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Benefits and Regulation Unit
Personal and Retirement Income Division
The Treasury
Langton Crescent
PARKES ACT 2600

Review of retirement income stream regulation

The Actuaries Institute identified “the pressing need to develop a more vibrant annuities market” as one of its major policy objectives some years ago. Removing the legislative barriers preventing innovation in developing-retirement income stream products such as annuities is a crucial element of making it possible to achieve this objective. ¹ We therefore enthusiastically welcome the Government’s Review of retirement income stream regulation.

Actuaries have a particular interest in this area as the profession has played a central role in the design and financial management of annuity products for two centuries. The mathematical models underlying annuity design form an important part of actuarial education, and the profession is active in research into relevant mortality rates and their projection.

This submission responds to the questions asked in the discussion paper. Attached as an appendix is an Institute discussion on the principles underlying our response. It was prepared by the Institute’s Retirement Income Working Group that has been working on these issues over the past two years.²

We make various suggestions as to ways of adapting the regulations to permit greater flexibility. In particular, we suggest a unifying principle of using a prescribed real investment return and mortality basis to set a target retirement income. This is already inherent in the minimum drawdown regulations and provides a basis to answer the questions posed. Coherence of policy can therefore be maintained while permitting greater flexibility.

The Institute would be pleased to discuss any of these recommendations in more detail. Please do not hesitate to contact our Chief Executive Officer, David Bell, on (02) 9239 6106 or email david.bell@actuaries.asn.au if you wish to discuss the matters raised in this submission.

Yours sincerely



Daniel Smith
President

¹ <http://www.actuaries.asn.au/Library/MediaAndPublicPolicy/2013/RetirementIncomesPolicyPosition.pdf>

² Its background paper on the issues can be found at:
<http://www.actuaries.asn.au/Library/Events/SUM/2013/Sum2013Retirement%20Incomes%20Working%20Group.pdf>



Question 1

What types of income stream products would enable retirees to better manage risk in the retirement phase (in particular longevity risk and investment risk)?

We agree with the analysis in the discussion paper on the effect of limitations in the current rules. The rules currently permit products where the retirees bear all investment and longevity risks, or contracts where the product provider takes all these risks. We see a real need for products where the risks can be shared. Such products go beyond hybrid contracts (including variable annuities), which were initially questioned as to whether they were permissible, but there are now a few versions available in the market.

For ease of reference, the word “annuity” is used in this submission to cover a broad range of products designed to provide income in return for monetary consideration, including those with a life company guarantee, products defined as hybrids for the purposes of the discussion paper and products providing longevity protection either by way of guarantee or participation in a pooling mechanism. It does not include account based pensions with no guarantees attached. Words such as “traditional guaranteed annuity” or similar are used when describing products issued almost entirely by life companies, where the amount and timing of income payments is precisely defined at the outset in either nominal dollar or inflation linked terms and are guaranteed by the product provider.

To better allow for products that permit both longevity and investment risks to be shared more efficiently between providers and retirees, we suggest that the following flexible long term products are needed. All are available internationally, some more widely than others. It is important to note that, when designing the legislative framework, retirees will often require more than one type of product to meet their retirement needs, having regard to their overall income needs and risks. Consistency of principle in regulation between products is important to ensure that choices are not distorted as well as government objectives also being met.

- Pooled annuities and Group Self-annuitisation (GSA) products. For the purpose of this paper, pooled/GSA annuities are taken in the broadest sense as any lifetime income product which involves sharing of longevity experience within a pool. These include with profit annuities (WPA's) and Group Self-annuitisation products such as tontine annuities, some forms of which are widely used internationally, but not in Australia. Pool members share longevity risk and so, if the pool is large enough, idiosyncratic (individual) risk can be almost eliminated although the members are still exposed to systematic changes in longevity. Some of the common forms are separately discussed below, but a wide variety of designs is possible:
 - With longevity risk, providers can absorb some risks (particularly shorter term risks when the pool is small), and there are different ways of sharing idiosyncratic and systematic risks between cohorts.
 - Investment risk varies with the underlying investments, with some providers providing a variety of smoothing arrangements and guarantees.
 - Under some structures, initial payments are based on assumptions as to expected mortality rates and investment returns. Subsequent payments are adjusted to reflect actual investment returns and mortality. Providers use a variety of methods to vary payments as a consequence of changes to future expectations.
 - Other mortality sharing pool arrangements may simply distribute mortality profits to survivors each year, reducing or eliminating the need for any reserving or assumptions about future mortality experience.



