MERCER

TALENT • HEALTH • RETIREMENT • INVESTMENTS

RE:THINK

SUPPLEMENTARY MERCER SUBMISSION TO THE TAX DISCUSSION PAPER –

COMMENTS ON AUSTRALIA'S RETIREMENT INCOME SYSTEM

23 JULY 2015

MARSH & McLENNAN COMPANIES

CONTENTS

1

Executive Summary

Mercer's initial (1 June 2015) submission responding to the Re:Think Tax discussion paper released on 30 March 2015 restricted itself to the following question in the paper:

> *22. How appropriate are the tax arrangements for superannuation in terms of their fairness and complexity? How could they be improved?*

This supplementary submission focuses on certain issues associated with the treatment of retirement incomes and draws in part on our response to the following Financial System Inquiry (FSI) recommendations.

Objectives of the superannuation system **FSI Recommendation 9** *Seek broad political agreement for, and enshrine in legislation, the objectives of the superannuation system and report publicly on how policy proposals are consistent with achieving these objectives over the long term.*	We support this recommendation. A clear vision and future roadmap is important to benchmark future policies and proposed changes against. Refer to Section 2 for further details.

The retirement phase of superannuation **FSI Recommendation 11** *Require superannuation trustees to pre-select a comprehensive income product for members' retirement. The product would commence on the member's instruction, or the member may choose to take their benefits in another way. Impediments to product development should be removed.*	We support the general concept of this recommendation. Until now there has been an undue emphasis on the accumulation phase as opposed to the retirement phase. We also support the removal of impediments to product development. Refer to Section 3 for our thoughts on how this recommendation might be implemented.

Superannuation member engagement **FSI Recommendation 37** *Publish retirement income projections on member statements from defined contribution superannuation schemes using Australian Securities and Investments Commission (ASIC) regulatory guidance.* *Facilitate access to consolidated superannuation information from the Australian Taxation Office to use with ASIC's and superannuation funds' retirement income projection calculators.*	We support the recommendation to include income projections on members' periodic statements and the recommendation to facilitate access to consolidated information from the ATO. These proposals will provide members with better information to gauge how their retirement savings will support their retirement. Any new legislation and/or ASIC guidance should be designed in a way which does not discourage innovative presentation methods, enables projections to be prepared assuming benefits are taken as a pension, allows a reality check on inputs and can also take into account any potential age pension entitlement. Refer to Section 4 for further details.

Before considering the existing arrangements and some options for reform, it is essential that some high level principles be established so options can be discussed with some objectivity. The following principles are suggested:

- A coordinated and holistic perspective towards retirement income is necessary taking into account superannuation, taxation and the age pension arrangements.
- The taxation of superannuation should be as efficient as possible for employers, individuals, superannuation funds and the ATO.
- Community confidence in the overall retirement income system is critical and fairness represents an important component of this acceptance.
- The current level of compulsory SG contributions is insufficient for many Australians to receive an adequate income in retirement. It is therefore important that Australian workers are encouraged to make additional contributions.
- In the absence of any particular legislative requirements, the taxation and social security arrangements should encourage retirees to take income streams and not lump sum benefits. In that regard, some immediate incentives for retirees to invest in some longer term longevity products would represent an important trigger and provide desirable long-term outcomes.

We look forward to continuing to contribute to the discussion to develop a better tax system for a better Australia.

2

Objectives of the superannuation system

FSI Recommendation 9 related to setting objectives of the superannuation system:

> *Seek broad political agreement for, and enshrine in legislation, the objectives of the superannuation system and report publicly on how policy proposals are consistent with achieving these objectives over the long term.*

The enshrinement in legislation of objectives for superannuation is important.

The proposed primary objective *"To provide income in retirement to substitute or supplement the Age Pension"* is a sound starting point.

However superannuation has additional objectives and with this broader perspective in mind, we consider below the subsidiary objectives proposed by the FSI.

