YOU CAN SEE THE POLICY PRESSURE HERE: IF TAX CONCESSIONS ARE TO BE RETAINED INTO THE RETIREMENT PHASE, SUPER SAVINGS NEED TO BE DOING WHAT THEY'RE SUPPOSED TO BE DOING

ENOUGH CONTROL?

Would the Government care if there were a mass exodus from super because the relative appeal of staying in super had been removed? Certainly there are regulatory controls over trusteeship and investments that protect superannuation savings, but which may not exist outside of super. However, currently there are no maximum drawdown restrictions for super pensions (other than transition-to-retirement pensions); no constraints on large lump-sum withdrawals; and no requirement to take any kind of benefit at all. You can see the policy pressure here: if tax concessions are to be retained into the retirement phase, super savings need to be doing what they're supposed to be doing.

Broadly expressed, the purpose of super is to provide retirees with an adequate source of funds to live on in retirement. The strong appeal of the current system is that it is flexible enough to address a wide range of spending patterns and needs during retirement (and is supported by a means-tested age pension). But questions are being posed by various stakeholders (including the FSI and the government) about whether there is enough control over the drawdown patterns of retirees under the current system.

Specifically, the purpose of introducing controls may relate to super savings:

- being drawn too fast and consumed for unsuitable purposes and/or for causing an extra drain on social security expenditure at some point; or
- remaining undrawn by the time a retiree dies, then being transferred to a beneficiary, which in some cases could be because the amount saved was more than adequate. The perceived problem here is that the tax concessions provided for the savings will have been wasted, except to the extent that they are clawed back, either by benefits tax or by being forfeited as part of an insured product pool.

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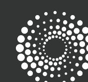
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DEFERRED LIFETIME ANNUITIES - A CASE STUDY:

Let's see how the introduction of advantages for deferred lifetime annuities (DLAs) might affect the decision-making of Roger and his fellow retiree Novak. Roger, aged 65, is a single homeowner with $500,000 of super. He invests $400,000 in an account-based pension and $100,000 into a DLA. His neighbour, Novak, has similar circumstances but invests $500,000 in an account-based pension.

As Roger's DLA is exempt from both the income and assets tests over the next 20 years, Roger picks up extra age pension, initially at the rate of $3900 a year. Novak misses out on this extra age pension, even though he is minimising his drawdown rates to make his savings last as long as possible. This would be the case even if Novak were so concerned to make his savings last that he chose instead to leave $100,000 in an accumulation account until 85 and start only a $400,000 account-based pension. Novak would also miss out on the tax exemption on the earnings on the accumulation account. If the investment portfolio backing Novak's super accounts has been well managed and his drawdowns are well applied throughout his retirement, should his government support be so different from Roger's?

Perhaps the government could at least improve Novak's position to some degree by reducing the minimum drawdown levels for account-based pensions so that Novak will not feel the need to quarantine some of his super savings for late in life and will therefore put all his savings in his account-based pension. Indeed, the government is reviewing the current minimum drawdown levels for account-based pensions, particularly having regard to changing investment conditions (for example, the 2008 GFC). The prospect of improved longevity is also a relevant consideration for this review.

Alternatively, perhaps Novak should be able to acquire a non-commutable, deferred market-linked income stream, which gets treatment equivalent to a DLA.

Whatever the breadth of the proposed new DLAs, it would seem that the tax or social security advantages would come at a cost to government, bearing in mind that the rate of return from a conventional DLA will typically be lower than the expected return rate for a prudently invested account-based pension, albeit without the variability. How would that extra cost be paid for? With tighter contribution caps? With less favourable treatment for other types of retirement arrangements? Or can it be shown that there would be a net benefit to the government because the DLAs will reduce the government's age pension expenditure in the senior years? How will the net benefit be calculated?

CHANGING THE RULES

Let's assume for the moment that the outcome of the reviews is that the government accepts that tax exemption should continue to be given to deserving pension products. We can then start exploring the issues that the current reviews are raising.

The broad issue could be said to be: should we stick with the current rules or could the rules be improved to better meet the purpose of super? There seems to be a presumption on the part of many stakeholders that the rules are either broken or, as the FSI interim report declares, "underdeveloped". This declaration could be challenged on the basis that, historically, the Australian system has had a number of eras of different sets of income stream rules and, while the current rules do not cater for or require certain pension characteristics, the system has very robust core characteristics. However, there is always room for improvement; so let's explore possible improvements and some of the specific issues that arise.

MANDATING VERSUS NUDGING

The FSI interim report contemplates whether the government should impose what could be called a mandating approach to accessing benefits. This could embrace some or all of the following:

- a limit on maximum lump-sum withdrawal
- a requirement to take an acceptable type of pension with some or all of super savings
- re-introduction of maximum drawdowns on account-based pensions
- a requirement to take some or all in the form of a particular pension product type.

The report canvasses the possible compulsory use of a longevity-based pension:

- for part or all of a retiree's super
- immediately or on a deferred basis (for example, at age 85) or
- for those retirees who do not actively choose a particular solution (for example, a default pension for MySuper product members).

