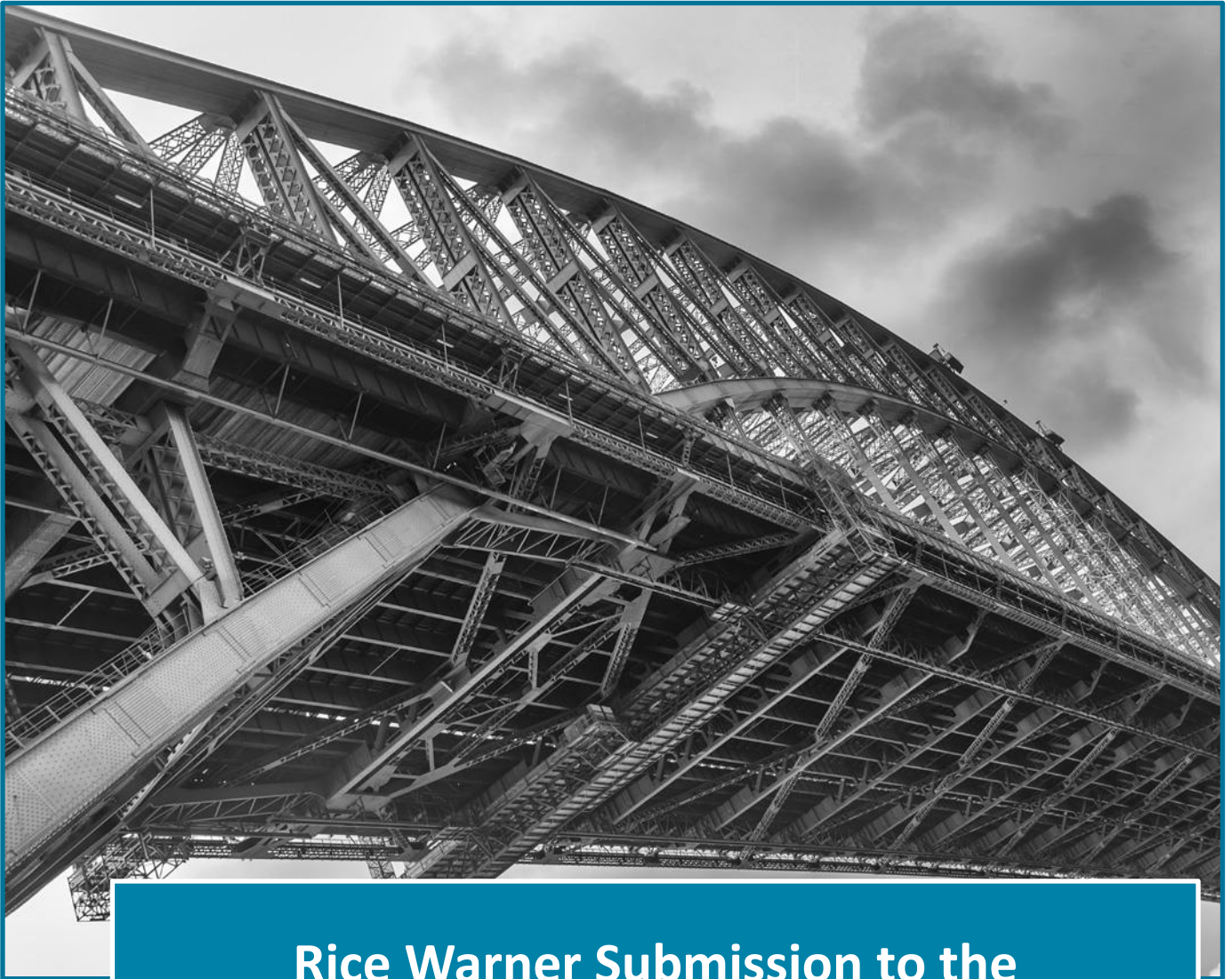


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Rice Warner Submission to the Financial System Inquiry *Retirement Income Solutions*

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This report has been prepared in response to the Interim Report of the Financial System Inquiry.

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1. Executive Summary

1.1 Background

Rice Warner is pleased to provide this submission to the Financial System Inquiry (FSI).

Our submission focuses on retirement incomes as we broadly agree with the observations in the interim report of the FSI that:

- ***The retirement phase of superannuation is underdeveloped and does not meet the risk management needs of many retirees.***
- ***There are regulatory and other policy impediments to developing income products with risk management features that could benefit retirees.***

We consider much work needs to be done by the superannuation industry on retirement strategies. Superannuation funds have an immediate need to develop suitable strategies to cater for the baby-boomer generation which has already begun to enter retirement.

We have been able to analyse what currently happens to members as they enter retirement based on our research and insights. From this, we have formed a view on what needs to be done to optimise retirement incomes and moderate the many risks facing retirees.

As it is not possible to consider retirement incomes without covering tax and social security, we have also included some commentary about improving tax equity and efficiency.

Finally, we have made some comments about leverage in superannuation funds as it is relevant to providing a sound retirement income for members.

This report covers the following subject matter:

- Problems with current strategies, including retirement myths
- Constructing a suitable default retirement solution
- Making long-term annuities more attractive
- Tax and social security
- Leverage in superannuation

1.2 Observations

Much of current practice is driven by myths rather than facts.

There is too much emphasis on avoiding negative returns on annual statements (short-termism) and funds worry about the sequencing risk of members retiring immediately after market prices have fallen. Further, most funds do not consider the needs for high levels of growth assets in retirement.

The baby-boomers are retiring and their superannuation is being converted into retirement incomes. This bulge of retirees will require better strategies than are provided in the marketplace today. In fact, most current solutions reduce living standards in retirement and add to social security costs.

In section 2 (Problems with current retirement strategies), we show that current products are unsuitable to cater for longevity and inflation protection. It is true that lifetime annuities provide longevity protection but only from a low starting point (providing a low return to retirees).

We also recommend that funds be allowed to create a joint superannuation account for married and de facto couples. Couples tend to have joint bank accounts and the social security system is built around family structures. Joint accounts would lift levels of engagement, reduce the anomalies that currently favour Self-Managed Superannuation Funds, and reduce the number of accounts administered in the superannuation system (see Appendix A for a newsletter on this subject).

1.3 A workable default retirement solution

When we consider default strategies for retirement incomes, the criteria are different to those which apply for someone making an active choice. For example:

- It is dangerous to default unengaged members into contracts which cannot be changed (for example, lifetime annuities) should they become more engaged at a later stage.
- Default structures should balance all risks, including liquidity, longevity and inflation. They should not protect one risk at the expense of others.
- It is inefficient for members to pay for any guarantees unless they are priced fairly and appreciated by members. Requiring members to pay for longevity protection is unlikely to be sustainable for retirees who already receive meaningful protection from the Age Pension, which they may feel they have already paid for via taxes during their working years.
- The default needs to be designed to be flexible enough to cater for a range of members.
- It is critical to have a comprehensive communications process so members can make an informed decision as to whether to accept the default, move to a different strategy or use a mix of the default strategy and choice strategies.

Pensioners have two primary needs:

- Certainty of cash flows to meet current consumption (living expenses) and available cash to meet contingencies.
- Growth of their capital so future cash flow is sufficient to meet future expenditure needs no matter how long they live.

Neither of these needs or their associated risks can be avoided and both must be managed concurrently. They impose competing investment objectives which cannot be met through a traditional investment strategy. Short term income needs demand investment in liquid assets that cannot produce sufficient growth. Long term protection against inflation and longevity demands investment in growth assets that have inherently volatile market prices - and asset values could be depressed when cash is needed.

