

**FaCS SUBMISSION TO PRODUCTIVITY COMMISSION INQUIRY
INTO
SUPERANNUATION INDUSTRY (SUPERVISION) ACT 1993**

The following paragraphs examine the administration of asset test exempt (ATE) income streams offered from self managed superannuation funds (SMSFs) and small APRA funds (SAFs), and outline the interaction of..

- the reserving requirements that the Australian Prudential Regulation Authority (APRA) applies via Modification Declaration 23 (MD23) to the Superannuation Industry (Supervision) (SIS) Regulations to achieve security of income streams; and
- the deprivation guidelines applied by the Department of Family & Community Services (FaCS) to achieve certain social security policy objectives in relation to these income streams.

Reserving Requirements under SIS Modification Declaration 23

Prior to September 1998, the market for superannuation pensions was restricted to relatively secure superannuation funds arranged by life insurance companies or sponsored by large employers. A wider range of superannuation funds has entered the market following changes to the social security assets test exemption for income streams on 20 September 1998. This resulted in a situation where APRA had concerns that some funds might not have the capacity, over the long term, to ensure continued payment of such pensions.

To provide an effective response to this concern, APRA, after consultation with FaCS, Treasury, the ATO and industry, modified the SIS Regulations to require superannuation funds paying pensions to produce an annual actuarial certificate that there is a 'reasonable degree of probability those pensions will continue to be paid under the governing rules of the fund'. This requirement was modified, following consultation with industry, in October 2000 to a 'high degree of probability those pensions will continue to be paid under the governing rules of the fund'. The further modification was given effect when the Institute of Actuaries (IAA) Guidance Note 465 was released in January 2001 and came into effect for social security purposes from 2 April 2001.

The modification applies to all funds paying pensions (with the exception of funds paying allocated pensions and funds providing pensions only through the purchase of annuities issued by registered life insurance companies). APRA has discretion to vary the annual actuarial investigation and certification period from one to three years for some funds that are not self managed superannuation funds (SMSFs) or small APRA funds. FaCS requires that social security customers with ATE income streams sourced from SMSFs and SAFs provide the annual actuarial certificate as a condition for the income stream continuing to receive an exemption under the assets test.

In introducing MD23, APRA accepted arguments put forward by FaCS and Treasury that product providers offering assets test exempt products should be subject to prudential rules so that governments can be confident that the product provider will meet its commitments to the customer. FaCS's concerns related primarily to the generous nature of the treatment to these products under the means test. If a product provider cannot meet its obligations to the customer, governments would be in a position where they have to provide additional financial support to a social security customer who has already received generous tax and social security concessions.

APRA has advised industry and the actuarial profession that the inability to meet the high probability requirement is not an automatic trigger for trustees to reduce the income streams so as to achieve high probability. The trustee should consider this in the light of all the relevant factors such as investment strategy, member profile, future pension increases etc and take appropriate action, with professional advice.

Rationale for Deprivation

The social security system is based on the principle that people should use their own income and assets to meet their day to day needs before calling on the community for income support. Thus, while people are free to gift to their families, charities and other organisations etc, where significant gifts are involved this should not be subsidised by the social security system. The deprivation provisions are in place to ensure that people do not reduce their assets, by giving them away or reducing their value, in order to avoid the assets test.

The rules relating to deprivation, or the disposal of income or assets, apply to *all income and assets, including income streams*. Where Centrelink considers that deprivation may have occurred, it compares the value of the income stream (over its term, or the individual's life expectancy) with the purchase price or the amount invested. The purchase price or the amount invested includes reserves set aside to meet pension obligations. Any 'deprived' amount is calculated as the amount by which the purchase price exceeds the value of the income stream.

Assuming there have been no other 'deprived' amounts assessed during the 'pension year' in which the income stream commences, the amount by which the purchase price exceeds the value of the income stream is reduced by the full amount of the annual gifting limit of \$10,000. (The 'pension year' is the year dated from the day when a social security customer commences to receive a social security income support payment.) The reduced amount is counted as an asset for pension purposes for five years from the commencement day of the income stream, and is subject to the income test deeming rules. This change is consistent with a targeted social security system that encourages people to provide for themselves where possible.

How is Deprivation applied to ATE income streams

In order to determine whether deprivation should be assessed in relation to a SMSF based ATE income stream, it is necessary to establish what it would cost an individual to purchase the stream of income payments, ie determine an equivalent asset or 'capital' value for the income stream payments.

Where the asset value of an ATE income stream is not readily identifiable for social security purposes, Centrelink requests a valuation from the Australian Government Actuary (AGA). The AGA values an income stream (either lifetime or life expectancy) by discounting future expected income stream payments at an assumed (but conservative) interest rate. Other assumptions are made in respect of inflation, life expectancy and fees and commissions paid to secure the income stream. These assumptions are also conservative and produce valuations that reflect the value of an income stream to a healthy individual. The valuations also reflect the prices that the individual might expect to pay if (s)he were to purchase the income streams from an institutional provider.

