ARISA

Australian Retirement Income Streams Association Limited

Review of the Superannuation Industry (Supervision) Act 1993 and other Superannuation Legislation

Productivity Commission Act 1988

Introduction

The Australian Retirement Income Stream (RIS) market has increased tenfold in the past 8 years, growing at an annual rate of around 33%. Despite the increased growth, there is an urgent need to expand the range of retirement income stream products available in order to encourage more Australians to take their retirement benefits in the form of a regular income stream. Currently product development is subject to existing legislative restrictions and in many cases unnecessary duplication or inconsistency. There is also a pressing need to increase market competition with respect to the provision of retirement income streams in all sectors of the market.

(a) Inconsistencies/Duplication *within* SIS

(i) Permissible products

Division 1A.1 of the SIS Regulations describes 6 'types' of annuities which come within the meaning of 'annuity' for the purposes of s.10 of the SIS Act, and 4 'types' of pensions which come within the meaning of 'pension' for the purposes of s.10 of the SIS Act. The list includes:

Annuities:
- 'Complying' lifetime annuities (SIS Reg. 1.05(2))
- Allocated annuities (SIS Reg. 1.05(4))
- Fixed term or lifetime 'non complying' annuities (SIS Reg. 1.05(6))
- Annuity with bonus payments (SIS Reg. 1.05(7))
- Mixed annuity (hybrid) (SIS Reg. 1.05(8))
- 'Complying' life expectancy (SIS Reg. 1.05(9))

Pensions:
- 'Complying' lifetime pensions (SIS Reg. 1.06(2))
- Allocated pensions (SIS Reg. 1.06(4))
- Fixed term or lifetime 'non complying' pensions (SIS Reg. 1.06(6))
- 'Complying' life expectancy (SIS Reg. 1.06(7))

The focus of the legislative developments to date largely reflects the evolution of different products in the market (eg. annuities with bonus payments, allocated incomes, etc). The end result is that similar products (eg. allocated annuities, allocated pensions, RSA pensions) are covered under separate regulations leading to duplication of similar legislative provisions.

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Also superannuation funds can offer a more restricted range of income streams under existing regulations.

In short, existing superannuation legislation has a heavy bias towards product regulation rather than examining preferred income stream characteristics or features and benefits. As a result the legislative framework has evolved around product names rather than specific product benefits. This means that providers need to consider whether or not to develop income stream products as annuities or pensions, since different regulations apply.

(ii) Maximum commutation values

A commutation in relation to a pension or annuity is a conversion (in part or in full) of an income stream to a lump sum.

Divisions 1A.1 and 1A.2 of the SIS Regulations set out various 'rules' for determining the maximum amount that can be paid when a pension or annuity income stream is converted to a lump sum.

- Annuities described under Reg.1.05(2) and pensions described under 1.06(2) ('complying' lifetime income streams) are not limited in the lump sum amount that can be paid in these circumstances (except where the primary beneficiary dies within 10 years and a lump sum death benefit is paid to a dependant or the estate of the primary beneficiary).

- *All pensions* (other than those described in Reg. 1.06(2)) are limited by SIS Reg. 1.08 to the amount determined by applying the relevant factor in Schedule 1B of the SIS Regulations.

  (This Schedule was originally designed for calculating a 'Notional Capital Value' for RBL purposes for Public Sector (and some private sector) funds which pay pensions based on years of service, age etc. (ie. in situations where there is no identifiable purchase price). Its application to commutation values is not considered to be appropriate.

  There is no equivalent requirement for the lump sum value of annuities to be determined in the same way.

- For 'complying' life expectancy' annuities and pensions, the commuted amount "... cannot exceed the benefit that was payable immediately before the commutation;" (Regs 1.05(9)(ix) and 1.06(7)(viii)). However (see above) technically such *pensions* also fall under Reg. 1.08 which only serves to create legislative uncertainty and industry confusion.

- For fixed term and lifetime 'non complying' annuities (Reg. 1.05(6)), the commutation value is not limited in any way, but for fixed term and lifetime 'non complying' pensions, SIS Reg. 1.06(6) refers to Schedule 1B (at (g)), although a commutation from such a pension already falls within the provisions of Schedule 1B by virtue of SIS Reg. 1.08. Again this leads to legislative inconsistency and uncertainty.

(b) Inconsistencies between SIS and other legislation

(i) <u>Maximum commutation values</u>

The *Social Security Act (SSA)* prescribes the maximum commutation value for all 'complying' income streams (ie. lifetime pensions and annuities, and life expectancy pensions and annuities) in the following terms "...the commuted amount must not be greater than the benefit that was payable immediately before the commutation" (s.9A(2)(l) and s.9B(2)(l)).

This means that SIS and the SSA are 'out of step' except to the extent that the legislation can be interpreted consistently for life expectancy annuities.

The *Income Tax Assessment Act* places limits on the amount of a lump sum commutation from an *annuity* that can be taxed as an eligible termination payment (ETP). Amounts in excess of this limit must be taxed as income. Significantly pensions are not included in these taxation provisions. The provisions are explained in ruling IT 2492, with reference to s.110 and s.116 of ITAA36. These sections of the tax act were repealed by NBTS(Miscellaneous) Act (No.2) 2000 in June last year. Currently it is unclear whether or not the tax ruling is still valid as originally outlined.