- Investment Linked Annuities (ILAs). These products are a form of annuity, and provide an income throughout life where the income is defined as the value of a particular number of investment units each month, quarter or year. The number of units does not have to be constant but is specified in advance. Just as with traditional lifetime annuities, the product provider prices the product based on estimates of future mortality and effectively fully insures longevity risk. However, investment risk remains with the individual not with the provider, unlike with traditional guaranteed annuities.
- Guaranteed Minimum Lifetime Withdrawal Benefits (GMLWBs). These are investment-linked products which offer protection against a combination of longevity and adverse investment experience. In retirement, the product is similar to an account-based pension with an optional guarantee that pays an annuity for life if the account balance has been exhausted. The GMLWB is typically expressed as a fixed percentage of the highest account balance achieved at a prior policy anniversary. In Australia several life insurers have recently launched GMLWBs but take up has been limited.
- Participating (with-profit) Annuity (WPAs). These products share both investment and longevity risk between the retiree and product provider. They feature a guaranteed annuity at a rate that is less generous than the equivalent rate for a non-participating annuity supplemented by additional bonuses if investment and longevity experience is favourable. Some versions set the initial payments at a level that will reduce annually if bonuses are not earned. They are also a particular form of pooled annuity.
- Deferred Lifetime Annuities (DLAs). These can take any of the forms set out above, but initial payments start after a set deferment period and are then payable for life. The benefit payments are typically large relative to the initial purchase price. This feature of a DLA would provide a way to protect retirees against the risk of outliving their retirement savings at an advanced age. GSA/mortality pool products can be structured to provide similar longevity protection but without a guaranteed level of income.
- Enhanced or Impaired Life Annuities. Annuity rates that take no account of the annuitant's individual life expectancy do not provide good value to the unhealthy and lower socio-economic groups. Providers may offer enhanced annuities, under any of the above arrangements, which pay higher incomes to people with lower life expectancies. It is not expected that special rules are required for these, as payments would generally be higher and terms on average shorter, than for non-impaired lives. However, if these were products to be widely taken up it is possible that the mortality of those taking up non-impaired products could be lower (more select) than otherwise.
- Contingent Annuities – These are deferred annuities where payments are made, or the annuity commences, on the occurrence of a contingent event. Such an event could be the death of another person, a defined decline in health or entry into care or after a particular investment loss has occurred.

We have not distinguished between SIS regulation 1.05 and 1.06, believing that they should both permit the same products for life companies and superannuation funds. We anticipate retirees investing in a range of products from different providers.

Question 2

Do the annuity and pension rules constitute an impediment to the development of new products and if so, what features of the rules are of most concern from a product innovation perspective?

Several features of the current annuity and pension rules are an obstacle to product development:



- The restrictions on indexation arrangements (e.g. to the same percentage each year or to CPI or AWE) are problematic for pooled/GSA annuities, ILAs and WPAs (where the annuity payments may vary based on experience not known in advance).
- The requirement of no further contribution creates a barrier to product innovation where the ATO has interpreted this requirement to prevent account balances being increased by insurers paying out GMLWBs and raises doubt about the distribution of “longevity bonuses” from pooled annuity arrangements.
- Rules that benefit payments are made at least annually create obstacles to DLAs. Superannuation tax on investment income therefore has to be paid in the deferral period making them unattractive to retirees.
- Minimum payment rules are not defined in situations where no well defined “account balance” exists, except for certain immediate annuity types which were in existence in 2007 when the current rules were formulated.

Question 3

What changes could be made to the annuity and pension rules to accommodate a wider range of income stream products while having regard to the need to protect against abuse of the earnings tax exemption and to promote appropriate and prudent retirement income objectives?

The rules should be broadened and to the extent possible be principles based, rather than product specific, so that product providers are able to develop with confidence a wider range of product offerings. This will facilitate more choices to retirees for balancing income needs and risks during retirement.

