SUBMISSION TO REVIEW OF RETIREMENT INCOME STREAM REGULATION

The Academy of the Social Sciences in Australia (ASSA) is one of Australia’s four Learned Academies and consists of an elected fellowship of over five hundred of Australia’s leading social science researchers. ASSA promotes excellence in the social sciences and in their contribution to public policy. It coordinates the promotion of research, teaching and advice in the social sciences, promotes national and international scholarly cooperation across disciplines and sectors, comments on national needs and priorities in the social sciences, and provides advice to government on issues of national importance.

ASSA welcomes the opportunity to provide a submission to this review of the regulatory arrangements for retirement income streams.

By way of background, this submission follows a submission to the Acting Assistant Treasurer in April 2014 on Australia’s superannuation policy. Our comments are based in large part on deliberations at a seminar organised by the ASSA that became known as the Castles Roundtable (named after Ian Castles AO, former Secretary of Finance and Australian Statistician who was an expert on the interconnection between the tax and social transfer systems). The participants were a mixture of senior public servants, researchers in the relevant fields, representatives from NGOs and former agency heads like us. It was held in October 2011, after the Tax Summit of the previous Government, and the papers and a summary of discussion was published by ASSA as an Academy Paper in early 2013. The focus of the Roundtable was on the personal tax and social transfers sections of the Henry Review (several members of the Review team participated in the Roundtable). There was a dedicated session on Age Pensions and Superannuation.

Whilst ASSA has agreed we should make this submission, and it is based on ASSA activities, it includes some personal views. Andrew Podger was secretary of several Commonwealth Departments and Public Service Commissioner in a long public service career in which he was closely involved in social policy including on retirement incomes. In 2006-07 he chaired a review of military superannuation for the then Government. He is currently Professor of Public Policy in the College of Arts and Social Sciences at ANU. Dennis Trewin was the Australian Statistician. He was a Trustee and Board member of ARIA (the Commonwealth employees’ superannuation fund) for 4 years. Both of us are Fellows of the Academy.

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Submission to Review of Retirement Income Stream Regulation

This submission has been prepared by Andrew Podger and Dennis Trewin, both of whom are Fellows of the Academy of Social Sciences in Australia (ASSA). The submission follows work undertaken over recent years by and for ASSA including a submission to the Acting Assistant Treasurer in April 2014 on Australian’s superannuation policy. Like that submission, this does not purport to represent an official view of ASSA (which does not as a rule have views on public policies) but draws heavily on ASSA forums and research.

GENERAL COMMENTS

The Discussion Paper issued by the Review of Retirement Income Stream Regulation focuses on how individuals may manage their financial risks better and on increasing choice and removing barriers that restrict the availability of relevant and appropriate income stream products. While more choice may well be useful, particularly to remove obstacles to lifetime annuities, some risks cannot be safely managed by individuals but require pooling through some form of insurance. Moreover, some risks (including longevity risk in particular) may not be efficiently or effectively managed in the private sector without increased government intervention.

In addition, some choices may need to be curtailed for the good reason that they would be inconsistent with the objectives that justify government support for superannuation, either by exhausting superannuation savings well before death and thereby allowing individuals to rely excessively on the age pension, or by transferring tax-supported savings to beneficiaries of estates.

In many respects, therefore, we believe the Review puts the horse before the cart. Consideration of retirement income policy must start with a focus on the two key objectives concerned: policy alleviation in old age, and income maintenance at and through retirement. Age pensions form the main instrument to address the first objective and superannuation tax arrangements (and mandated superannuation contributions) form the main instrument to address the second. The central issue is whether the two instruments, working together, provide the most efficient and effective (and equitable) way of achieving the key objectives. International comparisons demonstrate that, notwithstanding the strengths of the Australian system, the post-retirement ‘decumulation’ phase is weak with too few receiving steady and reliable income streams throughout their retirement years. The regulation of retirement income streams is therefore a particularly important element in the achievement of the system’s key objectives, but such regulation should be considered strictly in this context.

Most importantly, regulation of retirement income streams should not be for the purpose of ‘wealth accumulation’ (other than to support adequate retirement incomes) or ‘estate management’ (except in terms of supporting a surviving partner to maintain living standards throughout her or his retirement years).