Subsidiary objective	Why the objective is important	Mercer comments
Facilitate consumption smoothing over the course of an individual's life	Superannuation is a vehicle for individuals to fund consumption in retirement largely from working life income. The system should facilitate consumption smoothing while providing choice and flexibility to meet individual needs and preferences.	To meet this objective, consideration needs to be given to adjust the current contribution caps which limit the ability of those who are out of the workforce for a period of time to "catch up" their superannuation contributions. This is particularly significant for females who may spend some years out of paid employment often because of family responsibilities. It is also significant for those working part-time while caring for young children or older parents. Such part-time workers are likely to have a very limited capacity to save for retirement during those years. Lifetime concessional tax limits to superannuation contributions, as opposed to annual limits, would create a fairer and far more equitable retirement savings system for all Australians. If an individual doesn't use the current concessional cap of $30,000 in a given year, half of what's unused should be rolled

		over to the next year and so forth. However, a concessional contribution in any year should not exceed three times the standard annual concessional cap, currently making $90,000 the maximum cap in any single year. Lifetime concessional contribution caps would provide all Australians with an equal opportunity to build their nest egg when they've the financial capacity to do so. This does not need to be retrospective. The reality is most Australians cannot afford additional super contributions of $30,000 for much of their working life and are therefore missing out if they leave the bulk of their super contributions to the latter part of their career, often when their disposable income is highest. Retirement savings are a lifetime journey and all Australians should have the opportunity and flexibility to build a more secure retirement when they can afford it. Lifetime limits would create a much fairer system; they would secure more adequate retirement incomes for more Australians; lessen the cost of the age pension to tax-payers; and allow people – particularly women – who have been in and out of the workforce to catch up in their retirement savings.
Help people manage financial risks in retirement	Risk management is important as retirees generally have limited opportunities to replenish losses. The retirement income system should help individuals manage longevity risk, investment risk and inflation risk. Products with risk pooling would help people to manage longevity risk efficiently.	This is an important aim. In particular, a range of longevity products needs to be encouraged. Our comments in the next section are consistent with this outcome.

Be fully funded from savings	A fully funded system, as opposed to an unfunded system, is important for sustainability and stability. The system is designed to be predominantly funded by savings from working life income and investment earnings, where superannuation fund members in general have claims on all assets in the fund.	We support the concept of full funding, however, except for some public sector funds; we note this is already in place.
Be invested in the best interests of superannuation fund members	Superannuation funds are managed for the sole benefit of members, which means the investment focus should be on maximising risk-adjusted returns, net of fees and taxes, over the lifetime of a member. This results in auxiliary benefits to the economy by creating a pool of savings to fund long-term investment.	We support this proposal. Superannuation trustees should not be required to invest in particular investments or asset classes (e.g. Government bonds, infrastructure etc.) for other purposes.
Alleviate fiscal pressures on Government from the retirement income system	The Government's total contribution to the retirement income system, through both the Age Pension and superannuation tax concessions, needs to be sustainable and targeted. Higher private provisioning for retirement should reduce the burden on public finances over the long term.	We agree the costs of the Age Pension and the superannuation tax concessions need to be looked at in combination. The cost of super tax concessions to Government is only part of our retirement savings story and should not be considered in isolation. Concentrating on this component only is a flawed approach to setting long-term policy that will adversely affect the development of a sound and sustainable retirement income system. For example, the potential revenue gain of removing super tax concessions is much lower than the often quoted value of the concessions. • Firstly, it ignores future age pension costs which will inevitably increase if super benefits were reduced due to higher tax on contributions, earnings or

		benefits. Secondly, it ignores any redirection of contributions to other tax effective investments that would occur if the super rules became less favourable. • Appropriate long term policy can only be determined taking into account the total cost of the retirement system.
Be simple and efficient, and provide safeguards	The system should achieve its objectives at the minimum cost to individuals and taxpayers. Complexity is less appropriate for a compulsory system, as it tends to add to costs and to favour sophisticated and well-informed investors. Given the compulsory nature of SG contributions, the system needs prudential oversight and should provide good outcomes in both the accumulation and retirement phases for disengaged fund members.	Simplicity and efficiency are important elements, but better outcomes for members should not be sacrificed for simplicity. For instance, we believe the most appropriate investment outcomes for disengaged members can be achieved through a lifecycle investment approach in which the asset mix changes dependent on the member's age. Whilst this adds some complexity, we consider the more appropriate investment outcomes outweigh the additional complexity. As noted earlier, there is much which could be simplified and made more effective in the superannuation system. This includes the current disclosure requirements and in particular the restrictions in relation to electronic disclosure.

We note a number of the proposed objectives will be difficult to measure. Nevertheless, if future Governments are required to justify future legislative changes against the enshrined objectives, this may reduce the chances of inappropriate legislative change occurring in future. Governments would need to justify why a particular change should be introduced if it did not support the previously agreed objectives.

