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Dear Sir/Madam,

**Submission to the Review of the Provision of Pensions in Small Superannuation Funds**

**Introduction**

The January 2005 Treasury Discussion Paper states that the 2004-05 Budget announced measures to address “prudential issues with small funds, namely the ability to manage the risks of providing a defined benefit pension. The objectives of these measures were broadly supported”.

Following the earlier invitation for interested parties to make a submission to the review into the provision of defined benefit pensions by DIY, 26 out of the 31 submissions were published on the website. An examination of all those submissions which are available to the public suggests there is scant evidence that these “measures were broadly supported”, even though the rather motherhood objectives may well be. The most important measure, namely the closure of the defined benefit option in small super funds, was heavily criticised, other than by those industry lobby groups who stood to benefit most from it. This paper examines that measure, and begins by addressing the three major concerns about Small Superannuation Funds which are found in the Terms of Reference for this Review, namely:

- access to unintended tax and social security benefits, particularly from the use of ‘RBL compression’;
- their use for estate planning purposes in the superannuation system outside what was intended and not available to other superannuation fund members; and
- whether a small number of members can effectively pool risk and guarantee income payments over the term of the pension.

The second part of the submission considers the option of defined benefit pensions being run in small super funds, by considering their strengths and weaknesses as seen through the eyes of a current pensioner.

The conclusion argues for the proposal that the right to begin and receive a defined benefit pension under the previous regulations should be grandfathered for all SMSF members who were enrolled as at 12 May 2004 and were then aged 55 years or over.

## **The Three Concerns**

### **Concern 1. Unintended tax and social security benefits from the use of ‘RBL compression’**

#### **a. The major source of RBL compression**

The major source of RBL compression comes about through the use of outdated PVFs (Pension Valuation Factors). It is more than 10 years since the last PVF review, when life expectancy was considerably less than it is today. It should be noted that the benefits of RBL compression apply equally to each and every new defined benefit pension offered by any super fund, whether commercial, corporate, public-sector, or a small super fund. It is quite wrong to suggest the problem is confined to small superannuation funds (such as SMSFs (Self Managed Super Funds)), and thereby ignore the obvious solution, which is to treat **all** funds equally and update the PVFs on a regular basis.

In August 2004 Treasury responded before the Senate Economics Legislation Committee stating that “Treasury believes that defined benefit pensions provide a disproportionate benefit compared with alternative products”. It clearly agreed that such pensions are undervalued for RBL purposes, so one would hope that Treasury would support a level playing field such that this source of RBL compression was removed from **all** defined-benefit super funds, rather than closing down only the small SMSF defined benefit pensions. The changes to the regulations of 12 May 2005 merely attacked a symptom by the elimination of the increasingly-popular defined benefit pension alternative for SMSF retirees. Should we not attack the compression rort at the root, since it only exists as a consequence of government administration, and it can therefore be easily rectified by reviewing the PVFs?

An answer could be that the recipients of large defined benefit pensions are mainly senior public servants, politicians, university teachers, and senior managers, who could be required to pay more taxes if their own pensions were to be subjected to realistic (i.e. “uncompressed”) valuations. In other words, for highly-paid members the **true** RBL value of defined-benefit pensions would in many cases be increased to the value where it would be classed as “excessive”. Political and public-service pensioners could well be faced with higher taxation in their retirement. As stated by public servants in their evidence to the Senate Committee, the issue of changing the Pension Valuation Factors “would need to be carefully considered before any amendment could be made as a change to the factors could have a significant impact on a much wider range of people

than the membership of smaller funds". But equity requires that this sort be attacked across the board, rather than by picking only on the smaller funds.

A version of the argument above was published as the lead letter in the Australian Financial Review on 9 February, 2005. Despite the wide exposure it received, I did not receive a single dissenting view, and therefore assume there is broad agreement that the fairest approach to the problem of RBL compression is to update the PVFs which apply to all funds.

#### **b. An additional source of RBL compression**

An additional possible source of 'RBL compression' arises from voluntary (ie undeducted) contributions made from already-taxed income. This possibility, which is more apparent than real, again applies equally to all Defined Benefit pensions offered by super funds, whether commercial, corporate, public-sector, or small superannuation funds (SMSFs). It is again anomalous to suggest the problem is only confined to small superannuation funds, and then by way of a solution to totally banish only the defined-benefit pensions which are located in this segment of the market. Indeed, the allocated pensions which can continue to be offered through small funds will still enjoy this source of compression, so one must assume that it is not viewed as a major problem by the government.