The broad requirement is that a product provides a regular income payable at least annually (once commenced) based on a reasonable set of product rules, which:

- Are specified in advance to the extent required to ensure retirees understand the product they are purchasing in accordance with current disclosure requirements;
- Permit variation based on actual investment, mortality and expense experience during the period, and do not require the product provider to guarantee any payments (the product provider may choose, but should not be required, to do so);
- Do not permit unreasonable deferral of income.

It is expected that the rules will need to contain parameters in order to achieve these objectives. For example:

- Minimum payment parameters will continue to be required for account based pensions.
- Existing rules for traditional guaranteed annuities linked to the minimum payment parameters are likely to still be required.



- For products other than account based pensions it is expected that, apart from the variations permitted due to experience as mentioned above, other variations must be limited in some way to ensure adherence to the principles of regular and no unreasonable deferral of income. Limitations would likely apply along the lines of requiring such variations to be specified in advance based on some risk sharing mechanism.
- Pooled annuities, ILA's and WPAs represent a particular challenge because the possible range of detailed product rules and operation is quite broad.

An example of an approach which could be followed for pooled annuities, ILAs and WPAs is by use of a scenario test, as follows:

- The scenario will comprise:
 - A prescribed real future investment earning rate on assets;
 - A prescribed mortality table.
- To meet the test the product must return, for all possible buyers and based on its disclosed product rules, a level or decreasing real income throughout the term of the product.
- The product provider will conduct this scenario test prior to product launch and provide a certification in the PDS that the minimum standards are met. Because it is in the PDS it must be continuously valid while the product is on sale, hence must be reviewed whenever the prescribed scenario or the product rules change. In force products do not have to be retested unless there is a change in product rules affecting the existing product holders.
- The initial minimum payment equals a percentage of the purchase price equal to $1/a$, where 'a' is the value of a lifetime annuity of \$1pa real, payable monthly, using the assumptions in the prescribed scenario. No subsequent minimum payment standards apply after year 1 for pooled, ILA or WP annuities, though the broader principles set out above limit variations.
- Annual payments from the pension or annuity will differ from the above scenario because the actual expected investment returns and longevity experience will differ from the prescribed scenario. These differences are not subject to the minimum payment rules provided they are in line with the product rules as disclosed to purchasers and incorporated in the scenario test described above. It is important to realise that the scenario testing concept does not limit product rules or require any guarantees. It is merely a scenario test conducted to ensure that the government's requirements are met in relation to protecting against abuse of the earnings tax exemption and prudent retirement income objectives.
- The following considerations apply in relation to the prescribed scenario:
 - The rate of investment return should be a real (inflation linked) risk free return, perhaps with a modest deduction to allow for fees and expenses. The risk free return would be based on the real yield on Commonwealth Government Indexed Bonds. No retiree should have a lower investment return aspiration, due to the low risk nature and inflation hedge.
 - The mortality table should again be on the light side with some allowance for expected improvements. Otherwise the test is unduly constraining, having regard to the need to allow for the self selection inherent in products in which



balances are placed in a mortality pool rather than the annuitant's estate, in event of death. Overseas annuitant or pensioner experience could be used to determine the table, though there is a practical advantage to using a widely available local mortality table that is regularly updated and suitably adjusted.

- o The prescribed scenario should be reviewed regularly, perhaps every two years or when a threshold change triggers a review, whichever is first.

Allowance for DLAs could be made with following considerations (but also see our answer to question 7):

- Purchase could be permitted at any time, but investment returns should only be free of tax once the purchaser has reached a well-defined proxy for retirement age (such as preservation age, tax free age or pension age). Accumulation style superannuation tax would apply before this proxy age.
- In order to be eligible, a DLA must provide a level or decreasing income throughout life, from the payment commencing age (or deferral age), based on the prescribed scenario. The minimum payment standard is the same as for pooled annuities described above, all based on a value of a deferred lifetime annuity of \$1pa real using the prescribed scenario. Provider certification applies in the same manner as pooled annuities.
- The benefits paid after vesting should be subject to the same rules applying to other annuities. Minimum payments are determined as above.