3

Comprehensive income products for retirement

FSI Recommendation 11 is as follows:

> *Require superannuation trustees to pre-select a comprehensive income product for members' retirement. The product would commence on the member's instruction, or the member may choose to take their benefits in another way. Impediments to product development should be removed.*

For too long there has been an undue emphasis in the Australian superannuation system on the accumulation phase as opposed to the retirement phase.

There needs to be greater scope for a much easier transfer of a member's accumulation benefits into an appropriate pension product at retirement.

For years, the superannuation industry has grappled with how to offer members simple, affordable and flexible longevity risk protection. However tax and other legislative barriers have made it difficult for new products to be introduced. The unwillingness of many members to tie up their retirement savings in annuity products has also restricted product development.

Mercer's LifetimePlus pension product is a recent innovation which will now enable funds to offer longevity risk protection at a much cheaper cost than annuity products.

Comprehensive Income Product for Retirement (CIPR)

The FSI recommended trustees should pre-select a CIPR for retiring members.

The FSI indicated a CIPR is one which has minimum features determined by Government. These would include:

1. A regular and stable income stream
2. Longevity risk protection
3. Flexibility
4. Low-cost
5. A cooling-off period.

At least in the current environment, we suggest many funds would find it difficult to offer a product which satisfies all of these criteria.

Account based pensions could satisfy features 3, 4 and 5. Longevity protection could be added by including Mercer's new LifetimePlus™ product. However, the first feature would not necessarily be satisfied. Stability could be enhanced by choosing an investment mix of low volatility. However this is likely to reduce long term investment returns and hence lower retirement outcomes. In any case, the large jumps in the minimum drawdown percentages which occur at specified ages make it difficult to maintain a stable income stream.

On the other hand, life time annuities could satisfy features 1, 2 and 5 but they generally lack flexibility and have a higher cost reflecting their guarantees.

Defined benefit pensions could tick all the boxes (except for flexibility) but many funds are effectively prohibited from offering these. If they can, overly specific legislative requirements make them impractical and few employers would be prepared to “guarantee” the ongoing financing.

Deferred annuities would also assist in longevity protection but are generally inflexible and currently tax inefficient.

The following table summarises the current position:

	Regular and stable income stream	Longevity risk protection	Flexibility	Low-cost	Cooling-off period
Account based pension	× [1, 2]	× [3, 4]	✓	✓	✓
Lifetime annuity	✓	✓	×	× [5]	✓
Deferred annuity	✓	✓	×	× [5, 6]	✓
Defined benefit pensions	✓	✓	×	× [7]	✓

[1] Investment options available to increase stability (but may give lower long term returns).
[2] Mandated steps in minimum draw down factors reduce stability
[3] Members can “self-protect” to some extent by only drawing down the minimum each year
[4] Mercer’s LifetimePlus product can be added as an option to provide longevity protection
[5] Reserving costs can be significant
[6] No tax relief during deferral
[7] Few employers are prepared to “guarantee” the costs of such pensions making this an unrealistic option for most Australians

If this FSI recommendation is to be adopted, we consider significant legislative change will be necessary to enable a wider range of products to be made available. We understand the Government is currently considering some of these issues via the Review of Retirement Income Streams Regulation (now incorporated into the Tax Review) and we are responding separately to consultation on this matter.

Nevertheless, it may be unrealistic to expect a single product could offer all of the features referred to above.

It may therefore be necessary to allow such comprehensive products to provide most but not necessarily all of the required features.

We also believe there are other features which the trustee should specifically consider - in particular, investment strategy and investment risk. These features would need to be considered in conjunction with any consideration of the regular and stable income stream and longevity protection features. However we believe they should also be considered as key features themselves. For example, as indicated above, a very conservative investment strategy may result in a more stable income stream but may produce less than appropriate returns.

Cost

A consequence of this recommendation is cost. For some funds, incurring the high cost of developing and providing a comprehensive pension product may not be in the best interest of members. Perhaps this problem could be overcome by entering into an arrangement with another provider who does provide a suitable pension product.

Opt-in or opt-out

Although adoption of the FSI recommendation will focus the attention of trustees on their pension products, it may not necessarily result in a greater take-up of income streams in retirement as it is still based on the member opting-in to the pension.