The optimal solution requires a separation of needs and a separation of the assets being used to satisfy those needs. Assets must be matched to liabilities and this cannot be done with a composite investment approach. Existing products can be easily tailored to meet these requirements.

1.3.1 Using an account based pension

The long investment horizon in retirement needs growth assets to provide inflation protection and make the funds last a long time. But this must be done in a way that does not force the realisation of assets at depressed values to meet pension payments. The key is to use the tools which maximise long-term investment performance while delivering returns in a way that supports the short term income requirements.

Growth can be maximised by harnessing the equity risk premium and franking credits, and the illiquidity risk premium from unlisted assets.

Meeting the short term income need requires delivering this extra return into the member's cash account by operating the Growth Pool as a distributing trust. The value of franking credits is also transferred. As the running yield on the fund would typically be between 4% and 5%, the cash built up will be very close to the average member's withdrawal requirements (pension payments).

The key to this solution is that the volatility of capital movements is largely irrelevant to the member – they are not being forced to draw their capital down. Another advantage is that the capital can be invested long-term and can access infrastructure and other unlisted assets without liquidity problems.

This approach has been compared to traditional defensive asset allocations and lifecycle asset allocations by modelling their outcomes in the face of historic market dislocations and booms. The results indicate that:

- Conservative and lifecycle asset allocations and annuities produce inferior outcomes because:
 - The volatility de-risking is insufficient when faced with a significant market fall.
 - The reduction in earnings capacity from moving significant proportions to defensive assets results in significant long-term underperformance.

In summary, the risk premium paid via reduced earnings is too high for the protection provided.

- A growth orientated portfolio operating in conjunction with a Cash account is a better proposition:
 - It provides a material improvement in a negative investment scenario
 - It does not materially affect outcomes in a positive investment scenario
 - The risk premium is better value for money.
- Sequencing risk cannot be adequately reduced by changes in asset allocation alone.

We note that those members requiring a nest egg will need to move money into cash well in advance so they are not subject to low market prices when they draw their payment.

1.4 Making annuities more attractive

1.4.1 Lifetime Annuities

Lifetime annuities, which are issued by life companies, have a number of inherent features that lead to sub-optimal outcomes for investors.

Retirees have a long term need for income which needs to be maintained in real terms. As the average term of retirement now exceeds 20 years (and will grow as future generations will be longer-lived),

their time horizon is long-term. Consequently, the underlying assets backing their retirement income need to be heavily based around growth assets which will generate real rates of return. However, the assets backing lifetime annuities are invested conservatively and under-perform over long periods.

The other core feature that needs attention is the absolute guarantee provided over very long periods by these products as it requires a strong reserve which also causes a sub-optimal investment outcome for annuitants.

1.4.2 Contrast to Defined Benefit Superannuation

Defined Benefit (DB) superannuation also provides long term guarantees, but there are some differences in the management of these guarantees that, if applied to lifetime annuities, would support greater emphasis on growth assets, with lower capital requirements and hence better yields.

The approach for DB benefits is to manage a pool of assets which includes a prudent reserve to deliver the promised benefits over time. Whenever liabilities exceed assets, there is a plan to bring the situation back to a surplus over time.

In some markets (notably the Netherlands) risks are shared between working-age members, pensioners and employers. For example, a deficit might be cleared with a combination of investment returns, increased contributions from working-age members and employers, and reducing or freezing pension increases for a period.

In the context of annuities, the equivalent to the employer guarantor is the shareholders of the life company. The approach to managing the annuity pool would need to rely on rebuilding shortfalls over time, and, in the extreme, adjusting future and potentially accrued benefits. The question is the amount of adjustment that should be allowed.

If assets were invested long-term so they could deliver higher yields to the annuitants, APRA could require a recovery plan which includes:

- A requirement that the assets recover to (say) 105% of liabilities within three years
- A requirement for some additional shareholder capital to be provided should the ratio fall below (say) 85%
- Some limitation on issuing new policies until the financial position has recovered
- Another measure (last resort) would be to have a temporary hold on indexation of policies, with annual increases to resume once the shortfall has been removed.

1.4.3 Deferred annuities

Deferred annuities also offer an opportunity to improve outcomes for retirees. They can be used to provide base incomes at advanced ages to ensure that those who live longest can do so with dignity. For example, deferred annuities could be used to provide income guarantees at advanced ages either from within a superannuation fund or an insurance fund.

These products could be sold as insurance policies from young ages. The benefit would be sufficient to provide members with a comfortable retirement from an advanced age (say, age 85). The cost would be relatively low if built into the default insurance structure.

A benefit of this kind could be provided within each superannuation fund, but there will need to be arrangements for transferring accrued benefits should the member wish to move to another fund. Providing the benefit via an insurer would be a better solution as it would allow simple portability.

Alternately, the benefit could be purchased at the time of retirement from the accumulated retirement benefit.

1.5 Tax and social security

1.5.1 Tax equity

We propose a number of changes which would make the retirement system fairer and simpler.

The tax rate should be the same for the accumulation and retirement phases. As 30% of assets are in the pension phase (rising to nearly 40% in 15 years), it would be possible to lower the tax on accumulation benefits to about 10.5% if there was tax neutrality. This change would greatly simplify superannuation administration and it would eliminate Transition to Retirement pensions which add little value other than tax savings for those on high incomes.

The changes to tax on pension earnings would mean that the cumbersome extra tax for those earning more than \$300,000 could be abolished.

1.5.2 Death on pension

At present, the death benefit on a residual pension benefit not left to a dependant is 17% (15% plus 2% Medicare levy). However, the actual tax rate is much lower due to so-called re-contribution strategies.

This structure could be disallowed simply by taxing the full death benefit at 17% irrespective of the source of contributions. A variation would be to allow the benefit to be transferred tax-free into the superannuation (or pension) account of close family members (spouse, siblings, children or grandchildren) free of any tax.

1.5.3 Withdrawals during pension phase

We recommend reintroducing maximum withdrawal factors for account-based pensions. An appropriate level could be three percentage points above the minimum withdrawal factor. The factor would be 7% up to age 65 then 8% until age 74. Withdrawals above this amount would be treated as lump sum withdrawals.

We would limit the maximum lump sum to twice AWOTE (about \$140,000) over the period of retirement. Members who took a lump sum of \$50,000 at retirement would still be able to draw \$90,000 for emergencies later in life. For simplicity, once an account falls below 50% of AWOTE (say \$35,000), it could be withdrawn in full at any time as a pension payment.

1.6 Social security

We are uncomfortable with the proposed change to indexation of the Age Pension. We believe it would be better to tighten the means test rather than alter indexation. We concede that the Age Pension costs have blown out and accept that the government wants the level of single pension to fall.

However, we would maintain the floor of 25% of MTAWWE so that pensioners can enjoy some benefit from the future growth in the economy. Indexation to CPI will preserve the purchasing value of pensions in payment, but it will cause pensions to new pensioners to progressively fall behind their income and expenditure requirements immediately prior to retirement.

Appendix B sets out some work we have done in this area in the past.

1.7 Franking credits

There has been a lot of debate about franking credits with commentators claiming that:

- Franking credits are a form of tax subsidy for equities
- Loans and other fixed interest assets are disadvantaged by these subsidies and should also receive the same treatment
- The tax subsidy is giving equities a favoured status and is encouraging superannuation investors to over-invest in equities and thereby expose themselves to too much risk.

