To whom it may concern

The review has no doubt received many submissions giving detailed arguments and costings. For that reason, I will simply state the principles that I consider to be important and the outcome that I believe is appropriate. I also suggest a more radical alternative that would permanently remove most of the problems.

If there are perceived problems with the operation of small defined benefit superannuation funds, the problems should be addressed, rather than prohibiting such funds. To do otherwise is to reduce freedom of choice.

I consider the Social Security changes already made have dealt with the problem of people destroying assets for Social Security purposes. If it were thought necessary to tighten this regime, the tightening should come from a reduction of the exemption from 50% to some lower number. To provide different exemptions for self managed superannuation investments would be to add complexity and to reduce fairness.

It is also inconsistent with the sound policy of addressing problems at their root.

Turning now to the other objections to small defined benefit funds, these appear to fall into the following mutually exclusive areas: -

1 There is a risk that these funds will fail to provide adequate benefits into very advanced age.

2 These funds may provide a vehicle for retaining capital in the tax protected superannuation environment and

3 The use of these funds allows RBL compression not available to members of public offer funds.

Adequacy into very advanced age

It needs to be recognised that the required 70% probability of adequacy in small defined benefit funds is greater than that offered by term allocated pensions (which will fail around one third of all couples using them).

As members of defined benefit funds survive, and the solvency of the fund deteriorates, the pensions can be managed downwards. This allows for some income to continue into very advanced age. This is in contrast to the sudden cessation at the end of the term of a term allocated pension..

In my valuations of small defined benefit funds, I see little or no evidence of imprudent, speculative or excessively cautious investments. Retired people conducting their own funds recognise the need for long term growth in their investments but are very careful to invest in sound well respected companies paying dividends. The investment policies and practices of self managed term allocated pensions can be expected to closely follow those of the current defined benefit funds.

In passing, I note that these largely buy and hold investment policies and the fact that administration work is often done by accountants effectively demolish the argument that trustees will not be able to manage their funds as their faculties deteriorate. Whatever problems that this loss of financial faculties cause for defined benefit funds are no greater nor smaller than the similarly caused problems in any other investment arrangement and specifically no different from those in term allocated pensions.

To summarise my views on this issue, small defined benefit funds provide greater security into very advanced age than do term allocated pensions. If it were desired to enhance this security, the current 70% requirement could be increased. There is however, a trade off in that this increases the likelihood of death with substantial unspent funds.

Retention of funds in superannuation environment

The first point to be made in this connection is that only funds needed to meet the central estimate of pension liabilities are free of tax in superannuation funds. The income of prudential reserves suffers the normal superannuation tax of 15%.

The second point to be made is that on the death of the last survivor of a couple, funds held to meet their pension liabilities are generally distributed to their families either by payment from the fund to the family or the estate or by a surplus distribution within the fund. The funds paid from the superannuation environment are generally taxed at 15% in addition to the 15% ingoing and ongoing tax they have suffered.

Funds distributed within the fund are, if significant, subject to the Superannuation Surcharge. They also ultimately reduce the amount that the family members contribute if they face Reasonable Benefit Limits. To the extent contributions are not made, tax deductions are not claimed and superannuation contribution tax is not paid. The net effect is to the advantage of the Revenue.

The whole exercise is at best a delay of Revenue, not a reduction of Revenue and it must also be remembered that the investment earnings are included in funds that ultimately flow to the Revenue.

Notwithstanding this, if the Government wishes to increase the tax on earnings of prudential margins or on superannuation benefits that ultimately reach non dependent family members it can do so. Fairness, however demands that this apply to all vehicles other than small defined benefit funds. Honest government demands transparency in any such increase.

RBL Compression

RBL compression is available to people in defined benefit arrangements of any size, not only small funds. It is only not available to people in public offer funds. RBL compression works for no reason other than that the valuation factors used to convert pensions to capital amounts for RBL purposes are inadequate. Prevention of RBL compression is simply a matter of changing these factor so that they accurately reflect the cost of pensions.

In the absence of a change to the Reasonable Benefits Limits, an increase in the pension valuation factors would disadvantage everyone starting a defined benefit pension. However, this disadvantage can be offset by changing the pension RBL in proportion to the increase in the valuation factors.

Radical alternative

The existing RBL arrangements are based around converting pensions to a capital value and then deciding which of the pension and lump sum RBLs are applicable. The radical alternative is not to be concerned about capitalising pensions. It would start from the premise that a reasonable pension was say $58,000 with a 2/3 spouse reversion commencing at age 65 and appropriately indexed. This pension's cost is not dissimilar to the current RBL and the pension level is chosen as the threshold for the 42% tax rate.

Adjustment factors could be published that broadly revalued pensions where there was a different start age or reversion proportion. For example an age 60 start pension could have an adjustment factor of 0.95 and a 100% spouse reversion a factor of 0.97.

The RBL for a pension starting at age 60 with a 100% spouse reversion would be

0.95*0.97*58 000 = $53,447

Fixed term pensions of various durations (including term allocated pensions) could be assigned factors to convert them to standard pensions.

A person starting a $40,000 pension with such characteristics would be assumed to have used up $40,000 / $53,447 or 74.84 % of their RBLs. This means they have 25.16% of their RBLs unused. If this person sought to take a lump sum, up to 25.16% of $619,223 (ie $155,797 could be withdrawn under concessional taxation.

The broad principles outlined above need to be fleshed out to deal with undeducted contributions and transitional arrangements. A broad brush change to the death benefits taxation arrangements is also needed.

A more significant issue that would need consideration is that while the proposal reasonably parallels the current regime for people who take all of their benefits in pension form, some modification would be needed for those taking half of their benefits in pension form. The simplest modification would be to double the lump sum limits once 50% of the pension limit had be used. A more sophisticated modification could be determined by the Government's desire to encourage pensions.

With these changes, the overall RBL system could be made simpler while retaining its fairness.

I would be happy to discuss this submission with you.

I disclose that I am a director of an actuarial practice and a discount investment origination company.

Dennis Barton