The report notes what it seems to regard as a contradiction within our current system: a compulsory contribution phase, but no compulsory drawdown requirements. However, it can be argued that on the whole, well-advised retirees would make prudent decisions in the drawdown phase. It is perhaps worth pausing to reflect, therefore, on the extreme contrast between a mandating approach and our current system, which caters for the fact that needs of retirees are diverse and change over time. Is there a more moderate approach? What if retirees were instead just "nudged" towards suitable drawdown patterns? That is, the rules would stipulate appropriate tax or social security incentives and disincentives structured around appropriate minimum and maximum drawdown levels.

UNIVERSAL PRODUCT RULES

If a nudging approach is to be preferred over mandating, the question arises as to whether you set the drawdown parameters on a product-by-product type basis or whether you establish a product-neutral, universal set of parameters.

If we are to continue to have different rules to define different products, then the question arises as to whether certain products should attract extra government concessions on the basis that they better address longevity, investment, inflation or other retiree risks. Certainly, this is one of the big themes being emphasised by a range of stakeholders.

DEFERRED LIFETIME ANNUITIES

In the product sphere, one of the key focuses of the government's review is whether or not deferred lifetime annuities (DLAs) should be enshrined in legislation as products that could be acquired by a retiree with super savings and would attract tax and social security advantages. There have been regulatory hurdles in developing products that come into play once a retiree's immediate income stream account has been exhausted. The broad idea is that DLAs would be purchased during the earlier phases of retirement and start producing an income stream at a mature age – such as age 85 – and would be guaranteed to last until death. This is presented as a means of addressing longevity risk and potentially reducing the government's exposure (via its age pension expenditure) to it.

So it's perhaps worth exploring an example involving DLAs to get a feel for what might happen if the government introduces product-based retirement income stream incentives. (See case study on page 24). The idea being put forward in the two current reviews is that DLAs should attract tax exemption during the deferral period (that is, the period between the time the DLA contract is entered and the first income payment is made). Also – at least in the view of some stakeholders and Henry – for age pension purposes, they would be exempt from both the income test and the assets test. This would be on the basis that there would be no access to capital, notwithstanding that DLAs clearly have a value.

BEYOND PRODUCT

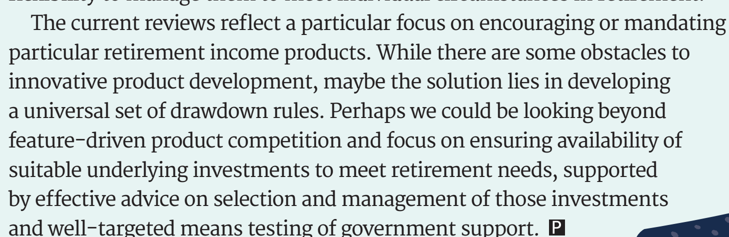
The government's review of retirement income stream regulation is limited to exploring product-related rules for income stream products. It does not explore the prospect of a universal, product-neutral set of parameters for all retiree drawdowns. Nor does it look beyond the product sphere to the manner in which advice is delivered and the tax and other settings affecting the choice of underlying assets to back an income stream. By contrast, the FSI interim report does touch on the advice and underlying asset aspects, at least for part of the solution.

There are some fundamental questions to be addressed: How much focus needs to be given to each sphere? Do we need to explore more thoroughly ways of improving knowledge and access to super fund investment portfolios that suit various stages of life?

And would it help if, for example, both retirees and product providers could acquire longer-dated government bonds, including inflation-linked bonds? The FSI interim report suggests that these bonds could be provided to assist life offices to provide guaranteed products. And they could be made available to all super fund trustees, including self-managed super funds (SMSFs), for the purpose of backing account-based pensions to varying degrees.

You could be forgiven for being confused about the inter-relationship between the various reviews of our retirement income system and for being left with the impression that radical change is afoot. You could also be forgiven for forgetting that many commentators regard the Australian retirement income system as one of the most desirable in the world. It compels and encourages appropriate superannuation savings and provides flexibility to manage them to meet individual circumstances in retirement.

The current reviews reflect a particular focus on encouraging or mandating particular retirement income products. While there are some obstacles to innovative product development, maybe the solution lies in developing a universal set of drawdown rules. Perhaps we could be looking beyond feature-driven product competition and focus on ensuring availability of suitable underlying investments to meet retirement needs, supported by effective advice on selection and management of those investments and well-targeted means testing of government support. P



DLA features and alternatives to conventional DLAs

There are some fundamental issues to be addressed if DLAs are to be introduced as a viable income stream option, particularly on how they would relate to a retiree's other (immediate) retirement income arrangements. This could be addressed by developing rules flexible enough to allow "hybrid" income stream products, which have multiple stages, including "embedded" DLAs in some cases.

However, in relation to stand-alone DLAs, there are also specific questions about product features that are being worked through, such as:

- Should a DLA be able to be commuted?
- Should it be able to provide residual capital on death?
- Should the DLA be purchased with a single upfront payment or should it be able to be purchased by instalments.
- Should a DLA be able to be purchased before retirement?
- Should income payment levels be guaranteed, or could the returns be market-linked (for example, by surviving investors sharing in a pooled investment on a proportional basis). This sort of arrangement has already been explored in the development of some hybrid products and might help address some of the risk and return issues with conventional DLAs referred to above.

David Shirlow is an executive director of Macquarie. The views expressed in this article are that author's own and do not necessarily reflect the views of Macquarie Bank or the Macquarie Group.