In many funds, this will result in little change from the current arrangements where super funds already provide an income stream facility which is not utilised by all retirees.

We believe an opt-out approach where members would automatically commence receiving a pension would more be more successful in achieving greater take up of income streams.

We accept the introduction of an opt-out approach would not be straightforward. The issues to be considered include:

- How to determine when the income stream should commence – the super fund would not necessarily be aware when the member retires (although the member's age could be a suitable trigger in cases where contributions have ceased)
- How to obtain the member's bank account details (for efficiency purposes, direct credit of pension payments to a bank account is far preferable than payment of pensions by cheque). One potential method of obtaining bank account details would be to obtain them from employers who will generally have those details for salary payment purposes. Alternatively it may be possible for the details to be provided by the ATO. Privacy concerns would need to be taken into account but should not be of prime concern.
- Any default opt-out pension would need to have the facility enabling the member to opt-out of the income stream within a period of up to 6 or 12 months from the commencement of the pension. This opt-out facility could replace the current requirement for application forms.
- Legislative changes to enable the transfer of a MySuper account to a default pension would be necessary

Although the adoption of an "opt-out" approach is likely to result in greater pensioner volumes, we accept neither the industry nor the public may be ready for such an approach in the near future.

Implementation

We consider the most appropriate way to implement the CIPR proposal (irrespective of it being on an opt-in or opt-out basis) would be through a principles-based APRA Superannuation Prudential Standard with only very high level requirements set out in legislation. Such an approach:

- would provide greater flexibility
- could be modified more easily and promptly to reflect emerging concerns (compared to specifying requirements in legislation or regulation)
- is more amenable to enabling trustees to make decisions which are best suited to the members of a particular fund

We suggest the approach taken could be similar to that adopted in SPS 250 relating to insurance in superannuation.

Each trustee would be required:

- to have a "pension framework"
- to consider each of the specified criteria in establishing a CIPR
- to ensure that the appropriateness, effectiveness and adequacy of its pension product and framework are subject to a review at least every three years.

Note that it would not be essential for the resulting pension product to provide all of the above features. For example, if the fund's members are generally retiring with low superannuation balances, the trustee might consider the need for longevity protection may be minimal. Members will have the protection of the Age Pension which will represent the majority of their income in retirement.

Any APRA Standard should be sufficiently flexible to allow:

- A trustee to develop more than one such pension product. For example it may be appropriate to have a different CIPR depending on the member's account balance; and
- A trustee to decide a CIPR is not necessary or appropriate in the circumstances. This could include cases such as a very small fund, a fund which is likely to wind-up or a fund in which retiring members are highly likely to obtain financial advice in relation to their pension option through the fund's advice arrangements.

Having established a CIPR (or multiple CIPRs), the following would occur:

- The details of the CIPR would be included in the fund's PDS together with details of what will happen at "retirement". (It would be preferable to increase the maximum number of pages which can be included in a PDS rather than including the details in a document incorporated by reference).

- Under the opt-in approach, the member would be approached at "retirement" to gain confirmation the CIPR should commence. An application form would not be necessary although the trustee might need additional information (such as banking details, details of spouse if it is a reversionary pension, nominated beneficiary details etc.).
- Under the opt-out approach the member would be approached at "retirement" and advised their CIPR would commence in say, 1 month unless the member opts-out. A cooling off provision would provide a further period in which the member could opt-out, even after the CIPR has commenced. Again, an application form would not be required.
- Under either approach, the member could elect to commence their CIPR before Age Pension Age. An application form should not be required unless an alternative pension is chosen.

Removal of impediments

Currently the requirements relating to pensions are extremely complex and overly prescriptive. Greater flexibility needs to be introduced to enable better and simpler products which cover more of the features referred to above to be developed. Changes which should be considered include:

- Amending taxation legislation to provide for a similar tax treatment for deferred income stream products (both annuities and pensions) as applies to current income streams.
- Allowing pensions to be increased by rolling over additional amounts to an existing pension.
- Tweaking the minimum draw down rules for account based pensions to reduce the significant jumps in draw down that are required after achieving certain ages.
- Freeing up the overly prescriptive rules relating to defined benefit pensions.

It would also be necessary to ensure the costs of developing a pension product can be met by all members of a fund rather than just those who take out the pension product. If not, then any pension product is likely to be so expensive it will be unattractive for pensioners. In particular it must be possible for such costs to be recovered from those in the growth phase (including MySuper members) who will eventually become eligible for a pension.