These are all unsustainable claims and are at variance with the purpose of franking credits.

Franking credits were introduced for a number of reasons including:

- Without franking credits, dividends from equities were tax disadvantaged in comparison to interest receipts from bonds. Interest payments on bonds were (and are) tax deductible to the entity paying the interest. Dividends however are paid from after tax income.
- Taxing dividends in the hands of investors therefore imposed a second level of tax.
- The introduction of franking credits ensured that investment returns were taxed once only and at the end tax payer's marginal rate.
- The double taxing of company earnings in the hands of investors also raised the cost of capital for companies in comparison to debt therefore encouraging higher, and potentially inappropriate, gearing levels. The introduction of franking credits was seen as a way to encourage responsible capital management.

Removing franking credits and once again putting equity investments at a disadvantage to debt investments would encourage investment into lower yielding portfolios which would lead to lower retirement incomes for the population and a greater call on the Age Pension. It could also tilt capital structures towards a higher proportion of debt capital, potentially increasing the rate of failure of business, especially in times of financial crisis.

1.8 Leverage in superannuation

We consider that the regulator should set guidelines for APRA funds regarding an appropriate level of leverage within trusts holding unlisted assets.

The traditional use of geared instruments like warrants by SMSFs has generally been well managed with good diversification. The use of Limited Resource Borrowing Arrangements (LRBAs) has however been very different and raises a number of issues in relation to the provision of retirement incomes.

Prudential guidelines on the use of leverage by SMSFs would be beneficial. We would suggest that these should include:

- Concentration limits on the maximum percentage of a fund's assets that can be exposed to a particular asset. We suggest that the gross asset value (i.e. not net of the outstanding value of any loan secured against the property) of any asset should not exceed 25% of the total asset value of the fund.
- The limitation of recourse in respect of any loans should be entirely to the property (or other asset). Lenders should not be permitted to seek guarantees from trustees in their personal capacity or other third parties.
- Limitations on the loan to valuation ratios (LVRs) for specific loans. It may also be prudent to limit the total value of debt to the total value of assets.

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2. Problems with current retirement strategies

2.1 Myths

One of the difficulties debating Australia's retirement system is the high level of misinformed commentary and supposition made by prominent commentators. It is necessary to correct incorrect assertions before we can form a view on any required changes to the retirement incomes system.

2.1.1 *Australia is a lump sum society*

The FSI Interim Report¹ states that half of all retirement benefits are taken as a lump sum. This statement is commonly made and is based on:

- The unlimited access to retirement benefits once a member has reached the Preservation Age. A member could draw out their whole retirement balance at any time.
- The absence of any annuitisation of benefits in Australia
- The ability of retirees (who have attained age 60) to draw out their whole pension balance tax-free at any time
- APRA statistics which are not disaggregated enough to show the true position.

It is true that more than 50% of accounts are paid out as lump sums at retirement. However, these are generally small amounts. As there are more than two accounts for each member, the number of accounts does not provide enough information. It is not known what portion of these lump sum benefits is consumed. Some will be placed in bank term deposits or savings accounts as a different form of retirement saving, and some will be paid into a different fund as a non-concessional contribution.

Rice Warner has analysed exit information from funds and only about 15% of the **value** of retirement benefits is taken as a lump sum. More than half of the value of benefits is converted into a pension within the same fund and the rest is rolled out to become pensions in other funds.

2.1.2 *Australians do not buy retirement incomes*

It is true that most retirees do not want lifetime annuities. However, many retirees draw a regular income from their account-based pensions so this is a form of retirement income. The average amounts drawn from account-based pensions are about 7% a year which is only a few percentage points above the minimum required pension payments. Consequently, retirees do have retirement incomes, albeit more flexible ones than annuities.

2.1.3 *Retirees spend their superannuation too quickly*

Many commentators question whether account-based pensions are income streams. In practice, most retirees are frugal and many take the legislated minimum withdrawal amount each year (see table 1)². Even when these factors were reduced between 2008-09 and 2012-2013 financial years, many retirees still took the minimum balance.

¹ Lumps sums (4-12)

² These are based on the account balance at 1 July each year

There is growth in the number of Age Pensioners between 65 and 70 but this does not reflect pensioners spending their superannuation benefit too quickly. Rather, it is a result of some people leaving the workforce after age 65 and moving onto the Age Pension.

Table 1. Current minimum withdrawal factors

Age	Percentage of account balance
Under 65	4%
65-74	5%
75-79	6%
80-84	7%
85-89	9%
90-94	11%
95+	14%

2.1.4 Australians will struggle to reach a modest retirement

Many commentators look at the average superannuation benefit and recognise that it is inadequate. Some³ speculate that few Australians will even achieve a modest retirement. However, the Age Pension provides a benefit which is less than \$500 below ASFA's definition of a modest retirement. So, almost all Australians will benefit from at least a modest retirement. It is true that too many will not reach a comfortable retirement.

2.1.5 Lifetime annuities are a panacea

As we will demonstrate in this report, lifetime annuities are unattractive for two reasons:

- The guarantees built into the products are costly.
- The asset allocation of the investments backing these liabilities provides a low return which is unsuitable for a long-term investment.

It is worth noting that the UK which had historically operated a system of compulsory annuitisation of pension (superannuation) benefits has now scrapped this compulsion in recognition that annuities are at best only a partial solution for retirees. Calls to introduce compulsory annuitisation in Australia are clearly at variance with the experience of other economies that have found this approach wanting.

2.1.6 Growth assets need to be reduced in retirement

This is one of the most contentious suggestions and it is made frequently by a number of industry commentators. The development of lifecycle funds follows this dictum.

The main objective of funds appears to be to minimise *sequencing risk* at the point of retirement. The rationale is that a few retirees drew lump sums following the GFC and received a lower benefit due to

³ *Adequacy and the Australian Superannuation System*, Deloitte, June 2014

bad timing. However, had they been invested in a pension, even with a significant growth component, they would only have had a temporary paper (unrealised) loss and a small reduction in income.

The impact on more conservative balanced funds would have been very similar except that their long term return (and the retiree's future income) would be lower. In essence, the move to a more conservative asset allocation would have done very little to protect investors from the sequencing risk, but would have exposed them to greater long term risk from inflation and longevity.

Obviously, members who have a need for any lump sum should shift assets into cash over the few years before they retire. Superannuation funds need to improve their engagement with pre-retirees to assist them to understand the sequencing risk pertaining to lump sum withdrawals.

2.1.7 *Bequests are a leakage from the retirement system*

Several commentators have considered that there is 'leakage' from the system if benefits are not used for retirement incomes. There are three situations where this can occur:

- Withdrawal of large lump sums (though we have shown that this behaviour is overstated)
- Pension payments (above age 60) are tax free in the hands of the retiree and there is no maximum payment that need be made in any year. This means that retirees can withdraw large lump sums at any time, potentially eroding their income long before they die. While this behaviour is not common, it is a potential leakage from the system.
- Dying in retirement with a residual benefit used as a bequest for family or charities. We consider this is better dealt with by adjusting the tax rate for benefits passed to non-dependents on death in retirement. A variation could be to allow the benefit to pass tax-free to a superannuation account of a family member.
- If there is concern about superannuation being used as an estate planning vehicle, this is best addressed by taxing large bequests, not by distorting investment strategies of all retirees.

