CSRI
COMMITTEE FOR SUSTAINABLE RETIREMENT INCOMES

Submission on the Social Security Means Testing of Retirement Income Streams

Response to the Department of Social Services Discussion Paper of December 2016

1 February 2017

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Introduction

The CSRI welcomes the opportunity to respond to the Department of Social Services Discussion Paper on Means Testing of the Retirement Income Streams. The development of a regulatory framework for the retirement phase of the system is critical to delivering better retirement outcomes for retirees and ensuring the sustainability of the system.

The development of retirement income policies need to be carried out within the context of the objectives of the retirement income system. The Commonwealth government is seeking to enshrine the objective for superannuation as *"to provide income in retirement to substitute or supplement the Age Pension*". This highlights the importance of taking into consideration the interaction between the superannuation and age pension in determining retirement income policies.

The government has also announced its intention to facilitate the provision of Comprehensive Income Products in Retirement (CIPRs) that include a longevity risk management component. The Murray Inquiry concluded that the retirement phase of Australia's superannuation system was underdeveloped and could better meet both the risk management needs of many retirees and the objective of the superannuation system. The retirement income market is currently dominated by Account Based Pensions (ABPs) that provide little protection against longevity risk for the majority of retirees. Improvement in the availability and take up of products that pool longevity risk would assist in transferring part of the burden of longevity risk management from the Commonwealth to the private sector and would, over time, improve fiscal sustainability. Policy development needs to help overcome the behavioral biases in decision making that deter the demand for pooled longevity risk management products.

The DSS Discussion Paper states that the primary purpose of the means testing is to ensure that income support is fair and targeted to those with the greatest need of support. It further states that effective means testing is important for ensuring that the age pension is well targeted and sustainable as the population ages and fiscal pressures increase.

A singular focus on targeting, however, is unlikely to achieve retirement income objectives. A key risk in targeting assistance is that it will lead to behavior, such as restructuring finances or reducing savings, to circumvent the means test. Despite the best of intentions, policy may not achieve its objectives and can often lead to unintended consequences when insufficient consideration is given to likely behavioural responses. In developing an effective means test, consideration should also be given to the likely behavioral responses. Achieving long term fiscal sustainability will require a balanced consideration of targeting assistance to those in need and maintaining incentives to save and self-provide for retirement.

It also bears noting that the difficulties raised in means testing income stream products often reflect the complexities associated with the operation of dual asset and income tests. CSRI suggests that consideration should be given to merging the income and assets test with a view to simplifying the arrangements.[1] However the below submission is premised on the continuation of parrallel income and assets tests.

Please let me know if you have queries relating to any aspect of this submission.

Yours sincerely,

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[1]CSRI (2016), Encouraging Sustainability and Self Provision in Retirement, Consultation Paper Prepared for the CSRI Leadership Forum, 12-13 October 2016.

About CSRI

The Committee for Sustainable Retirement Income (**CSRI**) is an independent, non-partisan, non-profit think tank whose Mission is to progress the development and implementation of policies to further the goal of encouraging “adequate incomes through all the years of retirement for all Australians on a fair and fiscally sustainable basis”.

It pursues its Mission by acting as a catalyst for the development of evidence-based policy and engaging widely with stakeholder groups to reach common ground on policy positions in the community interest.

With a focus on the development of thought leadership and public policy, the CSRI brings together multi-disciplinary and diverse perspectives from a range of different parties (including academics, superannuation fund providers, investment managers, life companies, financial planners, federal government representativs and importantly consumer advocacy groups).

CSRI takes a holistic view of income and needs in retirement, including the aged pension, superannuation benefits, housing, health care and aged care.

Recognising that the effectiveness of the retirement income system is undermined by short-term policy thinking and lack of clarity about purpose, the CSRI injects an integrated and longer-term perspective in policy formulation and seeks to build consensus on a reform programme.

Performance of the current means test rules

Life time Incomes Streams

Fundamental differences exist between ABPs and pooled longevity risk products relating to access to capital, the nature of the income stream and the ability to manage longevity risk (as summarized in Table 1). These differences need to be recognized in the respective means test treatment of these products.

Account based products are:

- asset tested using the account balance and,
- income tested, since 2015, by deeming income on the account balance.[2]

Non-account based products are:

- asset tested using the reduced purchase price, derived as a straight line from the premium at the date of purchase to zero at the retiree’s life expectancy;
- income tested on the income paid net of the deduction amount, which is calculated by dividing the premium by life expectancy.

The Discussion Paper concludes that the current assets test assessment of lifetime income streams (lifetime annuities) is highly concessional beyond life expectancy. The CSRI does not agree with this conclusion as the premises underlying it do not reflect adequately the unique features of lifetime annuities compared with account based products and other products.