The Government should therefore be cautious about acting precipitately on these regulatory issues ahead of clarifying its broader retirement incomes policy.

Suggestion 1: The Government should establish a review of its retirement income policy which draws upon the three related reviews already announced (this review, the review of the financial system and
the foreshadowed review of the tax system) focusing firmly on the key objectives of poverty alleviation and income maintenance at and through retirement.

**Suggestion 2:** Any earlier action on the regulation of retirement income should be consistent with the Government’s broader retirement incomes policy and focus strictly on supporting these two central objectives.

**RESPONSES TO SPECIFIC QUESTIONS IN THE DISCUSSION PAPER**

**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)?*

While investment risk is something well-informed individuals should be able to manage reasonably limiting any adverse impact on income maintenance (as well illustrated in the Discussion Paper graphs), longevity risk management necessarily requires a pooling arrangement as it cannot be satisfactorily managed by individuals (who would inevitably either run out of savings or have savings left over at death).

Like the issue of indexed bonds to facilitate management of the risk of inflation, some government intervention may be required to help the market to manage longevity risk efficiently and effectively. The option involving minimum intervention (identified in the Henry Report) is the issuing of some form of longevity bonds which, just as indexed bonds allowed the market to trade the risk of inflation, might in theory facilitate a market trade in the risk of longevity.

We suspect, however, that this might not be sufficient to make lifetime annuities financially attractive because of other factors such as self-selection (eg. healthy people choosing to buy annuities and sick people choosing not to do so) and high management fees. Other options include mandating the purchase of lifetime annuities from a proportion of accumulated superannuation savings, and the government sale of annuities (noting the government already gives annuities away in the form of age pensions).

These options would be far more effective and efficient than the current policy framework which leaves the government meeting most of the longevity risk through age pensions despite the high level of savings mandated by the superannuation guarantee and encouraged by tax concessions.

**Suggestion 3:** The Government should much more actively promote the use of lifetime annuities to help individuals manage the risk of longevity, giving serious consideration in particular to mandating a proportion of super savings at preservation age to be invested in a lifetime annuity and/or to the Government itself selling lifetime annuities.

**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?*
Question 3: What changes could be made to the annuity and pensions rules to accommodate a wider range of income stream products while having regard to the need to protect against abuse of the earnings tax exemptions and to promote aggregate and prudent retirement income objectives?

Lifetime annuity products should attract the same tax support as allocated pensions i.e. no tax should be imposed on the returns of funds invested by the insurers to finance lifetime annuities (subject as detailed further below that these products meet other conditions required to ensure they address the fundamental objectives of the retirement income system). But this will not be sufficient to make them attractive.

The Discussion Paper notes that lifetime annuities may appear to involve low rates of return. Indeed, this perception reflects reality in many cases. Current products often involve much lower rates of return than allocated pensions, primarily because of the prudential requirements and also because of self-selection problems and small market take-up. Prudential regulations in the absence of a market in longevity risk may be requiring insurers to hold unreasonably large assets in low yield investments.

This suggests consideration be given to the introduction of some form of ‘longevity bond’ that would facilitate a trade in longevity risk and allow a less onerous prudential regime. Promotion of the purchasing of lifetime annuities at a relatively young age, and the mandating of a proportion of accumulated savings into such products, would also sharply constrain the danger of self-selection which increases annuity prices (and reduces returns). Requiring people to direct a proportion of their accumulated savings into lifetime annuities could still permit a considerable range of income stream products as indicated further below (see response to Question 7).

Suggestion 4: Insurers selling lifetime annuities should have access to the same tax advantages as superannuants directing their savings into allocated pensions.

Suggestion 5: The Government should explore the possibility of issuing a form of ‘longevity bond’ to facilitate market trade in longevity risk.

Suggestion 6: The Government should promote the purchase of lifetime annuity products at an early age (such as the preservation age).

Question 4: Would such changes lead to new products being bought into the market?