2.1.8 *Tax of super is inequitable*

Broadly, we agree with this statement and have made several suggestions in the past to address several issues and to simplify the tax structure and its fairness in relation to superannuation.

However, we take issue with many of the claims put forward by commentators and some of the suggested changes. For example, we believe that franking credits are sound as a means of avoiding double taxation of company dividends. We also believe that lifetime contribution caps and/or limiting the size of superannuation accounts would be inefficient to administer and there are better ways of taxing large benefits.

While it is outside the scope of the FSI, we have commented on tax and social security in this report as it is not possible to cover retirement incomes without considering these matters.

2.1.9 *SMSFs have unfair advantages*

The SMSF segment has grown strongly and many commentators within the superannuation industry have suggested these funds have unfair advantages. In fact, they operate under the same tax and superannuation rules as APRA-regulated funds but they are more flexible so can manage tax more easily. The real difference between the two types of fund is that SMSFs can easily allocate tax at

member level whereas pooled funds cannot. The growth of Member Directed Investments allows some APRA funds to offer members the ability to hold direct investments in listed equities and term deposits but this is not enough to close the gap in flexibility.

We believe that it is desirable to allow superannuation funds to issue joint accounts for couples. There are about seven million couples in the superannuation system and that number of accounts could be eliminated if joint accounts were permissible. This would allow funds to more closely replicate some of the advantages of an SMSF (which is usually family superannuation). Rice Warner set out our logic for these accounts in a newsletter issued in April 2014 (see Appendix A).

2.2 Current situation of retirement

The next 15 years will see more Australians leaving or winding down from the workforce than entering it. The workforce will only grow from migration. On analysis undertaken by Rice Warner, Australia's ageing nation will comprise two million men and 2.3 million women in retirement drawing a pension from their superannuation savings by 2029.

This represents a shift to around 40 per cent (or \$1.3 trillion – in 2014 dollars) of Australia's retirement savings assets being within some form of retirement income stream. Currently that number sits at 30 per cent (or \$492 billion of total superannuation assets) in today's dollars.

At a personal level, many retirees will not have adequate savings for their retirement. Rice Warner's latest Retirement Savings Gap research, commissioned by the Financial Services Council, measured (at 30 June 2013) a \$727 billion savings gap. Even allowing for Age Pension receipts, this is \$67,000 per person less than the amount required for an 'adequate' retirement, which would pay retirees up to their life expectancy (more than 20 years from the time of retirement).

Compounding this issue is longevity risk. Half of Australia's retirees will live beyond their life expectancy age and they require suitable long-term products to provide them with retirement incomes over an extended period.

The problem represents a looming challenge requiring a comprehensive range of solutions from industry and government. Our own investigations show today **there is not one Australian superannuation fund provider that has in place the right default retirement incomes package** to meet the wave of retirees preparing to shift their super into pensions.

One problem facing retirees is the complexity of retirement and the significant changes which occur both financially and socially. The circumstances of retirees vary greatly so no product can be a magic bullet to solve all situations. A comprehensive retirement strategy is required which should cater for the whole retirement period even though there is a great deal of uncertainty over longevity, expenditure needs and health.

We consider that existing products can be easily tailored to meet the needs of retirees by incorporating them within a holistic strategy. However, superannuation funds follow the myths described above rather than facts in setting their solutions. Consequently, most solutions are not optimal – by definition that means they lead to reduced living standards in retirement and add to social security costs.

When planning for retirement (often in conjunction with a financial adviser), it is usual to put the benefit into four notional buckets, namely:

- A lump sum for immediate consumption at retirement

- A nest egg for emergencies
- a liquid pool (cash) for pension payments over the next few years
- the bulk of assets invested long-term to provide inflation and longevity protection – and a bequest for the residual amount left on death.

While these buckets are earmarked mentally for specific purposes, they are not normally separated (apart from the lump sum).

This bucketing structure is not adopted by superannuation funds, partly because they don't know enough about their members to categorise their assets for them. Two-thirds of retirees are part of a couple yet funds will only have partial financial details about the partner who is a member of their fund. However, funds could provide a combination of:

- a default combination of buckets suitable for a larger proportion of members than current defaults
- an understandable menu of choice products to help members adjust to their own circumstances and adapt to changes in their circumstances over time.

2.3 Time horizons

In order to provide some protection against inflation and longevity, the assets of pensions need to be invested long-term. The average period of life during the retirement years now exceeds 20 years and it will be longer for those entering retirement in the next decade.

Any investment period of 20 or more years requires a significant proportion of growth assets. Superannuation funds tend to select balanced funds (default options) which are well diversified. However, they contain too great a portion of lower yielding asset classes.

Table 2 sets out some expected 10 year returns for a range of asset classes. These were provided by a number of asset consultants and fund managers.

As can be seen, the expected returns differ widely between asset classes.

Table 2. Expected returns by asset class

Asset Class	Number of Responses	Median Response (%)	Average Response (%)	Lowest (%)	Highest (%)
Australian equities	13	8.9	8.8	7.9	10.3
International equities (unhedged)	13	8.7	8.5	6.7	10.3
International equities (hedged)	12	8.8	8.8	6.9	12.7
Listed property	12	7.8	7.3	4.5	10.0
Direct property	9	8.1	7.9	6.3	8.5
International Property	12	8.2	7.6	2.0	10.3
Australian Fixed Interest	13	4.5	4.5	3.5	5.5

International Fixed Interest (Hedged)	13	5.2	4.8	3.0	6.1
Mortgage/Loans	5	6.9	6.9	6.7	7.0
High yield debt	8	7.1	7.0	5.5	8.0
Cash	13	4.2	4.1	2.5	5.1
Inflation-linked	9	4.4	4.1	1.5	5.4
Emerging Markets	12	11.0	11.1	8.5	15.7
Private Equity	8	10.7	10.6	9.0	12.5
Infrastructure	7	9.8	9.1	7.4	10.0
Hedge Funds	10	6.9	7.2	5.7	10.0
10 year Bond Rate	9	4.3	4.7	4.0	6.8
90 days Bill rate	6	4.7	4.5	4.0	5.0
AWOTE	7	4.1	3.9	3.5	4.3
CPI	11	2.5	2.7	2.5	3.5

While table 2 shows the position at a point in time, the relativity between most asset classes does not vary much over time. The expected long-term equity risk premium remains at all points of the economic cycle.

2.4 Existing account-based pension structures

In their current format, these products are not suitable as a default retirement solution. Most funds use a simple variation of their default (MySuper) investment strategy. There are many weaknesses of these structures which would preclude them from being a suitable default fund for retirement.

2.4.1 Investing during the accumulation years

APRA-regulated funds do not maximise retirement benefits for default members. Almost all funds focus on smoothing results for each financial year as trustees do not like declaring negative returns on annual statements. Of course, the emphasis on minimising negative annual returns can only be implemented by diluting the main goal of maximising long-term benefits.

Trustees and their asset consultants worry about risk but this is equated incorrectly to short term market price volatility. Funds do not consider enough the primary risk of long term underperformance created by having sub-optimal investment strategies.

The position is worsened as APRA funds are poor at managing tax compared to SMSFs. They tend to give fund managers gross investment targets and in the past many have not participated in tax-privileged opportunities such as listed company 'buy-backs.'

2.4.2 Investing for lump sums

APRA-regulated funds are often concerned about the sequencing risk for those members withdrawing a large lump sum, perhaps their whole benefit, at the point of retirement.

