19 July 2021

Ms Lynn Kelly
First Assistant Secretary
Retirement, Advice and Investment Division
The Treasury
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Dear Ms Kelly

Innovative Retirement Income Stream (IRIS) Legislative Considerations

Many trustees and product providers in the industry are developing retirement income products designed to comply with the IRIS provisions of SIS Regulations 1.06 A and B. The Retirement Income Working Group (RIWG) of the Actuaries Institute, which is comprised of employees and interested parties within the retirement income industry, have found a number of potential unintended consequences and legislative/regulatory inconsistencies and constraints. This letter details these issues with a view of engaging with Treasury to consider technical amendments to address them.

1 Capital Access Schedule

The SIS Regulations prescribe a Capital Access Schedule (CAS), designed to ensure IRIS products are used predominantly for income purposes and not for the preservation and transfer of capital. The RIWG strongly supports this objective, but there are three issues we would like to raise.

1.1 Variable Income Products

In instances where death benefits are a formula that is linked to income already paid, and that income is variable (either since it relies upon customer experience, or market performance, or both), in extreme circumstances the death benefit formula may breach the CAS.

Possible Solution

The simplest way to address this issue could be to require that product rules are designed to comply with the CAS "in expectation", thus allowing market-linked and experience-based (non-guaranteed) products to vary from the CAS in isolated circumstances. This could be achieved by simply amending SIS REG 1.06A (3)(d) as follows:

"(d) if the benefit is commuted on or after the retirement phase start day for the benefit--the expected commutation amount does not exceed the amount worked out for the benefit under regulation 1.06B;"

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1.2 Life Expectancy of Couples

A further issue with the CAS is that it is calculated based on the life expectancy of the primary member, but for couples the income payments for IRIS products are likely to be based on either the joint life expectancy or the spouse with the longest life expectancy. This creates unintended outcomes and inequity in product operation. For example, if an 80 year-old member had a 60 year-old spouse, the CAS would prohibit the payment of death benefits after only approximately 8 years, yet the product's income would be based on an approximately 24-year life expectancy. This creates inequity for the spouse compared to a single member aged 60 – in both scenarios the income payments would be similar but the permissible death benefits would differ drastically.

Possible Solution

This issue could be addressed by refining the definition of life expectancy period for the income stream to be based on the spouse with the longest life expectancy where an IRIS has a reversionary benefit.

1.3 Product Portability

The CAS does not appear to consider or facilitate product portability – for example if providers were able to facilitate an individual rollover from one IRIS to another then the CAS maximum withdrawal amount applies and is likely to be less than the reserve held for that member. This may impede further development of IRIS products and constrain competition. Mergers of products can be an important part of the efficient running of the superannuation sector.

Possible Solution

The legislation could be amended to clarify that the CAS does not apply to successor-fund transfers or rollovers between IRIS products.

2 Transfer Balance Cap – Conflict with Capital Access Schedule

The Transfer Balance Cap (TBC) creates potential conflict with the CAS (and with the product rules) in cases where an excess balance triggers an ATO commutation authority. The most likely example is where, on death, an IRIS reverts to a spouse who already has a transfer balance account. Consider a couple who each commence an IRIS worth $1.6m at age 60. Should one of them pass away after 25 years, the actuarial value of the reversionary pension results in a transfer balance credit for the surviving spouse that pushes them over the TBC. Consequently, the ATO would issue a commutation authority to the reversionary beneficiary, requiring them to cash out their pension. This causes two conflicts:

1. Pooled product rules may prohibit the commutation of lump sums – contractually the value of releasable capital in this scenario would be zero; and
2. Any commutation may breach the CAS. This could result in the entire product becoming non-complying.

This issue does not apply to Capped Defined Benefits income streams. This is because for Capped Defined Benefit income streams an excess transfer balance triggers an additional tax liability to the member but not a commutation authority in respect of the income stream (given that such products typically do not provide liquid capital).

Possible Solution

This issue could be addressed if all IRIS products are treated in a similar manner to Capped Defined Benefit income streams for the purpose of ATO commutation authorities.

3 Family Law Splits

Many product providers are focussing on helping members who have already met a condition of release to open an account. In the case of family-law splits, product providers may be required to split a member's interest in the IRIS with a spouse who may not otherwise have met a relevant condition of release. This may have adverse consequences for the pool in respect of meeting the requirements in regulation 1.06A of the SIS Regulations.

Possible Solution

For the avoidance of doubt, the regulations could be updated to clarify that splitting of a member's interest to an ex-spouse following a family court order does not put in jeopardy the product's ability to satisfy 1.06A of the SIS Regulations.

4 Deferred Products and Couples with Age Gaps

If a retiree has a younger spouse who has not met a condition of release, there can be scenarios where IRIS products cannot meet the "income for life" requirement (of the primary and reversionary). For example, if the retiree dies during the deferral period (so payment has not yet commenced) and the spouse has not yet satisfied a condition of release, then the resulting death benefit income stream would not be in 'retirement phase' and the policy must be commuted.

Possible Solution

IRIS products be exempt from forced payout where the spouse has not reached retirement age (or for non-super, Age Pension age). Treasury Laws Amendment (2018 Measures No.4) Bill 2018 fixed a similar issue for Transition to Retirement Income Streams (TRIS), and now allow a reversionary TRIS to be paid to a beneficiary who has not themselves met a condition of release.