APRA's surrender standards can be an obstacle to the sale of DLAs by life companies. LPS360 permits APRA to waive the requirements of the standard, and – for immediate annuities – there is no minimum commutation benefit if there is no death benefit. We assume that APRA would apply the same rules to DLAs, but it would be desirable for this provision to be specifically included in LPS360.

Question 4

Would such changes lead to new products being brought onto the market?

There can be no certainty, but we note:

- While guaranteed annuities had all but disappeared from the Australian market, active marketing and some product innovation has seen their re-emergence, suggesting that there is more of a demand than was thought.
- Alternative products are widely available overseas and are often more popular than guaranteed annuities.
- There has been wide-spread interest in removing the regulatory barriers by individuals representing a wide range of participants in the Australian financial sector
- Financial advisers and retirees are becoming more aware of longevity risk and are looking for products which can help manage this.

Question 5

Should people only be able to purchase a DLA with superannuation money?

No. However, only DLAs purchased with superannuation money should be subject to the concessional superannuation tax rates on investment income of the product provider.



Question 6

Should people only be able to purchase a DLA for an up-front premium or should other purchase options also be allowed? If an annual premium approach is allowed, what should be the consequences if the premium payments cease?

Purchases could be made by annual premiums, although we note that the considerations suggested in question 3 become complicated. Each payment could be considered as purchasing a defined amount of DLA. If premium payments cease, a DLA equal to that purchased by premiums already paid would continue to be contractually payable.

Question 7

Should there be an upper limit on the amount that can be invested in a deferred lifetime annuity?

There are a variety of options that can be taken to prevent DLAs being used to defer tax. Sufficient limitations on possible commutation and death benefits would mean that they would not be attractive for deferring income. We suggest some limitations in our answer to question 10.

An alternative would be to limit the proportion of superannuation used to purchase a DLA benefit.

- The proportion should be no greater than a prescribed maximum percentage. It is expected this will be taken from a simple table by age group and period of deferment only. A possible refinement would be to allow for joint lives in the table, but this would make it more complex and hence is not recommended.
- Underlying the prescribed maxima are calculations of the type B/A where A and B are determined at the purchase date using the prescribed scenario assumptions described above. A is the value of a lifetime annuity of \$1pa real, commencing from age of purchase of the DLA. B is the value of a deferred lifetime annuity of \$1pa real commencing from the payment commencement age of the DLA (note - \$1 is at date of purchase not commencing age). Results from these calculations are grouped and rounded (with judgment) to form the prescribed table. Rules will be required on how to apply the table in more complex situations such as reversionary beneficiaries, multiple DLA purchases etc.

Limiting the proportion would both stop the DLA being used to circumvent the current minimum withdrawal rules by wealthy retirees (hence obtaining significant tax deferral potentially beneficial for estate planning), and ensure that less informed individuals do not over-insure.

We note that it would be conceivable that a retiree with a significant DLA may not be able to access a benefit before the vesting age, but might not qualify for an age pension as a consequence of means tests. It would be necessary that DLA providers either make provision for retirees in such circumstances to be given access to their DLA benefits at an appropriate level or provide a prominent warning in the PDS of this risk. The prominent warning requirement might also apply to Statements of Advice issued under the legislation governing the provision of personal advice.



Question 8

Should there be a minimum deferral period for a DLA? If so, what would determine the period?

Our answers in question 7 and 10 eliminate the need for a minimum period.

We note that the simple table of maximum amounts and minimum payments for DLAs described in section 7 may operate somewhat bluntly in some cases. For example high income couples have a joint life expectancy of over 30 years at retirement.

Question 9

Should there be a maximum deferral age or period? If so, what should it be?

The nature of the suggested maximum limit for DLAs means the maximum reduces as the deferral period increases. This and the limited ability to provide an attractive death benefit at high ages means there is no need to specify a maximum deferral age or period.

Question 10

Do the payment features described in paragraphs 51 and 52 strike the right balance in allowing people to insure against longevity risk while avoiding unnecessary restrictions on product development?

- **Commutability (paragraph 51)**

The limits on commutability after retirement are a regulatory residue of the maximum payments that used to be applied to qualifying pensions and annuities. They are therefore unnecessary except in legacy situations where social security means test concessions still apply, but these concessions have not been available for many years now for new annuities and pensions.

