



Institute of Actuaries of Australia

8 August 2006

Mr J Lonsdale
General Manager
Superannuation, Retirement and Savings Division
The Treasury,
Langton Crescent,
PARKES ACT 2600

Dear John,

**A Plan to Simplify and Streamline Superannuation –
Our Eighth Submission: Transition to and beyond retirement**

The attachment to this letter is the eighth of a number of responses that the Institute is making to the invitation to comment on the Treasurer's Plan.

This submission covers the following topics:

8A: Pension rules and availability of annuities

8B: Workforce participation incentives.

This topic considers separately each of the three age groups 55 to 60, 60 to 65 and over 65.

We recognise that the issues we are raising are not central to the Plan. We would however like to discuss our ideas with you at a suitable time, as we believe they would build on the approach being taken by the Government to simplify our retirement savings system and increase workforce participation.

I would be happy to arrange for the members of our Task Force to discuss this submission with you at your convenience.

Yours sincerely

M A Stevenson
President

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A Plan to Simplify and Streamline Superannuation – Topic 8: Transition to and beyond Retirement

Topic 8A: Pension rules

Arrangements proposed in the Treasurer’s Plan

The Plan proposed replacing a number of different rules for different types of pensions with one new set of payment rules for future pensions purchased. These new rules include:

- A requirement that all pension payments will be at least equal to the amount determined from the table below

Age	Minimum annual pension payment: % account balance
55-64	4%
65-74	5%
75-84	6%
85-94	10%
95+	14%

- No upper limit on the maximum that can be withdrawn at any time.

Under these new rules, retirees will be responsible for managing their own longevity and investment risks within these parameters, which will be a challenging task.

Guaranteed lifetime annuity

One option would be for retirees to ‘outsource’ their longevity and investment risks by purchasing a guaranteed lifetime annuity

However, guaranteed lifetime annuity products will only be available on attractive terms if there is a sufficient pool of demand to enable suppliers to spread the risks and to make it economic.

Although this product provides much needed investment and longevity risk protection, it is not attractive to either suppliers or consumers for the following reasons:

- The longevity risk is difficult to accurately quantify because of continuing mortality improvement and a lack of longevity reinsurance facilities. Hence the product currently requires substantial amounts of capital to back the inherent risks.
- There is a lack of suitable long term sovereign debt and investment grade fixed interest assets in Australia to ‘match’ against the long term liabilities, both nominal and CPI linked stock.

Hence, financial planners and consumers regard these products as offering low returns despite the certainty they bring.

Another guaranteed lifetime product which could fill a real need is a deferred lifetime annuity, which would provide longevity protection for people who fear exceeding their life expectancy and thus running down their accumulations. For example, on retirement at 60, a proportion of the superannuation funds could be used to purchase an agreed (possibly CPI indexed) level of income payable for life from say age 80 or 85. This would allow individuals to target their level of income from an allocated pension or other 'managed draw-down', safe in the knowledge that when it is exhausted at 85 they will have a secure income (should they still be alive).

However, this kind of deferred annuity is very difficult to contemplate in the present environment because the pricing issues discussed above are amplified by its exceptionally long term nature.

If the guaranteed lifetime annuity (and deferred alternative discussed above) is to be a significant and relevant option in the income stream market, then the Government will need to consider options such as:

- Reinsurance for longevity risks
- Issuing long term nominal and CPI indexed debt of a length and in a suitable format for annuities.

Amending legislation to allow the assets backing deferred annuity products to be exempt from income tax as per annuities in the course of payment (i.e. in the case of life insurers, annuities in the course of payment are treated as part of their Segregated Exempt Assets).

Topic 8B: Workforce participation incentives

Workforce participation rates

In order to help mitigate the impact of our ageing population, Australia needs to increase workforce participation rates of those aged 55 and over.

Workforce participation rates for males reduce from 87% for those aged 45-54 to just 51% for those aged 60-64 and the rates for females also show a significant reduction¹. Even though our Age Pension commences at age 65 for males (62.5 for females) our average (or “effective”) age of retirement is only 62-63 (61 for females)².

In order to increase workforce participation rates for older workers and hence the effective retirement age, we believe that the following three conditions need to be satisfied:

- Financial incentives for people to carry on working
- Subsidised early retirement pathways minimised
- Increased employment opportunities for older workers.

Arrangements proposed in the Treasurer’s Plan

Proposed changes in the Plan which will influence workforce participation rates include:

- Superannuation benefits paid from a taxed fund either as a lump sum or as an income stream such as a pension would be tax free for people aged 60 and over.
- Benefits paid from an untaxed scheme (mainly affecting public servants) would still be taxed, although at a lower rate than they are now for people aged 60 and over.
- The reduction in the assets test taper rate from \$3 to \$1.50 per fortnight for every \$1,000 above the assets test threshold.

Comments on new arrangements

The Institute supports the Treasurer’s intent to simplify the complex tax arrangements that currently exist in order to improve retirement incomes and increase incentives to work and save.

Our assessment of the potential impact of these proposals on workforce participation rates follow:

¹ 1301.0 - Year Book Australia, 2005
² Live Longer work longer OECD2006

The 55-60 age group:

We expect the changes to have an increasingly positive impact over time because -

- The changes should encourage people to continue working at least until age 60, due to the significant reductions in tax on superannuation benefits after age 60
- As most people do not currently have superannuation benefits in excess of the tax free lump sum limit of \$135,590³, this change is likely to provide greater incentives over time as average account balances increase with the maturity of the Superannuation Guarantee system
- Increasing the preservation age from 55 to 60 will also assist.