The Life Act 1995 prescribes minimum surrender values for all policies of life insurance, including annuities. A full commutation of an annuity is a 'surrender' of that policy. No such minimum values are prescribed for pensions when they are commuted. The only annuities that are not required to have a minimum surrender value are nil RCV lifetime annuities with no guaranteed term (ie. these are a subset of the lifetime non-complying annuity class).

Overall the area of commutations remains one subject to various differing legislative requirements and/or legislative duplication both within superannuation legislation and across other legislative provisions.

(c) Restrictions on market competition

Individual life expectancies are increasing at a rapid rate, due to better overall health as well as medical breakthroughs. Many retirees today will spend as long in retirement as they have in the work force. This is vastly different to the situation earlier this century, when retirees could only expect to live for a few years beyond retirement. Hence, the issue of funding retirement has only really arisen in the past couple of decades as a serious policy issue.

Related to the increase in life expectancies is the rapidly increasing cost of health care for the aged, particularly in the later stages of life. It is becoming increasingly important to ensure that older retirees have enough assets to pay for medical care and/or medical insurance to ensure some control over future government outlays. A structured income stream (payable over a long period of time) is vital to ensure that appropriate income is available later in retirement rather than dissipated early.

One of the effects of longer life expectancies is the need to ensure that limited retirement assets last as long as possible. Where retirees were expected to live only a few years earlier this century, fixed interest investments were appropriate for most retirees. However, today's retirees must invest in a mix of assets (including growth assets such as shares, property, etc) in order to ensure that they will have sufficient income during their retirement. This is reflected in the high level of share ownership among all Australians, particularly retirees, as well as the rapid growth of allocated income streams, which allow growth investments to be used during retirement.

The use of growth investments has also been encouraged by the recent tax reform changes. These changes encourage investment in assets which provide capital growth vie an improved capital gains tax regime (including specific small business concessions). In addition, the changes to the taxation of life companies have the effect of reducing the rates offered by life companies on guaranteed annuities. This means that it is essential to allow retirees to invest in growth assets under whichever product structure they choose, including all types of retirement income streams.

While allocated income streams have introduced many new retirees to flexible income streams with tax and social security incentives, many older retirees who cannot access superannuation have been denied access to these type of retirement products. Having access to a flexible structured retirement income that provides a simple regular pay-packet (after tax deductions), as well as providing some social security benefits, would greatly assist these people in their retirement income planning.

The current restrictions also result in a restriction in choice for retiree consumers, as well as lessening the competition amongst providers of RIS. This arises out of current legislative provisions that restrict non-ETP income streams to guaranteed immediate annuity products only.

Another area of market restriction is with respect to "complying income streams". Complying lifetime or life expectancy pensions and annuities are currently restricted by legislation to guaranteed products only, due to the requirement to ensure that income payments never decrease from one year to the next. This legislative restriction results in life companies being the only effective providers of these products to the broader public. Even public offer superannuation funds that wish to offer such products are usually required to source the necessary income guarantees from a life company.

The effective restriction of complying income streams to fixed-interest style investments also creates an illusion of safety for retirees. The income returns will be restricted compared to the potential returns from growth investments over a longer period of time. In addition, any attempt to change providers in the future may result in penalties (eg. if interest rates have risen), thus ensuring that retirees are locked in to existing products rather than being able to seek the best returns in a free and competitive market place.

The reduction in potential income from fixed-interest style investments also has the effect of increasing, over time, retirees' reliance on the age pension, as well as potentially reducing the amount of tax paid by retirees over their retirement (due to lower total income payments).

(d) Potential Solutions

In order to address the areas of current legislative inconsistency and duplication within the retirement income streams market, a potential solution is to consider drafting one set of pension and annuity regulations based around various product characteristics, such as:

- product type (eg. fixed term, lifetime or allocated);
- guaranteed term or non-guaranteed term;
- no indexation, fixed indexation, variable indexation, CPI linked, etc;
- RCV or nil RCV;
- commutable or non-commutable.

Overall the objective would be to establish one set of rules for all potential income stream providers based around preferred product characteristics from a regulatory perspective. This would ensure that the required 'product rules' do not depend on product names or type of provider (eg. bank, life company, super fund, etc). Note that streamlining the regulation of income stream products in this way also opens up the market to improved competition by ensuring that similar products can be offered under any structure (ie. annuity or pension). It also greatly aids market development by simplifying the current legislative framework involved with product development, reducing compliance costs in the process.

ARISA also believes that there are two fundamental gaps in the range of products that can be offered to retirees under current legislation. Specifically:

- The inability for retirees to invest in an allocated style income stream, where money cannot be invested in superannuation; and
- The inability for complying income streams to vary the income payments from year to year in order to offer retirees exposure to growth assets over their life expectancy in retirement.

While it is acknowledged that both of these areas involve various policy considerations, it is important to note that the current superannuation legislative framework restricts market competition in both of these areas by:

- Limiting the range of potential product suppliers; and
- Limiting the range of potential products.

Both of these restrictions pose significant implications for the future development of a truly open retirement income market moving forward.