Commutability options should therefore be permitted, but not required for immediate pensions and annuities. If commutation is permitted in whole or part for any type of product with a guarantee that payments will continue throughout life, the amount of that income will be much lower than if no commutation is permitted.

An exception could be made if rigorous evidence of good health was required for commutation, but this may well defeat some of the reasons why commutation is attractive to retirees in the first place.

Some degree of commutability can help overcome consumer obstacles to purchase and will be essential, at least in the early years, if the product is to be considered as part of a default 'MyPension' arrangement.

As discussed in our answers to question 7, there are quite likely to be circumstances where commutation may be necessary to avoid hardship. If DLAs are restricted to a sensible portion of superannuation proceeds, we believe that all commutation options should be acceptable.



Alternatively, if commutations were limited to a return of the initial investment in the first (say) five years, and to cases where there are grounds of financial hardship similar to those required for early release of pension benefits, DLAs would not be attractive vehicles for tax deferral.

- **DLA lifetime payments guaranteed or indexed (paragraph 52)**

We think this leads to unnecessary restrictions on product development, and that the benefits could be payable in any way permitted for other types of annuities.

Question 11

Should providers of DLAs be able to offer a death benefit? If so, should there be restrictions on the size of the death benefit that could be offered? If so, what restrictions?

To prevent the use of DLAs for estate planning purposes, the death benefit should be restricted to the size of the initial purchase price or the commutation value (if permitted).

Question 12

Are the current minimum payment amounts for account based products appropriate to achieve the objectives outlined above, given financial conditions can change?

These reflect annuity factors that at one point would have been very conservative, but are now too high for retirees investing in government inflation linked bonds due to the low real return on such bonds. These bonds are arguably the most "risk free" investment for retirees and hence form an important benchmark return. They currently yield about 1% to 1.5% above inflation. The illustrations in chart 1 of the discussion paper, however, assume returns of 3.5% above inflation.

In the case of guaranteed pensions and annuities, providers are struggling to offer profitable products meeting the standards. Products available for those with higher life expectancies may therefore be withdrawn from the market. Application to all retirees, regardless of their life expectancy, is also somewhat inconsistent. That being said, there is merit in not distinguishing between males and females, or socio economic group, in setting the limits.

In the case of allocated pensions and annuities, balances can - at younger ages - increase if investment returns are reasonable, but at ages over 80, the minimum payment standards force members to reduce their balances at increasingly faster rates, causing them to be potentially exhausted prior to death. They do, however, ensure that the retirees using these products enjoy approximately the same tax advantages as those with other types of life annuities.

We submit that the minima should be adjusted periodically as per our suggestion in question 3 above: they should be determined as the amount required to purchase a level real income payment throughout life using the prescribed scenario. The scenario described in question 3 may need to be converted to a simple table of minimums for account based pensions. It is arguable the mortality assumption should be higher, taking out the allowance for self selection applicable to pooled and deferred annuities. The use of the scenario in question 3 ensures some consistency of principle between account based pensions and other products.



Question 13

Should there be an automatic mechanism for adjusting the minimum drawdown amounts in response to significant adverse investment market performance? If so, what should that mechanism be? How would this also satisfy the rationale for setting minimum payment amounts?

We understand that one reason for the relief given to the minimum drawdown amounts was that retirees were being required to base their drawdown amounts on their balances of the previous 1 July. We think that there would be arguments for permitting the use of more recent balances should they be less than, say, 85% of the value at the beginning of the financial year.

Our suggestion in response to question 12 could be applied here. Some automatic mechanism for adaptation should be incorporated into the minimum drawdown requirements. It is suggested that the table of minimums be reviewed whenever there is a change to the prescribed scenario tests.

It should be based on long term real interest rates as they are the appropriate benchmark for retirement incomes. Those invested in share markets should be aware of the risks attached. Very large falls in the share market will often (but not always) be accompanied by falls in real yields. It should be noted that market falls are accompanied by a rise in income yields (interest, dividend or rents). Thus the most important quantity for retirees, being income, is more stable than asset values.