Incidentally, we consider the very long transition in the preservation age from 55 to 60, not due to be complete until 2025, should be shortened.

The 60-65 age group

The proposals support people who wish to draw down their superannuation in order to top up their income in the years prior to age 65 -

- This may encourage people to remain in part-time employment when they would otherwise have ceased employment altogether, which would be a positive result
- The ability to “recontribute” (that is, salary sacrifice into superannuation and redraw the same amount net of tax) is likely to provide a major incentive for the 60 to 65s to remain in the work-force since the marginal tax rate achieved is 15%.
- However, it is difficult to predict behavioural responses and it is possible that this proposal may encourage some people to reduce their hours of employment when they would not otherwise have done so, because they can top up their income by drawing upon their superannuation savings with a minimal reduction in income post age 65

For example, a person with superannuation savings of \$466,000 (being the projected savings quoted in the Plan for a person on average income in receipt of the 9% employer contribution for 40 years) could use \$100,000 of savings to fund a reduction in working hours before age 65 and be only \$2,000 pa worse off after age 65. The loss of \$100,000 in savings reduces the post age 65 gross income by approximately \$6,000 pa⁴ but the Age Pension would increase by approximately \$4,000 pa⁵ as a result of the reduced assets.

In choosing to use superannuation benefits to fund early retirement, this person is rewarded with an increased Age Pension. Thus the Age Pension is effectively subsidising the reduction in working hours before age 65.

As the vast majority of people (80% now, reducing to 75% over the next 40 years⁶) rely on the Age Pension (or similar payment) for all or part of their income, the Age Pension exerts a significant impact on behaviour.

³ Tax free lump sum limit for 2006/07 year

⁴ Based on the minimum pension factor of 15.7 for a 65 year old under current allocated pension rules

⁵ Based on proposed reduction factor of 1.50 for assets within asset thresholds of \$157,000 - \$494,000

⁶ Department of Family and Community Services Occasional Paper Number 11

The 65s and over age group

One of the main deterrents to people working beyond Age Pension age is the high effective marginal tax rates which result from the loss of the Age Pension under the income test.

Although the proposed reduction in the taper rate is positive in that it reduces the taxes paid on income from superannuation benefits, the impact of the Age Pension's income test may still provide a major deterrent to people working beyond age 65. This is because high effective marginal tax rates will still occur when incomes exceed the tax free income levels of \$24,867 (Senior Australians singles) and \$41,360 (Senior Australian couples) but are below the upper income threshold levels for the Age Pension, being around \$36,000 (singles) and \$60,000 (couples).

Further Workforce Participation Incentives

The behavioural changes resulting from these proposals should be monitored so that further actions can be taken if required, to encourage workforce participation rates beyond age 60.

If we exclude compulsion or any further changes in tax rates, the Government would have a further policy option, which is the Age Pension rules.

Some options, which we are still working on, but believe could potentially provide clear financial incentives for individuals to continue working after age 60 are as follows:

1: Include early withdrawal of superannuation assets in Age Pension testing

- All superannuation assets withdrawn from age 55 to 65 in excess of those taken in accordance with transition to retirement rules, plus perhaps a lump sum limit (for example \$50,000), to be included in the assessment of assets under the Age Pension test for a limited number of years (for example, 5 years) in a manner akin to the current deprivation rules.

Under this option, a person who withdraws superannuation savings in order to subsidise a reduction in working hours before age 65 will have his or her Age Pension reduced for a limited number of years after age 65.

2: Replace Pension Bonus scheme with improved Pension Deferral Scheme

- Replace the current, but very restrictive, lump sum Pension Bonus system with a more comprehensive and effective Pension Deferral system which allows an increased Age Pension on deferral.

Under this option:

- A person who voluntarily defers commencing an Age Pension or part Age Pension would receive an increased Age Pension or part Age Pension
- The rate of increase could be determined on an actuarial and financially neutral basis (i.e. on a 'no loss' basis for the Government). Our initial work suggests that equivalence in value would support a

rate of increase of around 5% to 8% for each year of deferral. The Government would still benefit from mortality (i.e. people not living to deferral age) and also the taxes paid on income earned during the period of deferral.

- A person, while deferring an Age Pension entitlement could decide, as an alternative, to access the existing Pension bonus amount (approximately \$30,000 after 5 years) subject to satisfaction of the rules.
- A person aged 65 could then target their work and existing superannuation benefits to last until say age 70, at which time their Age Pension could be around \$18,000 pa compared to the \$13,000 pa currently payable from age 65, (assuming that assets and non work income at age 65 did not exceed the full pension thresholds).

3: Offer deferred Age Pension in return for annual premium

- Given the lack of availability of deferred lifetime pensions from the private sector, another option may be to provide a (non means tested) deferred Age Pension from an advanced age, say 85, in return for premiums paid to the Government from an earlier age.

4: Replace current dual Income and Assets Tests with a single improved Asset Test

- The existing income test is very intrusive and was never designed to cope with earned income post age 65. There would be significant administrative advantages if this test could be removed in favour of a modified asset test.