

6 October, 2004

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Dear Mr Thomas

**Re: Submission to the review of the provision of pensions  
by small superannuation funds**

This letter is in response to the call for preliminary comments and suggestions on the provision of pensions in small superannuation funds.

I am a solo financial adviser with my own Australian Financial Services license. Many of my clients have self managed super funds and I provide investment and superannuation planning advice in relation to those funds. In addition McKenzie Fund Administrators provides a complete administration service for self managed super funds.

I commenced employment as a financial adviser in January 1986 and since that time superannuation has played a major role in the advice provided to clients. This is a consequence of dealing with clients who have higher than average incomes and therefore have the capacity to save. The income-tax regime governing superannuation has generally meant that saving via superannuation is more efficient than other savings vehicles and hence many clients have accumulated substantial balances in their superannuation funds overall period of time. Many have chosen self managed superannuation funds to avoid the investment inefficiencies inherent in managed funds, particularly for those with larger than average balances.

I am a member of ASFA's National Small Funds Committee (but note that any comments in this letter are entirely my own and I do not in any way represent ASFA's view).





I advise on 42 funds and these have an average asset size of between \$400,000 and \$500,000 per fund. Of those funds, five are paying allocated pensions, one is paying life expectancy pensions and the balance are in the accumulation phase.

The reason many of my clients have saved substantial amounts through superannuation is as a result of my encouragement for many years that they contribute any income not needed for immediate consumption to superannuation, subject to complying with relevant contribution limits.

The clients have been happy to do this and have seen the fund assets accumulate over time and realise that their superannuation fund will provide them with financial security in retirement, not just tax savings on contributions, as superannuation is intended to do.

As well as advising on contributions, I advise the trustees of the funds about investment. For the funds I advise on, the majority of assets are invested either in direct shares, direct fixed income securities (both listed and unlisted) and managed funds. In one case a fund owns direct property.

Whatever the investments, it is my view that the overriding objective of trustees is to obtain the best possible investment returns without putting the funds at an unacceptable level of risk. In other words, investment strategies are typically selected with the fundamental objective of maximising benefits obtained in retirement. I would suggest this is no different from the behaviour of most employees in the community irrespective of the means by which they are superannuated: where choices are available they will seek to create the optimum benefit for themselves at retirement within the rules that apply in their circumstances.

I provide this background because some of the statements attributed to Treasury such as at the recent Senate Select Committee hearings suggest that Treasury may consider many trustees of self managed super funds are somehow trying to manipulate the superannuation system and obtain benefits to which they are not reasonable entitled. While in any large sample of people there will always be some who ignore regulations, in the case of self managed funds my experience is that such people are a small minority and most people just want to do what is best for themselves (as they are legally obligated to do through being fund trustees) within the relevant regulations.

In the case of the pension issues identified by Treasury such as RBL compression, estate planning and risk pooling, my observation is that the behaviour of trustees in relation to these issues is simply a result of having their advisers assess the legislation and advise what is the most beneficial way to arrange their affairs in compliance with that legislation. I consider any



implication that people in general deliberately try to manipulate the system is not correct. Rather, I consider that the current rules in place have been poorly designed or have been allowed to get out of date and this has resulted in outcomes which are not reasonable.

Whilst I have no objection to rules being changed to address some of the issues identified, I feel it is important that the approach to fixing those rules be done on the basis of developing from first principles a set of rules that is reasonable for paying pensions from small super funds rather than assuming most want to misuse the system and imposing an unreasonable level of restriction as some form of industry wide penalty for supposed past transgressions.

### **Types of pensions**

An appropriate starting point is considering what types of pensions should be payable by small super funds.

Currently small super funds can pay allocated pensions and market linked income streams (from 20th September). Subject to transitional provisions, some funds may also be able to commence defined benefit type pensions until 30 June 2005.

Rather than just addressing the rather narrow question of "can a small super fund pay a defined benefit pension", I suggest the better question is what types of pensions should any superannuation fund without the ability to guarantee a fixed payment regime be able to pay.

Pension benefits need to have sufficient flexibility to provide for the cash flow needs of members in different circumstances and with substantially different life expectancies while also meeting government requirements. It is assumed the government wishes that on the one hand a benefit is not paid out too quickly (on the basis that such people would then become reliant at an early stage on the Social Security system) and not be paid out too slowly (on the basis that this represents a loss of taxation revenue by allowing an excessive amount of assets to remain in a superannuation fund at an advanced age). The apparent contradiction within the government's objective that payments occur neither too quickly nor too slowly illustrates the difficulty in devising a payment system that still has the flexibility required to meet differing member needs.

To illustrate the range of possible member needs, at one extreme are the retiree who retires in ill-health and has limited life expectancy and either no financial dependents (or with a financial dependent who is in similar poor health) and the retiree with a family history of minimal life expectancy beyond retirement age. In such cases it would seem reasonable that the members have access to the majority of their superannuation benefits over a relatively short period (say 10 years?).