While many funds change asset allocation as members approach retirement, this does not reduce this risk by much. What it does do is reduce long term returns for members.

Finally, many superannuation funds hold too much cash as they need it for liquidity purposes due to portability of benefits under Member Choice.

The best approach is to have the lump sum separated from the rest of the benefit and placed in cash well before it is withdrawn. No fund has a strategy to provide this facility efficiently.

2.4.3 Growth assets

Many funds reduce exposure to growth assets in retirement as they focus on retirees drawing pension payments from this growth pool. Where funds do have appropriately high levels of growth assets, they have no practical means of diverting income into cash to fulfil the consumption needs of the retiree. Hence, all pension payments are a combination of income and capital.

2.5 Lifetime annuities

While the number is growing, there are no more than \$750 million of lifetime annuities sold in Australia each year. Most annuities sales are very short duration term certain annuities (one to three years), so are effectively term deposits sold through superannuation.

It is clear that there is little demand for lifetime annuities despite the fact that they are relatively simple and easy for consumers to understand. This should come as no surprise given the role of the Age Pension in underpinning the retirement incomes of the majority of Australian retirees.

They are not suitable **as a default retirement product** since:

- They provide lower long-term value than well-managed account-based pensions.
- They lead to higher levels of Age Pension benefits, both through the favourable means-testing rules (relative to other products) and through providing lower earnings in retirement.
- They are inflexible and cannot be commuted.
- They provide no fall back for emergencies.

To illustrate relative values, Graph 1 below shows the range of outcomes for an account-based pension where the retiree draws pension payments which are the equivalent to a lifetime annuity indexed to prices.

The investment strategy is a 70/30 Growth/Defensive portfolio with income distributed in cash (explained in next section). The lifetime annuity is taken from the best rate available for a lifetime annuity including return of capital on death in the first fifteen years. The return on death provides reasonable value for those dying in 25% LE.

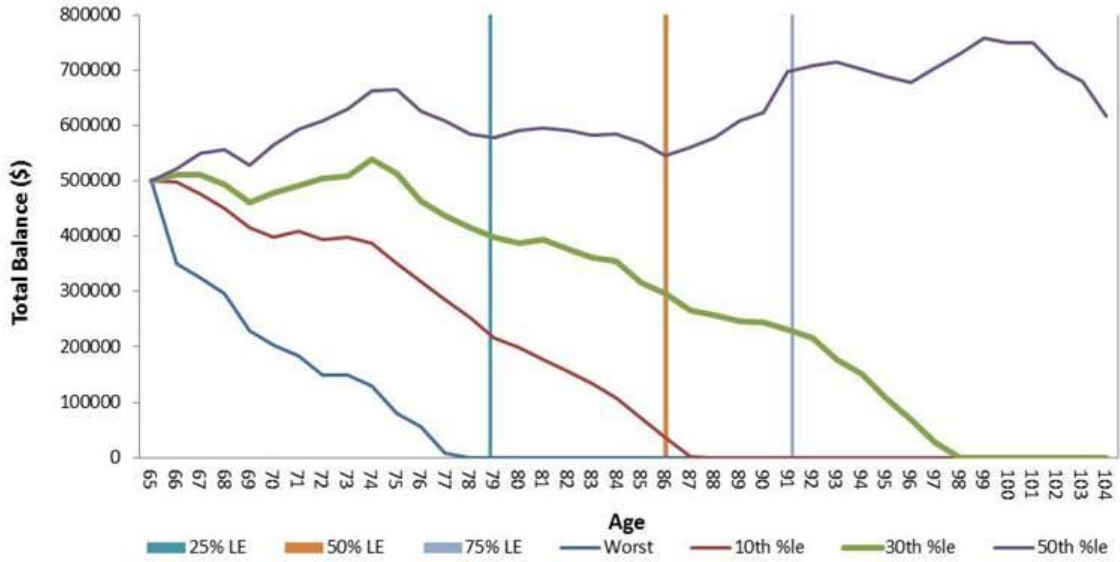
Results are for a 1,000 scenario stochastic model. 25% LE, 50% LE and 75% LE represent the 25th, 50th and 75th percentile of life expectancy. That is 25% of retirees have died by the 25% LE.

The modelling shows that:

- There is a 90% probability that the retiree will have sufficient money to replicate the indexed annuity income for their life expectancy
- There is ~70% probability that the income will last to age 100

- The median case maintains the income for life AND the capital!

Graph 1. How long will my money last?



3. The Rice Warner Retirement Solution

3.1 Criteria for a sound default fund

At present, the default retirement solution is a lump sum! Members of superannuation funds who signal retirement without actively choosing an income stream will be paid out their benefit as a lump sum. If they do nothing, it will stay in the accumulation fund indefinitely (at the extreme, until they die at an advanced age), possibly without them being aware of the benefit being available to them.

Those members who want to roll their retirement benefit into a pension or annuity need to apply for these products even if they want a pension within their fund. It would be preferable to default into an account-based pension within the fund at a specified age unless members opt out. This specified age could be the Preservation Age, the Age Pension eligibility age or some other age. Trustees could make the decision based on the demographics of their fund's membership.

When we consider default funds for retirement incomes, the criteria are different to those which apply for someone making an active choice. For example:

- It is dangerous to default unengaged members into contracts which cannot be changed (eg lifetime annuities) should they become more engaged at a later stage.
- It is inefficient for members to pay for any guarantees unless they are priced fairly or to pay for any services which they don't want.
- Default structures should balance all risks, including liquidity, longevity and inflation. They should not give over-riding priority to protecting against one risk at the expense of others.
- The default needs to be designed to be flexible enough to cater for a range of members.
- It is critical to have a comprehensive communications process so members can make an informed decision as to whether to accept the default or opt out.

Choice products need not meet the needs of all members; it is sufficient that they be suitable for members with specific requirements. Consequently, not all the criteria for a default product need to be present for a choice product.

3.2 Retirement needs

Pensioners have two primary needs:

- Certainty of cash flows and cash values to meet current consumption (living expenses) and contingencies.
- Growth of their capital so future cash flow is sufficient to meet future expenditure needs no matter how long they live.

Neither of these needs or their associated risks can be avoided and both must be managed concurrently. They impose competing investment objectives which cannot be met through a traditional investment strategy. Short term income needs demand investment in liquid assets that cannot produce sufficient growth. Long term growth demands investment in growth assets that have inherently volatile market prices - and asset values could be depressed when cash is needed.

The optimal solution requires a separation of needs and a separation of the assets being used to satisfy those needs. Assets must be matched to liabilities and this cannot be done with a composite investment approach.

3.3 Using an Account Based Pension

The long investment horizon in retirement needs growth assets to provide inflation protection and make the funds last a long time. But this must be done in a way that does not force the realisation of assets at depressed values to meet pension payments. The key is to use the tools which maximise long-term investment performance while delivering returns in a way that supports the short term income requirements.

Maximising long term growth requires investing the Growth Pool to:

- Harness the equity risk premium
- Harness the extra returns from the illiquidity premium from investing in unlisted assets
- Utilise the valuable franking credits from investments in Australian tax-paying businesses.

Meeting the short term income need requires delivering this extra return into the Liquidity Pool by operating the Growth Pool as a distributing trust. This results in all dividends, interest and rents being moved into the member's cash account. The value of franking credits should also be transferred as the dividends are paid (even though the franking credit will only be repaid to the fund after the tax return for the financial year is lodged). As the running yield on the pension assets will be between 4% and 5%, the cash built up will be very close to the member's withdrawal requirements.