A difficulty in this situation is that if the government wishes to encourage superannuation saving it must not penalize voluntary contributions. Individuals making voluntary contributions in effect lock away their money for the rest of their lives, where it is constantly diminished in value by inflation. Their own voluntary contributions are only released back to the contributors in their retirement, and on a basis which is strictly proportionate to their life expectancy. Because these final repayments of their original deposits may only be worth in real terms one fifth of their present-day value, some concessions are required in this area. No-one would make undeducted contributions in these circumstances unless there is some incentive.

This second type of 'RBL compression' comes about due to the formula used to determine the RBL value, and in particular the way undeducted contributions are counted. If it is felt there is a real problem here, then the solution is to change the formula itself, because the formula again applies to all super funds and not just the small ones. This would be seen as a fair (and simple) solution.

#### **Concern 2. The use for estate planning purposes in the superannuation system outside what was intended and not available to other superannuation fund members**

The principal form of estate planning is via reversionary pensions, and it is available to all Super Funds, whether commercial, corporate, public-sector, or small superannuation funds (SMSFs).

Where SMSF pensions may differ is that any non-reversionary surplus on death often goes to the deceased estate. Although equivalent arrangements could be made in many commercial, corporate, or public-sector funds, their current practice is to retain any surplus within these funds. One of the problems with commercial annuities has been this

matter of retention, and if an annuitant dies early, then the funds still in the late member's account will generally be taken by the annuity company, rather than go to the heirs. (This is only one of several factors which have made commercial annuities unattractive as pension alternatives).

If the government believes that such estate planning use is bad, then it should be banned for all pensions, and not just defined benefit pensions offered via SMSFs.

### **Concern 3. Whether a small number of members can effectively pool risk and guarantee income payments over the term of the pension**

Again the problem is more apparent than real, with the damage caused by the total failure of an individual SMSF pension quite miniscule when compared to the widespread misery caused when corporate funds have collapsed here and in the UK. But have many SMSF pensions actually failed? Under the previous Regulations, it was a requirement that defined-benefit pension streams in SMSFs must be tailored by an actuary to meet the expected lifespan of the individual member with a 70% probability. The actuary would then supervise the SMSF on an annual basis to ensure that the pension could still be paid. It was accepted by SMSF members that in 30% of cases the actuary might need to re-base the benefits and pay a reduced pension. However, although about 30% of these pensions will not totally fulfil their original expectations, and will end up paying a reduced pension, is that any reason to outlaw all such pensions?

(If there really is a problem, then it has certainly been greatly exacerbated for existing SMSF defined benefit pensions by what appears to be the poor drafting of the new regulations. The existing practice, for those few SMSF accounts where the actuary could not certify that the Fund could continue the guaranteed payment stream, was for the actuary to rebase the pension at a lower level (ie one that the fund could manage with at least a 70% probability level). The new regulations appear to make this simple and logical procedure impossible, such that dismantling the complete defined benefit pension and paying out a lump sum or allocated pension is now the only option).

Note that the second and third concerns contained in the Terms of Reference reflect two possible and opposite long-term outcomes from defined benefit pensions that are currently run via a SMSF. It is only the successful funds which will have any surplus that can be passed to heirs. Conversely, it is only the less-successful funds where income payments cannot be guaranteed at the initial rate for the full term of the pension. Such a spread of outcomes would seem to be consistent with the recent public statement by Senator Mal Brough that he wanted more "engagement" from super fund members. The government is encouraging individuals to be self-reliant and save for their own retirement. Individuals running defined benefit pensions in SMSFs accept there are risks involved. The defined benefit option was increasingly being chosen by members of SMSFs, primarily by those members who wanted a specified pension lasting for the full term of their expected life with a high degree of probability. One reason more members have been commencing defined benefit pensions in SMSFs is because they do not want to become pensioners of the State, but wish to be engaged and plan for their own independence. I do not think that their increasing popularity should be seen as an excuse for such pension stream options to be closed off, but quite the reverse. Fiddling around

with further complications (such as longevity insurance, mortality diversity, or annual rebalancing within a corridor) would appear to miss the main point entirely, which is that SMSF members do not look for guarantees or seek to pool their risk with others, but are prepared to be individually engaged (in the words of Senator Brough) and shoulder the risks on an **individual** basis. If one individual invests in such a way that their capital reduces, and another such that their capital increases, why is that a problem? The fact that some are extremely successful may encourage others to save in a similar way for their own retirement.

## **Why do SMSFs wish to continue with the Defined Benefit pension option?**

The majority of pensions run by SMSFs are allocated pensions, and actuary Peter Crump has estimated that there are less than 5000 defined benefit pensions being run through small funds. Why select a defined benefit pension? We will examine this by considering the strengths and the weaknesses from the perspective of an individual who is in receipt of just such a pension.