At the other extreme is a couple in good health at retirement and with a family history of longevity. Such people could be expected to live for maybe 30 years or more and require a pensions system that allows them to spread their benefit over a long period, assuming they have sufficient assets in their fund.

I submit that the current benefit options do not cater well for such cases.

Firstly, in the case of allocated pensions, the factors for minimum payments have become inappropriate and result in too much having to be paid out in the early years, making it difficult to maintain an adequate level of pension benefits in later life unless the fund achieves exceptional investment returns. The minimum allocated pension factors are in need of urgent review to allow more meaningful pensions to be paid in the later years for those who live longer than average life expectancy.

Secondly, in the case of market linked income streams, the payment terms are fixed on the basis of life expectancy, with some flexibility at commencement time to choose pension periods that are a few years longer than the member's official life expectancy. There is no flexibility for a person with relatively low life expectancy to access the majority of their Pension RBL tested funds over a lesser time.

Defined benefit pensions have in some cases been used by small superannuation funds to overcome these restrictions. In particular, for someone with a high life expectancy, a defined benefit lifetime pension is the only option that allows for a smaller amount to be taken in the initial years so that there will be a meaningful level of pension in later life.

Further I believe the dominant reason why defined benefit pensions have been used by small funds in recent years is that there have been no viable alternatives for benefits in excess of the lump sum RBL. The regulators may argue that the market linked income stream now provides such an alternative and therefore defined benefit pensions are not required. I would argue against this on the basis that market linked income streams do not offer sufficient flexibility to cater for the reasonable range of circumstances of different pension recipients.

I feel I can speak with some authority here as I believe I was one of the early initiators of the proposal for market linked income streams. Specifically I raised the issue in a Victorian ASFA discussion group meeting late in 1996 and subsequently ASFA provided a submission to Treasury suggesting the introduction of an account based pension that complied with the pension RBL rules. While there may have been other independent requests for such a benefit, that submission may have played a useful role in development towards the product that is now the market linked income stream. However, it is important to recognise that the original proposal for an account based



complying pension was based on the assumption that it would be just one of the pension benefit options available under the pension RBL. It was recognised that an account based pension with fixed payment factors would not suit everyone's needs, but a defined benefit pension could be used as an alternative. If defined benefit pensions are to be prohibited, and then additional flexibility is essential within an account based pension to meet the varying needs of pension recipients.

The original account based pension proposed by ASFA suggested there be a single factor to be applied as a divisor to the opening account balance each year, with the factor determined by the persons age at the start of the year. In essence, the pension payable each year would be worked out in the same way as for an allocated pension except that there would be only a single factor, not a range between a minimum and maximum.

If defined benefit pensions are not to be available to small super funds, then I suggest the most appropriate way to provide a reasonable level of flexibility is to have maximum and minimum factors in the same way as the existing allocated pension does. In practice, the factors could indeed be the same as the factors used for allocated pensions although the current minimum factors used for allocated pensions are inappropriate and need revision to allow lower pension amounts in the early years if they are expected to pay adequate pensions during a persons advanced years.

In some ways it is unfortunate that the market linked income stream has been introduced with defined payment periods as there will obviously be some impracticality in introducing a revised pension so soon after the commencement of the market linked income streams. However such a change to a single set of rules to cover all pensions paid under the pension RBL would ultimately be simpler and more practical than having a range of pension options as has existed in the past and as still exists now in some circumstances.

If a pension with minimum and maximum factors were introduced for a benefit that complies with the pension RBL, it would be important that a new regular review mechanism be established to adjust factors in accordance with changes in longevity and expected investment returns.

If the government were looking to create a pension benefit structure that was both simple for pensioners to understand and funds to operate while being flexible and meeting the government's requirements, then I believe it would be possible to have a single allocated pension product that could be used irrespective of which RBL limit a person wish to comply with. The pension would have minimum and maximum factors as does the current allocated pension. It would have commutation restrictions which mean that the total commutations received during the life of the pension could not exceed a certain level. Commutations would be indexed to maintain real value. For example



the government may decide that \$200,000 is the maximum possible commutation amount in 2005 dollars. Upon retirement, a person would then have to decide whether to take a lump sum benefit of up to the lump sum RBL (although it would be possible to remove even this option) or whether to commence an allocated pension. The 50% asset test exemption for age pension purposes would then apply to the total purchase cost of the allocated pension less \$200,000.

Any such change would, I expect, raise some objections that it is encouraging lump sum benefits. However, with appropriate education and clarification of the taxation advantages of allocated pensions, I believe in due course most people would expect that it was in their interests to use allocated pensions to provide for their income in retirement rather than taking a lump sum and investing personally. Even if a person did take a lump sum, then they would still have the funds to invest and use to pay future retirement expenses and the government would have collected some lump sum tax and not be in a position where it was providing "tax concessions" to that person any longer.

On the basis of the above proposal, I then make the following comments on specific issues to be addressed by the review.