Overall, as the rules as apply to allocated pensions and annuities are intended to ensure that such retirees do not obtain excessive tax benefits, it is difficult to support any changes to the limits.

Question 14

Should the minimum drawdown amounts also increase in response to very strong market performance? Would the mechanism be similar to that for decreases? Would this satisfy the rationale for setting minimum payment amounts?

As above, the minima should be based on long term interest rates and take no account for share market movements.

Question 15

For how long should the change remain in place? Should it be left in place only for the year in which the shock occurs, or until balances have 'recovered' by a particular extent?

As mentioned in the answer to question 3, the prescribed scenario would be reviewed every two years or when a threshold change triggers a review. The latter is most likely for real yields, when a 1% change review trigger might apply.



Question 16:

What other issues need to be considered if the minimum drawdown amounts should fluctuate?

The mechanism of changing the level of minimum drawdown may consider the mean-reversion of long-term investment return. Other than market factors, the future longevity improvement and future needs of age care should also be considered.



APPENDIX

Draft Principles for the Development of Eligible Retirement Income Products

Retirement Income Working Group (RIWG)

1 Introduction

This paper has been prepared by the RIWG of the Actuaries Institute, and recommends changes to regulatory settings to permit a fuller range of retirement products in Australia.

Changes that would make retirement products more attractive than currently eligible arrangements - from the perspective of tax or means tests - are out of scope.

There are well-recognised regulatory barriers to the development of retirement income products in Australia. As a result, Australian retirees are currently limited to choosing between lump sums, account based pensions and guaranteed immediate annuities to provide their income in retirement. Lump sums and account-based pensions provide no longevity protection, whereas guaranteed immediate annuities reduce the flexibility and tax concessions available to retirees. Internationally a much broader set of retirement income products are available (see Appendix A), however there are barriers to the development of these products in Australia.

The issues and some suggested principles for a way forward were published in an ASFA research paper "Changes to Regulatory Settings for Financial Products Dealing With Longevity" by Ross Clare in October 2013. That paper indicated the following matters requiring attention:

1. Amend SIS regulations, mainly to be less product specific;
2. Amend APRA's minimum surrender value standard (LPS360) and other standards unnecessarily inhibiting retirement product innovation;
3. Amend the means test treatment for longevity products;
4. Reform approval processes for such products;
5. Facilitate advice provision for retirement products;
6. Ensure the tax treatment has parity, for both provider and beneficiary, with well established products;
7. Allow superannuation funds (including SMSFs) to purchase any eligible retirement product which an individual is entitled to purchase.
8. Allow MySuper products to pay benefits as pensions

This paper focuses on the product aspects - primarily the matters covered in 1, 2, 3 and 6 above - and some of the issues arising from regulatory requirements designed to:

- a. ensure products receiving favourable tax treatment do fulfil the intended purpose of providing retirement incomes on a systematic basis; and
- b. provide no opportunities for tax minimization and deferral inconsistent with that purpose.



Currently, if the regulatory requirements are met then investment income earned on assets backing the retirement income is tax free. For beneficiaries over age 60 the benefits (income or withdrawals) are also tax free. This contrasts with:

- superannuation fund investments, other than those referable to pensions and annuities meeting SIS requirements, where the investment income is taxed at 15% (10% for certain capital gains), and
- assets held outside superannuation where investment income earned each year forms part of taxable income so is taxed at standard rates (which range from 0% to 45% plus the Medicare levy), subject to deductible amount rules.

One proposal that could be considered is to begin retirement income product rules from scratch. The current legislation is so complex that it substantially increases the cost of product development.

2 SIS requirements

The SIS regulations describing the requirements an annuity (r1.05) or pension (r1.06) must satisfy to be classed as eligible are complex, in part to “grandfather” a number of legacy arrangements not available to new pensions and annuities. Some of the definitions that apply in the Income Tax Acts and the Superannuation Regulations are shown in Appendix B. The main requirements for **new** pensions and annuities are:

2.1 No contributions or rollovers may be added;

Comment: This restriction is presumably to ensure that contributions are paid into active accounts and not accounts in the drawdown phase. It is potentially a barrier to product innovation in that we understand that the ATO has interpreted it to prevent account balances being increased by insurers paying out variable annuity guarantees or the redistribution of “longevity bonuses” from pooled annuity arrangements. This can potentially be addressed by the ATO amending its interpretation or by defining contributions in the regulations as payments made by members.