The Discussion Paper draws the conclusion that lifetime annuities are concessionally means tested on the basis that policy holders are assessed as having no asset value once a person reaches their life expectancy even though they continue to derive benefit from the policy beyond this point.

Indeed, it is this potential to provide on-going value beyond life expectancy that provides the rationale for lifetime annuities as they enable retirees to better manage longevity risk. However, it doesn’t logically follow that the means testing of lifetime annuities is concessional.

[2] Before 2015, the income was tested after deducting a notional amount representing the return of capital, calculated by dividing the purchase price of the income stream by a measure of life expectancy.

This potential benefit beyond life expectancy is reflected in the pricing of the holders' initial investment and is therefore taken into account in the assets test treatment of all policy holders until their death or they reach life expectancy (which ever happens first).

However, such products do not continue to provide payments beyond life expectancy for all holders. Almost 50% of holders stop receiving any benefit on their death before they reach their actuarially determined life expectancy. Their remaining notional capital is retained in the pool making it available to pay the income of those who live longer.

Table 1: Key Characteristics of Income Stream Products

Account based products:

Capital Access - Like bank deposits and managed investment schemes, there is an account value that the retiree has a right to access either as income or a lump sum. The value of the assets to which the retiree has access at any point in time will go up or down depending on the market performance of the underlying investments and will be reduced by any payments, lump sums or death benefits.

Uncertain income - ABPs normally provide a higher return than traditional annuities although that return is highly variable (as compared with the guaranteed return of annuities).

No longevity protection – given uncertain income stream.

Pooled longevity products:

The retiree pays a premium and is guaranteed by the life office that they will receive an income stream with known characteristics for life.[3]

No Capital access - Apart from heavily restricted liquidity features, death benefits and surrender values, the retiree loses any access to their capital. The product does not have an account or asset value.

Pooled longevity risk - Retirees don't have an individual account balance but rather they pool their capital. The gains and losses on the capital are shared among the retirees in the pool according to age of death. In this way, those who die early effectively cross-subsidise those who die later.

Guaranteed income – In the case of lifetime annuities, the product provider pays an income stream for life at the promised rate. The promised rate is calculated allowing for costs, required regulatory capital, the yield on relevant assets and the expected life of retirees in the pool.[4] (A holder of a GSA would not receive this protection.)

Systemic longevity risk – In the case of lifetime annuities, to the extent that part of general population mortality improvement may be unexpected, retirees are protected by the life office guarantee. A member of a GSA would not receive this protection.

To the extent that the reduced purchase price of those who die before life expectancy is asset tested without them receiving the full benefit of their capital, there is a benefit to taxpayers. The converse of this is a detriment to taxpayers where a policy holder lives beyond life expectancy without being subject to further asset testing. These are the two sides of the pooling process. For those who do live beyond life expectancy, the payments continue to be income tested until their death.

Considered as individuals, holders are either under or over means-tested, but considered as a group they are means tested fairly when compared with the outcomes for account-based pensioners. This reflects the nature of pooled products – sharing risk and return among the members of the pool – and it is appropriate that it should also be reflected in the means test.

[3] The income stream may pay a fixed nominal rate, have a fixed rate of interest or be indexed by the CPI. The new category of longevity products will permit the income stream to be deferred or be set against a market index.

Given the pooled nature of lifetime annuities, it is appropriate that the means test be structured to ensure fairness among individuals on an ex ante basis and for the group overall. In doing so however, the outcome will not be the same for every individual on an ex post basis as to do so would undermine the nature and intention of pooled products.

On this basis, the means testing of lifetime annuities is not concessional recognising the characteristics of pooling longevity risk. It would not be appropriate to modify the existing rules to reduce the purchase price of the annuity over a longer time frame for lifetime products.

Alternative Assets Test Methods

In means testing income, allowance needs to be made for the part of the income payments that relate to the return of capital. The current rules reduce the assessable value of income streams on a straight line approach over time to recognize the return of capital on the original investment. While this approach is unlikely to perfectly match the portion of payments consisting of a return of capital, it provides a close approximation.

The Discussion Paper poses the question of whether the capital reduction rules for the assessable value of income streams should be on a straight line basis.

In theory, it may be possible to devise an approach that more precisely matches the rate at which capital is returned, however, the additional complexity and cost associated with such a change would need to be weighed against the potential benefit. Adding to the complexity of an already highly complicated retirement income system should be avoided wherever possible given that the costs of complexity greatly disadvantage people from lower socio-economic groups.

On this basis, the CSRI considers that the straight line approach strikes an acceptable balance between simplicity and accuracy for products where investors have limited access to their capital and the investment is managed at the fund level.

Income test deduction amounts for return of capital

The proposal to cap the maximum aggregate value of deductible amounts at the nominal value of the purchase price would mean that, on average, the initial value of life annuities will never be fully deducted for the majority of policy holders. This approach is not supported as it would penalize purchasers of pooled products relative to other income stream products and would therefore run counter to the principle of competitive neutrality.