### **What do I value in running a SMSF Defined Benefit pension?**

1. My pension has been carefully designed by an expert actuary to last as long as I will. This brings peace of mind.

The new market-linked income stream pensions (TAPs as they are called) introduced in 2004 are no substitute for a defined benefit pension, because they are in essence a more complicated type of allocated pension that has been granted complying pension concessions. A TAP neither provides any certainty of income, nor will it last for an individual's life expectancy (despite the odd tinkering with dates). Inevitably it will mean that a proportion of TAP pensioners must outlive this pension type (estimated at 50% by Kevin Deeves), and many will become a charge on the government. TAPS have so far been spurned by fund members, with sales of only \$44 million in the first three months.

An allocated pension offers far more flexibility than a TAP, with regard to pension and capital repayment provisions, but again a considerable proportion of allocated pensioners are certain to exhaust their capital and become pensioners of the State.
2. My family are all very long-lived, and no other alternative SMSF pension could bring the same sense of certainty that I will not eventually become a charge on the public purse.
3. My pension was tailored to meet my specific needs. I am in good health, I continue to run a business, and I do not need a large pension at present. I have therefore arranged for my pension to pay more as I grow older, when hospitals and nursing homes will beckon. Neither an allocated nor a TAP pension could meet my particular requirement.
4. The family super fund has consistently increased in value at a far greater rate than the commercial funds. For the five years to December 2004 ASIC reports

that the average balanced retail fund returned only 2.1% to 5.2% per annum. This is partly because retail funds charge investment management fees that cost about 2% of fund value per annum (which is 100 times the annual expense in our fund as certified by the auditor). The family super fund also has no trailing commissions or up-front entry fees to pay, which can again conspire to further savagely erode the final benefits obtainable from retail funds.

### **What do I find annoying in running a SMSF Defined Benefit pension?**

1. The constant government fiddling with the rules and regulations surrounding superannuation. For example, the whole basis of our family seven-year pension plan was abrogated by the change to the governing legislation introduced in May 2004. This change was made without any obvious consultation with the individual members who own and operate SMSFs, despite it being the SMSFs who were most clearly and adversely affected. The reduced choice they now face has resulted in forced changes to their plans, and these are plans which in many cases were carefully developed and actively followed over a considerable number of years.
2. The unnecessary costs and micro-management which applies only to small funds. Attention is drawn to the following three areas:

- a. Trust Deeds.

Huge amounts of money are being spent unnecessarily on Trust Deeds and subsequent Updates (which seem to cost at least twice the original Deed price) each time the legislation changes. For example, the press have suggested that no existing Trust Deeds can legally pay the new market-linked income stream pension (TAPs). If 300,000 SMSF trust deeds must be amended, at \$900 a go, it would represent a waste of \$270,000,000 of essentially unproductive national resources. Why cannot the supervising authority have a free pro-forma Deed on tap that could be adopted by all those who wanted it? It could be updated by the ATO as the legislation changed. The advantage would be that the ATO and the SMSFs would each know where they stood from the start, and there would be considerable financial savings to the wider community.

- b. Auditor/Actuary

Why must a SMSF have an auditor? Expensive annual audits were originally designed for large public companies whose managers might otherwise fleece their absentee owners. The members and managers of SMSFs are one and the same, so why impose this unnecessary layer of extra costs? And why is a SMSF audit (unlike most others) required to report even the most trivial of transgressions, including non-financial ones? Why are superfunds the only taxpayers to be charged money to lodge their own tax returns?

- c. ATO micro-management

The only organisation required by law to have an investment

strategy is a superfund, and there are severe penalties should the formal strategy be absent, even if the Fund has been more successful than the legendary American investor, Warren Buffett. Why is such a level of micro-management needed? It was recently reported that the ATO has indicated that each proposal to purchase an equity in a SMSF should be recorded in the written minutes of the Fund, with agreement duly noted. However, a decision to buy a share is usually made on the basis of price and availability at a point in time, which accords ill with any requirement to call a preliminary meeting in order to gain agreement. Should the ATO really be in the business of micro-managing SMSFs?

## **Conclusion**

Considerable hardship and worry was caused to many members of SMSFs who were approaching retirement when many of their long-term defined benefit pension plans were initially destroyed overnight by the changes to the governing legislation introduced in May 2004. If SMSFs will not in future be allowed to offer and manage their own complying income-stream pensions, such pensions will only be available if purchased from commercial interests, with all the loss of control and high fees and excessive charges that many of us had experienced and from which we had planned so hard to escape.

To redress the iniquity caused by the seemingly capricious curtailment of life-governing pension plans which had been actively developed over many years of working life, I propose that the right to begin and receive a Defined Benefit pension under the previous regulations should be grandfathered for all SMSF members who were enrolled as at 12 May 2004 and were then aged 55 years or over.

Yours sincerely,

David Lethbridge.