2.2 Transfer cannot occur other than on death of the last beneficiary, and cannot be used as security for borrowing;

This does not appear an obstacle to product development.

2.3 Pension or annuity payments must be made at least annually;

This does create obstacles for deferred annuities, but does not appear an obstacle to product development for other types of annuity.

2.4 Minimum payment requirements in relation to pensions must be met and for guaranteed annuities there are some additional restrictions on design. Brief key requirements are:



2.4.1 For an account based pension payments in each financial year must not be less than a percentage of the account balance at the beginning of the year, as follows:

Age of Beneficiary	Percentage
Less than 65	4%
65 - 74	5%
75 - 79	6%
80 - 84	7%
85 - 89	9%
90 - 95	11%
95 and above	14%

Comment: These reflect annuity factors that at one point would have been very conservative, but would now not be adequate for higher socio-economic groups investing in government inflation linked bonds. At younger ages, balances can increase with reasonable investment returns, but at ages over 80, they increasingly force members to reduce their balances at a rate that means their super draw-downs reduce at increasingly faster rates. They are therefore only really suitable for annuitized pools, which are currently not permitted.

The minimum payments standards are not benchmarked to real rates of return available in the market. The lower the real investment return environment the quicker is the reduction in residual product value of an account based annuity. In the case of guaranteed immediate annuities (see 2.4.4) providers may struggle to offer profitable products meeting the standards, if real and nominal interest rates are low enough. It is unlikely this is deliberate policy.

2.4.2 The minimum payment requirements are defined in very product specific terms, making product innovation uncertain or impossible from this perspective.

Comment: They do not permit deferred annuities and are seen as an obstacle to product innovation.

2.4.3 For a guaranteed immediate annuity, the residual capital value at the end of the annuity must not exceed 100% of the purchase price. Where a residual capital value is paid, a minimum pension payment must occur in each year defined by the above table, with initial purchase price replacing account balance in the calculation;

The products described are fixed interest investments rather than income stream products, and the restrictions do not appear to be an obstacle to product development.

2.4.4 For a guaranteed immediate annuity where

- i) no residual capital value applies, and
- ii) the annuity is either constant throughout the term, or increases annually at a constant fixed rate specified at outset, varies annually by CPI or AWE indexation specified in advance (perhaps subject to an upper limit); and



- iii) the term is either throughout life or is fixed and does not exceed [100 years less age of primary beneficiary at purchase], the minimum payment requirements only apply in year 1 of the pension or annuity.

Comment: The restriction to guaranteed CPI or AWE indexation effectively prohibits with-profit annuities, and annuities linked to other indices. Permitting them does require an amendment to the regulations, which is suggested in 4.4 below.

3 Principles

There is no clear statement of policy or principles in terms of what the government is seeking in return for the favourable tax treatment referred to above. Therefore this must be determined by inference from the above requirements. The following conclusions may be drawn:

- 3.1 Benefits remain with the primary or reversionary beneficiary while they are alive. Requirement 2.2 is designed for this and hence should remain after any review;
- 3.2 The income stream requirements result in releasing income and reducing account balances and residual real product value systematically over beneficiaries' lifetimes.
- 3.3 All products are subject to minimum payment requirements though there is variation by product.

These principles do form a benchmark against which alternatives may be evaluated.

4 SIS Requirements – Possible Changes

The following changes are considered desirable, in the interest of freeing product development from unnecessary constraints, while either retaining principles 3.1 to 3.3 outlined above, or substituting alternatives, such that the integrity of government revenue is not compromised.

- 4.1 Clarification for account based products: As suggested in the comment on 2.1 above, the following either needs a change in the ATO interpretation or a change in the regulations to permit contributions from a guarantee or the redistribution of a pool.

Where an account based annuity has an additional benefit which may result in income payments even after the account balance has reduced to zero (as with GMLWBs), this additional benefit should be regarded as part of the original account based annuity for minimum payment standard purposes..