New Retirement Income Products

The existing treatment of annuities is an appropriate basis for assessing the new category of retirement income products, which may include new types of immediate lifetime annuities as well as GSAs (Group Self Annuities), DGSAs (Deferred Group Self Annuities) and DLAs (Deferred Lifetime Annuities).

Immediate GSAs (which may or may not be account-based) that meet the capital access schedule should be treated in exactly the same way as immediate lifetime annuities. That is, they should be:

- asset tested using the reduced purchase price, derived as a straight line from the amount invested at the date of purchase to zero at the retiree's life expectancy; and
- income tested on the income paid net of the deduction amount, which is calculated by dividing the amount invested by life expectancy.

This treatment would ensure that social security outcomes are neutral among products and closely aligned with the income actually being received by retirees. The risk of significant misalignment between retirement income actually received and social security assessments could discourage retirees from using products that provide longevity protection.

Assessing pooled products with a deferral period

All deferred products will have to meet the capital access schedule. As far as possible, the means testing should maintain neutrality between deferred and immediate pooled longevity products. Two approaches are possible.

The first is to treat them consistently with immediate pooled longevity products from the time of purchase. This would require:

- The same asset test using an identical reduced purchase price to an immediate lifetime annuity from the date of purchase.
- An income test using an identical deduction amount to that applying to an immediate lifetime annuity of the same size and purchase date but only applying in payment, that is exempt in deferral.

The second option is to make deferred products exempt from both the income test and assets test during deferral. After the deferral period, these products would then be income tested on the same basis as immediate pooled longevity products: that is:

- Assets test - a purchase price should be imputed at the point of commencement in respect of the future annuity payments. This imputed value would be based on the amount of the premium for an immediate annuity on that date.
- Income test - is then applied to the actual income received net of the deduction amount.

This latter approach applies an asset value conceptually equal to the purchase price plus investment returns and mortality credits on the day the product commences to pay an income stream. In a commercial environment this calculation would be complex and not easily regulated to ensure a fair outcome. There would also be significant basis risk for the retiree because the capital market conditions on which the promise to the annuitant had been made at the time of purchase would inevitably be different to the capital market conditions on which the new assessment of asset value and deduction amount would be made. That would be expected to result in a misalignment of the actual income received and its means test treatment.

Regardless of the outcome of this basis risk, the means test outcomes for a deferred product and an immediate product bought on the same date and delivering the same amount of income would not be equal due to the significant differences in the reduced purchase price and assets test. This is an example of the infinite permutations of the complex interactions that occur between the income and assets tests. The actual outcomes are dependent on the existence of other assets and income.

In the time available to present this submission, CSRI has not had the benefit of quantitative analysis to properly assess the impact of these two options.

As noted earlier, significant behavioural bias' work against retirees foregoing capital to take up lifetime annuities to better manage the risk of outliving their savings. The death benefits offered under these new product rules attempt to counter these behavioural biases. Death is not a requirement that is readily open to manipulation for estate planning purposes. On that basis, it is not recommended that death benefits be included in the means test treatment of pooled longevity risk products.

Assessing complex and hybrid products

CSRI support a principles based approach where complex and hybrid income streams would be deconstructed into simpler products and then the means testing applied to those simpler products. At the same time, the option should be available for providers to seek agreement to a comprehensive annual actuarial evaluation of the product where they believe that this would better reflect the nature of the product. It should be left to product providers to decide what would be the most cost effective and appropriate approach for each particular product. However, there would need to be rules around the net present value assessment process to avoid the opportunity for gaming of the discount rate to provide greater access to the Age Pension.

A further approach that could be useful in providing certainty and facilitating innovation is to offer product providers the option of seeking a determination before they launch a new product. This determination would provide binding advice on the treatment of particular income stream products subject to appropriate review processes. A public register of past product determinations would further support innovation and competition by providing guidance on the likely treatment of similar products.

Interactions with other social policy systems

The CSRI is a strong advocate for taking an holistic perspective of retirement incomes policies including their interactions with related policy areas including housing, age care and healthcare.

Policy formulation that ignores broader implications and flow-on effects may result in unintended adverse consequences. Of particular relevance has been the tendency to consider public pension, taxation and superannuation regulatory reforms in separate domains, resulting in poor system integration, excessive complexity and often a failure to achieve their objectives because of countervailing effects in the other domains.

On this basis we support the DSS' intention to give further consideration to the interaction between social security means test and other targeting arrangements to ensure a consistent and cohesive approach. This is particularly the case as multiple layers of means testing may result in perverse incentives and unintended consequences. This will require consideration of what are appropriate benchmarks for maintaining competitive neutrality among various products.