5 DHS Asset Test Treatment

5.1 Products with less than 100% reversion

The DHS Asset Test is based on the Purchase Price of an IRIS product. Where an ISIS has a reversionary benefit, often the level of income payments to the reversionary beneficiary is less than 100% after the primary beneficiary passes away. This can result in a mismatch between the assessable value of the person's income stream compared to the income they actually receive. The DHS Asset Test does not recalculate the Purchase Price in this situation and hence the reversionary may experience cashflow problems due to the Asset Test in this event.

Possible Solution

Where an IRIS product "transfers" to a spouse due to the death of the primary beneficiary, the Asset Test value could be based on the Purchase Price, reduced in line with any reduction in income stream being paid as a result of that transfer.

5.2 Deeming rates

For ABPs, the full balance counts toward the Assets Test. Deeming rates are used to determine the assessable income towards the Income Test.

IRIS products are subject to Age Pension means tests introduced from 1 July 2019. The rules impose:

- Assets test - 60% of asset value contributes to assets test until age 84 then 30%
- Income test - 60% of income counted toward the Age Pension income test

The detailed calibration of these rules can impact the relative attractiveness of the two product types (Account Based Pensions (ABPs) and IRIS) compared to each other. Deeming rates have been cut several times since the rules for IRIS products were announced by government to reflect the lower returns being generated across 'deemed' products, such as ABPs, savings accounts, term deposits, shares and managed funds.

However, no equivalent adjustment has been made to maintain the relative attractiveness under the income test for IRIS products. This disadvantage can be amplified for deferred IRIS products given the higher eventual income payments vs an immediate lifetime income product for a given investment amount.

Possible Solution

When deeming rates are reduced, the means testing of IRIS products also needs to be considered, to ensure incentives across product types are maintained.

6 Product structure

6.1 One integrated product

Superannuation fund trustees have indicated a clear preference for delivery of a seamless solution for their members. This means solutions need to appear as 'one product' when viewed from the customer's perspective.

Where an IRIS-style product is intended to be offered in conjunction with an ABP, the preference seems to be for this to work as a single APB with several 'investment options'.

Under this scenario:

- The member chooses an investment option under which the trustee sets up longevity product cover; and
- Money from the longevity product would be credited to longer living members' ABP accounts and then paid out to the member.

Currently, the law does not clearly provide for this kind of ABP-based structure to exist. Longevity products are defined in SIS as stand-alone products and law does not allow for simple integration of a longevity solution 'into' an ABP. There are a number of technical issues, such as the minimum payment rules for an ABP, which make this approach largely unworkable.

Instead, a trustee creates two sub-accounts for the member, one for the ABP and another separate sub-account is created to house the longevity product. Under both scenarios there are technical barriers and issues which complicate delivery of CIPR-style products.

Possible Solution

For product development to occur unimpeded, a wider variety of options should be allowed, so that a suitable approach can be determined according to the needs of each trustee's members. Some funds may wish to allow a range of income streams for the same member – like investment options. A clearer statement as to how longevity products are intended to interact with ABPs is needed. The more flexibility that can be offered, the more opportunity there is to develop solutions which meet the needs of wider superannuation fund trustees and their members.

6.2 Funding of mortality credits

The funding of innovative income streams as envisaged by Superannuation Industry (Supervision) Regulations (SISR) Section 1.06A involves the transfer of funds (or reserves) from those who die to those who survive. Such transfers can take place within a mortality pool, or can involve payments to or from participants in the pool or to an insurer (or reinsurer) that is pooling, or guaranteeing, the mortality risk.

We have been shown a response by the ATO to a potential product design that identifies regulations that seem to prohibit these innovative products where the pooling of mortality credits occurs across a number of funds. We fear that the understanding underlying this response has prevented some innovative products being developed.

"Based on the information provided, the initial ATO view is:

- In general, a member's benefits in a regulated super fund cannot be cashed in favour of a person other than the member or their legal personal representative (SISR 6.22). There are exceptions to this rule but the ... scheme does not meet the requirements of any of them.
- SISR 5.08 is not met because the benefits are not cashed or rolled over or transferred as benefits of the member – they are transferred to a remaining participant of the MP scheme.
- Monies transferred between funds would constitute contributions1. This could result in the recipient's contributions cap being breached, or, if the recipient's superannuation is in the pension phase, a breach of subparagraph 1.06(1)(a)(ii).

The views expressed in the first two bullet points would prevent funds being "cashed" in favour of other members of the pool (or the insurer) on the death of an annuitant or pensioner, who was participating in a mortality pool. The view expressed in the third bullet point would prevent other members of the pool from receiving mortality credits from those that die (or the insurer). Mortality credits cannot be seen as contributions in the normal sense of the word even if these are transferred between different funds.

Possible Solution

It may be that this is a misunderstanding that can be quickly cleared up, or the relevant regulations should be amended to make it clear that they do not apply to payments that arise from a life annuity or group self-annuitisation type contract.

Please feel free to contact Brnic Van Wyk Brnic.VanWyk@qsuper.com or Anthony Asher a.asher@unsw.edu.au if you have any questions arising from this letter.

Yours sincerely

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