Intra-fund advice

Another aspect which should not be overlooked when considering the take-up of income streams is intra-fund advice. This can provide a cheap and effective mechanism for assisting members transferring from accumulation to draw-down stage.

Tax and Social Security Treatment

In the absence of any particular legislative requirements, the taxation and social security arrangements should encourage retirees to take income streams and not lump sum benefits. However it is also recognized that flexibility is needed in the provision of retirement benefits as capital needs (both the expected and unforeseen) can arise during the retirement years.

Given the societal benefits associated with longevity risk sharing products, the social security and/or tax systems should provide limited but immediate incentives for income streams offering longer term longevity protection – for example, the first $X or a percentage of any assets invested in a longevity risk sharing product could be excluded from the assets test and/or deeming under the income test.

4

Retirement income projections

FSI Recommendation 37 was to:

> *Publish retirement income projections on member statements from defined contribution superannuation schemes using Australian Securities and Investments Commission (ASIC) regulatory guidance.*
>
> *Facilitate access to consolidated superannuation information from the Australian Taxation Office to use with ASIC's and superannuation funds' retirement income projection calculators.*

We believe there are valuable benefits to be gained from projecting retirement incomes on superannuation statements. These include:

- Improved member engagement with their superannuation fund
- The means to represent retirement savings as an income to which members can relate
- The ability to use a standard comparator (eg. ASFA standard, replacement rate) to assist with understanding adequacy
- The leveraging of a fund's investment in retirement tools and advice services
- Driving positive action on retirement savings

A more educated and engaged superannuation membership will be more likely to take steps to meet their own retirement needs, by evaluating contribution levels, consolidating accounts, reviewing their investment strategy, assessing the value for money offered by their fund and seeking financial advice.

We believe the best way to promote these outcomes is to implement regular projections with the following features:

- An illustration of projected retirement income in today's dollars should be mandatory on accumulation-phase periodic statements (DB members optional). Members should be able to translate a super balance into a retirement lifestyle that keeps pace with inflation. (If not mandatory, we expect many funds will not provide such a projection.)
- This might be as simple as a ready reckoner to show the level of income that $100K, $200K etc might generate in retirement, or as complex as a personalised projection showing the impact of retiring two years later, contributing an extra $500 per month etc. An age pension estimate should be included based on prescribed assumptions. Subject to minimum principles based on content and disclosure guidelines, the format of the illustration should be at the discretion of the trustee.

- Projections of superannuation benefits and income streams should comply with the principles of Actuarial Practice Guideline 499.02 prepared by the Actuaries Institute (or equivalent), and be signed off by an appropriately qualified professional. Illustrations that comply with the Practice Guideline should not be deemed personal financial advice. We note the requirements of ASIC Class Order 14/870 can lead to misleading/inappropriate results in some circumstances (for example a requirement to base the projection on contributions and fees in the previous year). Greater flexibility is required to allow modification of the projection where the previous year's details are inappropriate.
- Assumptions about fees, investment returns etc. should be consistent with the provider fund's PDS.
- The illustration should provide a link to an online calculator where the same result can be generated (within a reasonable timeframe after issuing the statement), so that members can model the impact of different inputs (such as contribution levels, retirement age) from a known starting point.
- Funds should be permitted to offer retirement income illustrations outside the periodic statement cycle, provided they comply with the guidance.
- Funds should have at least two years' lead time to prepare systems for including the retirement income illustration.

As indicated above, greater flexibility to adopt more reasonable assumptions than those mandated by ASIC CO 14/870 is required.

We also note that, following the assets test changes that are to apply from 1 January 2017, a review is required of the ASIC Class Order provisions regarding how to determine the initial retirement income from superannuation and the age pension combined. This is because for many members the current methodology will show that the projected income diminishes as the super balance increases, due to the impact of the revised taper rate.

Whilst we support the idea of gaining access to consolidated data via the ATO, some obstacles exist with privacy, consent, scope of data, assumptions for other accounts and contemporaneity of records. It should initially proceed on a non-mandatory basis.

Mercer Consulting (Australia) Pty Ltd
ABN 55 153 168 140
AFS Licence # 411770
Collins Square
727 Collins Street Melbourne VIC 3008
GPO Box 9946 Melbourne VIC 3001
+61 3 9623 5555