The key to this solution is that the volatility of capital movements is largely irrelevant to the member – they are not being forced to draw their capital down. Another advantage is that the capital can be invested long-term and can access infrastructure and other unlisted assets without worrying about liquidity.

This core strategy can then be enhanced by building a Nest Egg to meet extra expenditure commitments and contingencies. This is best done by transferring money from the Growth Pool into cash following periods of strong performance.

Finally, later in life, when lifetime annuities provide better value and making financial decisions becomes more difficult, pensioners who want to lock in certainty could convert part or possibly all their accumulated assets to a lifetime annuity at, say, age 85.

3.4 Comparisons with other solutions

We have modelled the outcome of this approach against other solutions. We have specifically considered historic periods that have delivered significant negative results as members have moved into retirement – ie the specific circumstances that lifecycle products and conservative investment portfolios are supposed to protect against. We have also considered historic periods that have delivered highly favourable results.

This has allowed us to consider the results for the various approaches:

- Simply staying invested in the standard 70/30 Growth/Defensive portfolio

- Our proposed solution as outlined in Section 3.3 which maintains a cash account from distributed earnings and profit taking in good years sufficient to meet expected expenditure requirements while maintaining the bulk of assets in a Growth Pool invested in a 70/30 Growth/Defensive portfolio.
- Using a lifecycle approach to asset allocation

The results of this modelling are shown in Table 3

Table 3. Results of modelling

Investment approach	Negative Scenario	Positive Scenario
Stay in 70/30 portfolio	Returns impacted by market downturn. Better result than lifecycle, but underperformed Rice Warner approach.	Best result driven by high allocation to growth assets.
Rice Warner approach	Best result, but returns impacted by market downturn.	Slightly underperformed 70/30 portfolio due to value held in lower yielding cash portfolio.
Lifecycle fund	Worst result. Returns impacted by market downturn and conservative asset allocation.	Worst result. Returns impacted by conservative asset allocation

These results indicate that:

- Conservative and lifecycle asset allocations and annuities produce inferior outcomes because:
 - The volatility de-risking is insufficient when faced with a significant market fall.
 - The reduction in earnings capacity from moving significant proportions to defensive assets results in significant long-term underperformance.
 - In summary, the risk premium paid via reduced earnings is too high for the protection provided.
- A growth orientated portfolio operating in conjunction with a Cash account is a better proposition:
 - It provides a material improvement in a negative investment scenario
 - It does not materially affect outcomes in a positive investment scenario
 - The risk premium is better value for money.
- Sequencing risk cannot be adequately reduced by asset allocations alone.

3.5 Conclusions

Funds are wrong to shift assets away from growth as members retire. This reduces retirement income and must lead to higher social security payments. Existing products that operate in this way do not work in the retiree's best interests.

Retirees need to be exposed to growth assets if they are to maintain an adequate income for life. Investments need to be tilted towards Australian equities for dividend yield and franking credits and towards unlisted assets for higher returns. This investment should operate alongside a liquid asset pool via a distributing trust structure. This structure is efficient, flexible and needs few changes to administration systems.

4. Making long-term annuities more attractive

4.1 Lifetime Annuities

Retirees have a long term need for income which needs to be maintained in real terms. As the average term of retirement now exceeds 20 years (and the period is growing since future generations will be longer-lived), their time horizon is long-term. Consequently, the underlying assets backing their retirement income need to be heavily based around growth assets which will generate real rates of return.

Lifetime annuities, which are issued by life companies, have a number of inherent features that lead to sub-optimal outcomes for investors:

- They provide absolute guarantees against uncertain outcomes over very long periods.
- These guarantees require conservative pricing assumptions and the life company to set up significant capital reserves especially if the underlying assets are invested in growth asset categories.
- Life companies are not prepared to invest the levels of capital required to back a portfolio with significant amounts of growth assets. This forces them to have an emphasis on defensive assets which over long periods are lower yielding than growth assets.
- The cost of servicing the capital, together with the bias towards defensive assets, combines to reduce the yield from annuities to uncompetitive levels, especially at younger ages.

These underlying features of annuities will have to be changed if they are to be made more attractive. The core feature that needs attention is the absolute guarantee over very long periods as it forces all the other structural decisions.

4.2 Contrast to Defined Benefit Superannuation

Defined Benefit (DB) superannuation also provides long term guarantees, but there are some differences in the management of these guarantees that, if applied to lifetime annuities, would support greater emphasis on growth assets, with lower capital requirements and hence better yields.

The approach for DB benefits is to manage a pool of assets which includes a prudent reserve to deliver the promised benefits over time. The features of this are:

- Funding levels are managed so that accrued benefits are protected by the available assets.
- There is a 'guarantee' from the supporting employer ('guarantor') that stands available to provide extra funding as necessary should the funding position of the plan fall below acceptable levels. Should this occur, the employer will seek to restore the funding position over a timeframe acceptable to the regulator (APRA).
- The guarantee is not an absolute guarantee as the employer may not be able to meet the financial obligation required to restore the funding position.
- If the funding position cannot be restored, future benefits can be adjusted (reduced) to restore the funding position.
- In extreme situations, accrued and existing benefits (eg pensions in payment) can be adjusted.

In the context of annuities, the equivalent to the employer guarantor is the shareholders of the life company. The approach to managing the annuity pool would need to rely on rebuilding shortfalls over time, and, in the extreme, adjusting future and potentially accrued benefits. The question is the amount of adjustment that should be allowed.

As an example, let us assume that APRA required the assets backing a life annuity pool to be 105% of the liabilities. If the assets were invested heavily in long-term investments (say 75% growth assets), this ratio could fall to (say) 80% during a global economic crisis such as occurred in 2007/8.

We know that there will be a reversion to the mean in many investment markets and that the underlying investments will recover. Further, their income will not reduce by much (if anything) so it is reasonable to allow the life company to manage the recovery of the investment pool.

APRA would require a recovery plan which could include:

- A requirement that the assets recover to 105% of liabilities within 3 years
- A requirement for some additional shareholder capital to be provided should the ratio fall below (say) 85%
- Some limitation on issuing new policies until the financial position has recovered
- Another measure (last resort) would be to have a temporary hold on indexation of policies (but the increase would be paid at a later date)

With the current approach, no adjustment is allowed since there is an absolute guarantee. With Account Based Pensions, the amount of adjustment allowed for is open ended. There is no guarantee so income payments can cease.

Our proposal is that if some (pre-determined) level of variability is allowed and anticipated, the pricing margins and capital requirements can be less stringent and greater allocations to growth assets can be supported. The underlying investment portfolios will intrinsically generate higher returns and there will be a smaller charge to pay the cost of the lower capital requirements. This approach would support higher returns from annuities although they will fluctuate within the allowable band.

4.3 Deferred annuities

Deferred annuities also offer an opportunity to improve outcomes for retirees. They can be used to provide base incomes at advanced ages to ensure that those who live longest can do so with dignity. For example, deferred annuities could be used to provide income guarantees at advanced ages either from within a superannuation fund or an insurance fund.

Let us consider a couple wanting to ensure a comfortable income beyond age 85. The current ASFA Comfortable income standard for a couple is \$58,128 per year. The current Age Pension for a couple is \$33,036. So, in a worst case scenario, the couple having exhausted their superannuation benefits by age 85, would need to be provided with an annual income of \$12,546 each⁴.