- 4.2 Allowances for deferred annuities: If deferred annuities are to be permitted within the principles outlined above, the following restrictions should apply:

- Purchase should be permitted only at retirement or age 60, after which they would offer no tax advantages if they were part of life annuity with a term certain guarantee – so they can be tax free.
- The benefits should only be payable as an annuity that conforms to the requirements set out for the new category below. The maximum amount that may be used to purchase a deferred annuity would be that which, when combined with other superannuation proceeds, would provide for the pattern set out in 4.4.3 below.



- The vesting date may be advanced where the fund/insurer permits, subject to evidence of health.

Discussion: It can be questioned whether the arguments for the desirability of deferred annuities have adequately considered the possibility that the assets set aside for the deferred period prove inadequate. If they are exhausted, there will be a demand to bring forward the deferred annuity payment. There is therefore an argument for combining the two phases/products – into a life annuity with a guaranteed period.

4.3 New Category of Flexible Longevity Products: This is a new category of product, with suggested criteria as follows:

4.3.1 An admissible longevity product is one which pays a defined income stream from a specified commencement date (after retirement or preservation age) throughout the life of the beneficiaries.

4.3.2 After the specified commencement date, income stream payments must be made at least annually.

4.3.3 Income stream payments are not required to be guaranteed in dollar terms but are subject to minimum payment requirements (refer item 4.4 below).

4.3.4 The benefit structure of a longevity product may be defined entirely in terms of units or other well defined interest in an investment pool, or units whose value varies directly in line with a regularly published economic or investment index, or in nominal dollar terms. This change provides more product flexibility and is necessary to enable longevity products to be developed free (where desired) from the constraints of providing long term guarantees of investment returns or life expectancy.

4.4 Minimum Payment Requirements for Longevity Products: These are suggested as follows:

4.4.1 The requirements are assessed at the point of purchase of a longevity product, not on an ongoing annual basis after purchase;

4.4.2 The same numeric table applies as other products but is used differently.

- The income stream payment in the first year after the specified commencement date must not be less than the percentage of the purchase price specified in the table, based on age at the specified commencement date. Where the benefit structure of the product is entirely defined in units, this requirement may be assessed in units rather than dollars.

This does reduce the minimum payments required, and an argument can be made to escalate the purchase price where the annuity is not account based.

4.4.3 If the income stream payments are not guaranteed in advance in dollar terms, then the product provider must certify that the income stream payments are intended to form a pattern that would provide a level income in real terms throughout the life of each beneficiary (possibly taking account changes to Age Pension entitlements), based on:

- i) the method of determining the payments within the product structure, which would allow for deviations from the pattern because of unanticipated changes to longevity and investment experience or changes to the Age Pension in and



- ii) a hypothetical scenario of a constant 3% investment return from the specified commencement date and longevity equal to the most recent Australian Life Table. The life table would be adjusted for impaired lives, where a greater income was paid after the underwriting of the annuitant. {PARAMETERS ARE PLACEHOLDERS ONLY}
- 4.4.4 The life expectancy of any possible entrant or entrants to the product (entry ages, sex, other relevant characteristics).
- 4.4.5 The benefits are non-commutable.
- 4.4.6 A pre-determined reduction in the income stream at the point where the income stream switches from primary to reversionary beneficiary is permitted.

5 Provider Tax Issues

All reserves held in respect of annuity payments should be subject to post-retirement tax treatment (no tax and refund of tax credits.) Shareholder capital should be subject to corporate taxation.

6 Retiree Tax Issues (Accruals Tax Treatment)

We believe that the products that might be created possible changes suggested in section 4 would not be more attractive than existing products – from a taxation perspective.

Second order effects on government revenue might arise if retirement income products became more popular. It is not however clear what the net impact would be. The impacts are beyond the scope of this paper, as is any consideration of whether any products should be given favourable treatment.

7 APRA surrender value standards

The recent flexibility introduced into the standard should be made explicit.

8 Other APRA standards? – e.g. investment linked/other separate statutory fund requirements

No change recommended.

9 Social Security and Aged Care Means Test

As with the comments in section 6 above, there may be second order effects of the recommended changes, but they are beyond the scope of this paper. We also do not consider changes that might favour one or other product.