1. *Is there a need for pensions with defined benefit characteristics in small funds?*

Defined benefit implies payment can be maintained no matter what circumstances befall the fund. In practice this cannot be achieved for small funds except where very large reserves are maintained within a fund to cater for all possible investment outcomes. In practice such an approach is not reasonable because it would mean that little of the superannuation benefit is used by the member while alive.

In practice, a benefit can only be guaranteed when there is some external support to guarantee such payment. In the superannuation industry, this arrangement typically exists only where there is an employer of substantial financial strength standing behind the payments or where a life insurance company is using its shareholders' equity as reserves to guarantee the future pension payments. The size of a fund does not in itself guarantee a defined benefit can be paid because a systemic change such as general investment losses or a general increase in longevity could lead to an inability to pay a defined benefit, no matter how many members were in the fund.

Therefore I suggest it is not possible and not practical for small funds to pay true defined benefit pensions. However, there should be no need for funds to attempt to pay such benefits if practical pension benefit options were available for such funds.



2. *The ability to achieve RBL compression*

I understand that RBL compression means that the amount of benefit counted towards the RBL may be substantially less than the amount certified by an actuary as required to pay the pension. While there has been some suggestion that this arrangement is a rort, I suggest that is not the case and it is merely a function of the methodology in the legislation required for valuing pensions under the pension RBL.

Rather, the problem is that the pension valuation factors are inappropriate for any pension funded from a defined amount of money and some modification is required to achieve equity. My suggestion is that any pension which is funded from a member having entitlement to a capital sum within a superannuation fund is assessed for RBL purposes based on the amount of the capital purchase price rather than on the initial amount of the pension payable. This would eliminate the RBL compression problem and, combined with the recent changes to asset test exemption, eliminate the ability of those with large balances in superannuation to avoid the age pension assets test.

3. *Estate planning issues*

It is unclear to me exactly what is the problem in relation to so-called estate planning issues. If it is the ability to somehow pass account balances on death to subsequent generations, then I suspect the magnitude of such problems is quite small because the current taxation rules favour payment of residual account balances as lump sums rather than as allocations to other fund members (except for excessive benefits). I believe it would be appropriate for the committee to clarify in more detail the circumstances in which it believed there were estate planning issues so that the industry was in a better position to respond to those concerns.

If the issue is that funds have been able to create investment reserves and then allocate those reserves to younger generations, then the ability to do this would disappear if all pensions were run on an account based structure with RBL assessment based on the capital purchase price. For the purposes of clarity, the government may wish to specify that upon death any account balance must either be commuted for the benefit of a spouse or financial dependent or the member's estate or can be used to provide a reversionary pension to a spouse or financial dependent. With such restrictions it is difficult to see how pensions can be used for unreasonable deferral of assets into a person's estate.

For clarification, I confirm that part of my proposal is that all pensions paid by small funds should be account based and therefore there would be no need or ability for small funds to maintain reserves.

4. *Risk pooling and the guarantee of income payments*



This matter has been dealt with above. By way of clarification, I confirm that risk pooling is a concept that is not appropriate for small funds and is not necessary if pension benefit options are available that provide a reasonable level of flexibility in selecting pension payment levels to suit differing individual circumstances.

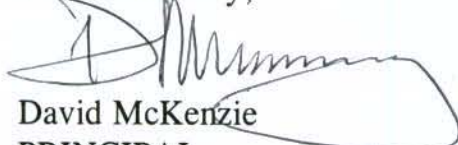
Further, members of self managed funds do not expect any guarantee of payment and the concept of there being a guarantee is inconsistent with a fund that has its own investments and uses only its capital and income to make pension payments. Where members do require a guarantee of payments, then the option should remain open for either their fund or themselves directly to purchase guaranteed income streams from life companies or other entities legally and practically able to provide such guarantees.

Longevity risk is not something that can be legislated away for small funds. The reality is that the money in the funds has come from the earnings and savings of the members, whether directly or via an employer, and that those members are responsible for choosing the rate at which they spend in order to have financial security in their advancing years. This is the same as for someone relying on a government pension where there is obviously an expectation that the pensioner will not spend more than they expect to receive by way of superannuation pension. There will be cases where people do not accumulate sufficient money to pay for living expenses for the rest of their years, particularly those likely to live for longer than average. In such circumstances the Social Security system should correctly pay age pensions to support those people. There will be other cases where people die prior to all of their superannuation benefit is being paid out and those benefits should correctly either be used to support spouses and financial dependents or be paid out to an estate so that the appropriate amount of lump sum tax is paid and the monies are removed from the superannuation system.

Finally, the benefit design suggested in this submission is not intended solely for small funds. While I believe it is appropriate for small funds, it is equally appropriate for any fund where there is no guarantor to assume the obligation that a defined benefit can be paid. This means a complying allocated pension should be equally attractive to industry super funds, employer accumulation funds and superannuation funds run by the funds management industry.

I thank you for the opportunity to lodge this submission and would be prepared to provide any clarification you require.

Yours faithfully,

  
David McKenzie  
PRINCIPAL