This modest level of security could be provided quite cheaply during the couple's working lives. Table 4 shows the annual contribution that would be needed at various ages to provide this benefit from age 85 with the contribution only being paid until age 65.

⁴ All values are in 2014 dollars and we have ignored means-testing for this exercise.

Table 4. Annual contribution per person (indexed to inflation) to age 65 needed to fund top up of Age Pension from age 85

Age	Male	Female
25	304	376
35	463	584
45	803	1,034
55	1,895	2,476

Note: Contributions are indexed to inflation and payable to age 65. Benefit from age 85 is \$12,546 each per year indexed to inflation.

The price estimation is indicative only. It is based on a generic balanced investment option (70/30 to Growth/Defensive assets), with reserving being managed as for a DB fund and an allowance for reserves of 1.5% pa. Earnings are taxed at current superannuation tax rates.

Someone retiring at age 65 without this form of deferred annuity and wanting to fund an equivalent benefit over the period until age 85 would require a contribution as shown in Table 5.

Table 5. Annual contribution per person (indexed to inflation) to age 85 needed to fund top up of Age Pension from age 85

Gender	Contribution
Male	1,131
Female	1,471

Note: Contributions are indexed to inflation and payable to age 85. Benefit from age 85 is \$12,546 each per year indexed to inflation.

These costs for ensuring a comfortable income at advanced ages are not significant for most working Australians.

A benefit of this kind could be provided within each superannuation fund, but there will need to be arrangements for transferring accrued benefits should the member wish to move to another fund. Providing the benefit via an insurer would be a better solution as it would allow simple portability.

The costs would reduce if the assets backing deferred annuities were tax-free during the deferment period (See section 5 for commentary on tax).

5. Tax and social security

It is not possible to consider retirement incomes without looking at tax concessions and social security. Three quarters of retirees receive a full or part Age Pension so the eligibility rules for that benefit are critical in formulating a retirement income strategy.

Rice Warner has raised some of these issues in its pre-Budget submission 2014. They are included here for completeness.

5.1 Tax equity

The superannuation system is very complex and various governments have attempted to introduce broad equity across the system. For example, the previous Labor government had an initiative to rebate the tax paid by low income earners on employer contributions paid on their behalf – the Low Income Superannuation Contribution (LISC). The rationale for this adjustment was that the tax rate charged to these contributions was 15% which was not concessional given the tax rate on their personal income. While this is a sound measure to restore equity, it was to have been funded by the Minerals Rent Resource Tax so its implementation is still being considered by the Senate.

It is self-evident that the tax concessions for superannuation are tilted towards those Australians who have the most income and wealth, and who have the highest personal marginal tax rates. Against this, other Australians receive an Age Pension in retirement. Dr David Knox of Mercer has demonstrated that the combination of tax concessions and Age Pension receipts provides a relatively equal contribution over the lifetime for most Australians⁵.

Notwithstanding this, there are a number of changes which should be made to make the retirement system fairer and simpler.

5.2 Assets held in pension phase

We note that 30% of all superannuation assets are held in retirement pensions and this figure will rise to nearly 40% over the next 15 years as set out in Table 6.

⁵ Securing Retirement Incomes, Tax, Super and the Age Pension – assessing the value of total government support
<http://securingretirementincomes.com.au/wp-content/uploads/2012/06/Tax-Concessions-Mercer-SRI-Report-feb20121.pdf>

Table 6. Retirement projections results (2013 dollars)

Market segment	Today		In 5 years		In 15 years		CAGR
	30 June 2013		30 June 2018		30 June 2028		
	(\$M)	(%)	(\$M)	(%)	(\$M)	(%)	(% p.a.)
Not-for-Profit Funds	84,967	17.3	163,135	23.5	372,027	28.5	13.7
Commercial Retirement Products	158,632	32.2	199,215	28.7	349,373	26.7	8.6
Self-Managed Super Funds	248,528	50.5	330,846	47.7	586,168	44.8	9.1
Total retirement market	492,128		693,196		1,307,567		9.9
Retirement assets as percentage of all superannuation assets		30.4		32.7		39.0	

5.3 Proposed change to tax on pensioner earnings

The previous government was concerned about wealthy retirees holding significant assets within a superannuation pension on which they paid no tax on earnings. It attempted to address this with a convoluted process to tax earnings above a threshold - which would have incurred considerable administration costs for the industry.

There is a better way of improving tax equity without breaking this government's promise not to tax retirement benefits. We consider it sensible to have a single rate of tax across accumulation benefits and superannuation pensions. We have argued for this before in past newsletters and speeches and it was also a recommendation of **Australia's Future Tax System Review**.

The government only taxes accumulation assets which are 70% of superannuation fund earnings. Consequently, it has an effective gross rate of tax of 10.5% - and the actual rate collected is lower due to allowable deductions such as fund costs and insurance premiums. Once pension assets become 40% of all superannuation assets, the effective gross rate will fall to 9% of total superannuation system earnings (less after deductions).

Other changes could be made to superannuation taxation (for example retaining/reintroducing LISC), and the overall cost could be balanced by striking the rate somewhere between 9% and 15%.

We have considered whether there would be any social impact of increasing taxes on pensioners. It could be argued that low-income earners would be able to avoid the tax on earnings by withdrawing their retirement benefit and depositing them in a savings account with a bank.

In fact, this is already established behaviour. The majority of members with accumulated retirement benefits under \$100,000 already take their benefits as a lump sum and then place it in a bank account. As these members have little personal income, their earnings on these deposits are tax-free.

Superannuation funds would want to retain retirement benefits as pensions so the onus would be on them to show that the fund earnings after tax and fees will be better than the return made from money left in a bank. As it is a competitive market, members would have good options either way.

5.3.1 Impact of Proposed Change

There are several advantages of this proposal including:

- Wealthy retirees will contribute towards reducing the Budget deficit and will pay an equitable share of tax in future. Taxing earnings means that those with larger balances pay more tax which is progressive and broadly equitable.
- The long-term tax rate (say, 10%) would help younger Australians build higher retirement benefits. While these would be extinguished faster if pension earnings are taxed, that could be addressed separately in future if the growth in the economy permits future enhancements.
- There would not be a loss of capital gains tax when members shift from accumulation to pension phase. At present, the deferred tax liability is made void for assets held in pension accounts. If the tax on earnings were the same during the pension phase, this would increase capital gains revenue over the next decade.
- Several administrative functions would be removed such as the requirement for Actuarial Certificates to segregate assets between accumulation and pension accounts. This would be a net saving to the system and would reduce tax deductions.
- Superannuation administration would be simplified as members would not need to change accounts when they move into pension phase. This would remove the need for an expensive range of extra products.
- It would be easier to set up a default retirement solution as there would be a smooth transition into retirement if members did not need to set up a separate pension account.
- The costs of managing Transition to Retirement benefits would disappear as these accounts would cease. It could be argued that these benefits are simply a method of reducing taxes without any long-term increase in national savings.
- The government would not suffer a continuing erosion of revenue over the next decade as the baby-boomers move into a tax-free earnings environment
- The system would be simpler to administer and this would lead to lower costs for members and lower deductions against taxable revenue.

5.4 Other tax changes

5.4.1 Death on pension

At present, the death benefit on a residual pension benefit not left to a dependant is 17% (15% plus 2% Medicare levy).

The actual tax rate is much lower due to so-called re-contribution strategies. During the period up to retirement, many wealthier Australians over age 60 take the equivalent of the maximum concessional non-contribution amount (currently \$180,000 a year) from their pension and contribute it back into an accumulation fund which is then shifted into a pension. This changes the taxable amount of the ultimate benefit.