The specific guidelines for the application of the deprivation provisions to ATE income streams were released to industry peak bodies in March 1999 and were available to the public from that time via the Family & Community Services (FaCS) website (www.facs.gov.au). In releasing the guidelines, it was the Government's intention that social security customers who purchase income streams be encouraged to maximise income payments from the product.

Interaction between Reserving Requirements and Deprivation Guidelines

SMSFs have a small population of lives over which they can spread the risk that recipients of ATE income streams will outlive their life expectancies. This has the consequence that they must reserve at proportionately higher levels than large corporate and institutional providers (eg life offices) that can spread their risk over a larger population of lives.

Consequently, the assets backing a given income stream sourced from SMSFs generally will be greater in relation to the income stream than the assets backing an equivalent income stream from an institutional provider. This has the effect that, in terms of the income received, the recipient of a SMSF based ATE income stream is likely to receive income stream payments that are sub-optimal in relation to those that could be obtained from a commercial provider. An undesirable consequence is that social security income support payments to a social security customer with the SMSF based income stream are higher than income support payments to a customer who uses assets of equivalent value to purchase the institutional product. The deprivation guidelines are intended to limit this effect.

The requirement for proportionately higher reserves means that SMSFs, or other small superannuation funds, are likely to experience greater difficulty than an institutional provider in meeting the reserving requirements of MD23 without having part of the assets backing the ATE income stream assessed for deprivation. However, given the generous tax and social security concessions these income streams receive, and in the interests of preserving consistency and equity, FaCS considers that non-institutional providers of income streams should observe regulatory requirements similar to those applying to institutional providers.

The application of the deprivation provisions also recognises that, without suitable safeguards, the lack of normal 'commercial arms length' arrangements surrounding the provision of SMSF based ATE income streams, in conjunction with the MD23 reserving requirements, could create potential opportunities for estate planning. Because of the lack of the normal, commercial 'arms length' arrangement that generally applies between trustee and beneficiary, social security recipients who are both trustees and beneficiaries of SMSFs could use the MD23 provisions to reserve at excessively high levels. The unused assets left in the SMSF on the death of the income stream recipient would become the property of the fund and be available for distribution to other beneficiaries (eg spouse and/or children) of the fund. This estate planning strategy effectively would be subsidised by the taxpayer and is not considered a desirable outcome of social security policy.

Requirements for Institutions

Deprivation

Because of the effective separation between trustee and beneficiary and the competitive market pressures that militate against the 'sheltering' of assets for estate planning, Centrelink generally does not assess institutional products for deprivation. However, the legislation does allow for deprivation assessments to occur where it is suspected that the income stream payments are low in relation to the assets backing the product and/or where the institutional product appears to be supporting estate planning objectives.

It has been suggested that certain life office annuities would be 'caught' by the deprivation provisions if those guidelines were applied to them. FaCS is unaware of any cases where the application of the deprivation provisions would result in a customer being assessed for additional income under the deeming rules. Certain providers of SMSFs have suggested that there are such cases but have been unable to give examples of specific cases when invited to do so. The AGA undertakes periodic assessment of the valuation guidelines to ensure that the valuation assessments are consistent with outcomes that could be expected in the marketplace.

Reserving Requirements

The prudential reserving requirements imposed on SMSFs via MD23 are no more stringent than those imposed on institutional providers of income stream products. Indeed, it is understood that

life offices and friendly societies have to meet significantly higher reserving standards under the Life Insurance Act Actuarial Standards than those imposed by MD23.

Transitional Provisions for Guidance Note 465

Until 2 April this year, Centrelink accepted actuarial certification based on Institute of Actuaries (IAA) Guidance Notes 400 and 452 that provide the actuarial standards for certificates used to secure complying pension status for tax purposes. This standard was never viewed as being sufficient for MD23 purposes but provided an acceptable interim solution pending release of the new 1AA Guidance Note 465 (GN465). As indicated previously, GN465 was released in January this year.

If an existing ATE income stream created prior to 2 April 2001 - in accordance with the reserving requirements of GN400 or GN452 - has to be commuted to meet the new reserving requirements of GN465, the new ATE income stream does not have to be revalued by the AGA. Under the deprivation guidelines, it will be assumed that the new income stream received by the customer constitutes fair value for the assets used to purchase it. This transitional provision is specified in section 4.1.10 'Deprivation Related to Self-managed Superannuation Funds' of the *Guide to the Social Security Law* (www.facs.gov.au). It will apply only where the last annual actuarial certification performed prior to the commutation to meet GN465 has occurred prior to 2 April 2002.

Conclusion

The interaction of the deprivation provisions and the reserving requirements represent a considered, logical response to the need to ensure that the reserving provisions:

- do not encourage social security customers to purchase income stream products that give an inappropriately low level of income compared to what could be purchased elsewhere in the marketplace; and
- not give rise to inappropriate estate planning opportunities.

The taxpayer would effectively subsidise both of these outcomes which is not a desirable outcome of social security policy.