The above suggestions would certainly encourage more insurers and other financial institutions to offer lifetime annuities and hence establishment of a more competitive market. There is also the possibility of other products of this type emerging, such as ‘group self-annuitisation’ products, though the attractiveness of such products would depend on the size of the pool of funds and of annuitants. Depending on how the requirement to direct a proportion of savings into a lifetime annuity is applied (see response to Question 7), retirees should have access to a wider range of income stream products and be able to choose a mix of products that not only suits their personal preferences but is fully consistent with the key objectives of the retirement incomes system.

Question 5: Should people be able to buy a DLA with superannuation money?
There seems to be no policy reason to deny people the option to buy lifetime annuities from any savings they have. These should attract tax advantages so long as the annuities are fully consistent with the Government’s retirement incomes policy objectives (see response to Question 10 in particular).

**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?

While some people might prefer to purchase DLAs through annual premiums, there could add to the risk of ‘self-selection’ (e.g. stopping payments in the event of early illness) if they were allowed to cease paying the premiums.

We would prefer a policy of a mandated proportion of savings at preservation age being directed into a DLA or equivalent product (the proportion could be related to the starting date of the annuity), without any annual premium (see Suggestions 3 and 7).

**Question 7:** Should there be an upper limit on the amount to be invested in a DLA?

No. Rather, consideration should be given to setting minimum amount to be invested, set as a proportion of accumulated savings at preservation age.

One way of mandating a minimum investment into a lifetime annuity would be to set a benchmark requirement based on an annuity from age pension age. We suggest this be at least 50% of accumulated superannuation savings at preservation age (more if the gap between the preservation age and age pension age is narrowed – which we do not support), allowing superannuants to draw on the rest of their savings to help in the transition to retirement. Those preferring a DLA from a later age could do so as long as the annuity was no less in real terms than that payable under the benchmark requirement: in other words, they would be required to invest the actuarially equivalent amount (for a DLA from age 75 this might be of the order of 25% of savings at preservation age), allowing them to invest in other income stream products such as account-based pensions before relying on the DLA. Those eligible for benefits-promise lifetime pensions should have these taken into account in applying the requirement.

As lower income retirees will continue to rely heavily on age pensions, particularly for longevity risk, this requirement might apply only where accumulated savings are above some threshold (for example, where the lifetime annuity would be more than the age pension income test free area).

We appreciate that applying such a requirement needs more detailed consideration, but believe it could be designed so as to be easily implemented and understood, allowing considerable flexibility for individual retirees, while greatly improving the effectiveness and efficiency of our retirement incomes system, including by achieving significant savings in age pensions.

**Suggestion 7:** The Government should consider setting a minimum proportion of accumulated superannuation savings at preservation age that must be directed into a DLA, of the order of 50% for a DLA commencing at age pension age.
Question 8: Should there be a minimum deferral period for a DLA?

We see no reason for a minimum deferral period, but suggest the minimum proportion of savings at preservation age directed into a DLA should vary with age, with the benchmark figure set for a DLA commencing at age pension age. This would promote greater coherence between the superannuation and age pension systems, and help people and the industry to focus on the total income they will receive from age pension age (and the superannuation savings levels they should aim for to achieve the target retirement income they want).

Question 9: Should there be a maximum deferral age or period? If so, what should it be?

So long as there is no death benefit or commutation benefit available (other than for a surviving spouse), we see no particular reason for a maximum deferral age, though a very high age might facilitate manipulation of other superannuation savings to maximise age pension entitlements. We would favour, without compulsion, DLAs generally commencing from age pension age.

Question 10: Do the payment features in the Discussion Paper (regarding commutability and annuity payments) strike the right balance in allowing people to insure against longevity risk while avoiding unnecessary restrictions on product development?

We support the suggestions in paragraphs 51 and 52. The benefits of the mandated approach we favour would be lost if the annuity product was commutable.

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?

As a general rule, we would support annuity products that offer a surviving spouse a continued lifetime annuity (at some proportion of the base amount). This in our view is the only death benefit that should be available. Alternatively, consideration could be given to imposing a tax on any death benefit, or any other unused superannuation savings, as a way of clawing back the tax advantages provided as the saving was accumulated. Such a tax regime might be hard to manage fairly, however.