This structure could be disallowed simply by taxing the full death benefit at 17% irrespective of the source of contributions. A variation would be to allow the benefit to be transferred tax-free into the superannuation (or pension) account of close family members (spouse, siblings, children or grandchildren) free of any tax.

5.4.2 High income tax

The changes to tax on pension earnings would mean that the extra tax for those earning more than \$300,000 could be abolished.

5.4.3 Withdrawals

We would reintroduce maximum withdrawal factors for account-based pensions. An appropriate level could be 3 percentage points above the minimum withdrawal factor. The factor would be 7% up to age 65 then 8% until age 74. Withdrawals above this amount would be treated as lump sum withdrawals.

We would limit the maximum lump sum to twice AWOTE (about \$140,000) over the period of retirement. Members who took a lump sum of \$50,000 at retirement would still be able to draw \$90,000 for emergencies later in life. For simplicity, once an account falls below 50% of AWOTE (say \$35,000), it could be withdrawn in full at any time as a pension payment.

5.5 Social security

We are uncomfortable with the Government's proposed change to indexation of the Age Pension. We believe it would be better to tighten the means test rather than alter indexation. We concede that the Age Pension costs have blown out and accept that the government wants the level of single pension to fall from its current historically high level.

However, we would maintain the floor of 25% of MTAW so that pensioners can enjoy some benefit from the future growth in the economy. Indexation to CPI will preserve the purchasing value of pensions in payment, but it will cause pensions to new pensioners to progressively fall behind their income and expenditure requirements immediately prior to retirement.

Appendix B sets out some work we have done in this area in the past.

5.6 Franking credits

There has been a lot of debate about franking credits with commentators claiming that:

- Franking credits are a form of tax subsidy for equities
- Loans and other fixed interest assets are disadvantaged by these subsidies and should also receive the same treatment
- The tax subsidy is giving equities a favoured status and is encouraging superannuation investors to over-invest in equities and thereby expose themselves to too much risk.

These are all unsustainable claims and are at variance with the purpose of franking credits.

Franking credits were introduced for a number of reasons including:

- Without franking credits, dividends from equities were tax disadvantaged in comparison to interest receipts from bonds. Interest payments on bonds were (and are) tax deductible to the entity paying the interest. Dividends however are paid from after tax income.
- Taxing dividends in the hands of investors therefore imposed a second level of tax.

- The introduction of franking credits ensured that investment returns were taxed once only and at the end tax payer's marginal rate.
- The double taxing of company earnings in the hands of investors also raised the cost of capital for companies in comparison to debt therefore encouraging higher, and potentially inappropriate, gearing levels. The introduction of franking credits was seen as a way to encourage responsible capital management.

The implication that there is excessive investment in equities in Australian superannuation portfolios is also false. As we have argued elsewhere in this submission, superannuation and retirement portfolios require a high allocation to growth assets if they are to satisfy their primary purpose of providing sustainable, inflation protected incomes in retirement. Removing franking credits and once again putting equity investments at a disadvantage to debt investments would encourage investment into lower yielding portfolios which would lead to lower retirement incomes for the population and a greater call on the Age Pension.

6. Leverage in superannuation funds

Superannuation law has historically prohibited leverage inside a superannuation fund except for short term cash flow management. Funds are not permitted to borrow (section 67 of the SIS Act) nor to have any charge over an asset (regulation 13.14 of the SIS Regulations). A consequence of this has been that funds have geared indirectly by investing in vehicles that are internally geared. Infrastructure and property investments are commonly implemented through geared trust structures. Warrants have also been popular investment vehicles especially for SMSFs.

The more recent introduction of Limited Recourse Borrowing Arrangements (LRBAs) has made leverage more explicit and it is these arrangements that have attracted significant commentary, including from this inquiry.

We believe that there is a need to review the use of leverage within superannuation and for the development of guidelines on this use. The positions of APRA regulated funds and SMSFs are intrinsically different and need separate consideration.

6.1 APRA funds

APRA funds have circumvented the prohibition on leverage by investing in internally leveraged vehicles. We do not believe that there are any significant issues with this approach because:

- The investments are carried out as part of a comprehensive, diversified investment strategy which is controlled by prudential standards.
- Risks are carefully assessed and managed under prudential standards.
- Each asset only comprises a small percentage of total fund assets.
- Geared assets in aggregate only comprise a small percentage of total fund assets.
- The internal gearing of the vehicles is controlled by asset pricing which falls if gearing becomes excessive. Gearing levels are therefore controlled within the vehicles by the need to maintain stable asset values.

APRA funds also use derivatives to increase or reduce exposure to various asset classes. This is a form of leverage which will not be readily seen from published material on investments.

We do not believe that the current use of leverage by APRA funds presents a significant risk to retirement incomes. Nonetheless, guidelines on the prudent use of leverage including within investment vehicles would be helpful.

6.2 SMSFs

The traditional use of geared instruments like warrants by SMSFs has generally been well managed with good diversification. The use of LRBAs has however been very different and raises a number of issues in relation to the provision of retirement incomes.

The use of LRBAs has generally led to a significant concentration of investments within SMSFs. Given average SMSF account balances and median house prices, it is clear that for many SMSFs using LRBAs, the underlying property represents a significant proportion of fund assets. This has a number of potential consequences for the funds:

- In retirement mode, without contribution income, the loan servicing costs may not be able to be met from fund earnings.
- Even where the loan servicing cost can be met, there may not be sufficient remaining cash flow to meet the minimum pension drawdown requirements.
- The earnings of the fund could be almost totally dependent on the rental success of a single property. Without this rental income the fund will generally not be in a position to meet loan servicing costs or drawdowns.
- The concentration risk extends to the capital value of the investment as the asset value of a fund could be predominantly dependent on the value of a single property in a single geographic location.
- This capital value risk is obviously exacerbated by the leverage.
- Funds paying pensions also have a significant liquidity risk even if the level of gearing has reduced to low levels. They need to meet minimum drawdown requirements and if these cannot be met from income, assets must be sold. Most funds will probably be able to meet these commitments for a while from more liquid assets, but at some point the underlying property would need to be liquidated. The timing and/or value of this disposal could be problematic.

The issues associated with investment in geared vehicles are not really different from those for APRA funds provided the vehicles are at arm's length and are suitable financial products. The issues with LRBAs are different and relate to liquidity, concentration and gearing levels. Prudential guidelines on the use of leverage by SMSFs would undoubtedly be beneficial. We would suggest that these should include:

- Limitations on the maximum percentage of a fund's assets that can be exposed to a particular asset. We suggest that the gross asset value (ie not net of the outstanding value of any loan secured against the property) of any asset should not exceed 25% of the total asset value of the fund.
- The limitation of recourse in respect of any loans should be entirely to the property (or other asset). Lenders should not be permitted to seek guarantees from trustees in their personal capacity or other third parties.
- Limitations on the loan to valuation ratios (LVRs) for specific loans. It may also be prudent to limit the total value of debt to the total value of assets.

Appendix A Joint Superannuation Accounts

See attached newsletter – Joint Superannuation Accounts

http://www.ricewarner.com/media/93823/Joint-Superannuation-Accounts_April-2014.pdf

Appendix B Reforming the Age Pension

See attached newsletter – Reforming the Age Pension

http://www.ricewarner.com/media/75088/Reforming-the-Age-Pension_August-2012.pdf