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Retirement Income Review Secretariat
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Dear Panel

Consultation paper: Retirement income review

The Centre for Law, Markets and Regulation (CLMR) is a premier research centre for the study of the dynamics of market regulation. The CLMR is a joint initiative of the Faculty of Law and the UNSW Business School. Centre members produce high quality research on the legal, regulatory and contextual aspects of markets, corporations, finance and business transactions. The Centre's work is distinctive in the range of market institutions it studies, and its focus on understanding the nature and effects of regulation. The work is also distinctive because while in a commercial context, the CLMR's research often has social justice aspects.

We thank the Panel for the opportunity to respond to their initial consultation paper. Our submission canvasses a wide range of academic and professional research from Australian and overseas sources. There are observations and suggestions throughout, but the following recommendations deserve prominence:

- The Panel should ensure that the true costs of providing choice at various points within the superannuation system are expressly weighed against the benefits to the individual and the economy of providing that choice. (Question 3)
- We commend the Panel for its initial focus on the objectives of the system, the role of different sectors, and principles to follow. We believe that this will contribute to a more reasoned debate and ultimately to a fairer system; one that is better understood and trusted. The Panel should ensure that non-financial voices are heard alongside financial and economic voices in the policy deliberations they are leading, and which will ensue after the review. (Question 3) We note the importance of a better resourced and coordinated public service for the ongoing evaluation of the system. (Questions 8 and 26).
- On the need to ensure a greater proportion of the benefits of the superannuation is paid as life annuities, we draw the Panel's attention to the alternative arguments for the existence of a second pillar in our answer to question 5. The possibility of biases by financial advisors is raised by the UK experience of pension freedom (Question 1) and the short term liquidity focus of institutional investment markets (Question 3).
- The Panel should consider reforming the means-testing of the Age Pension using a context-dependent annuity rate to convert asset holdings into income equivalence. (Question 21)

Yours faithfully

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Introduction

The thrust of our submission is that a balanced discussion of the retirement income system is bedevilled by narratives that serve vested interests rather than the common good. We suggest that an accurate view of the system needs to include the possibility that a variety of factors can distort both the products and prices in market transactions, as well as the possibility of regulatory capture – especially intellectual capture. We have therefore dwelt at length on these two issues, using them particularly to explain some of the reluctance to offer appropriate life annuities, and to even consider that mandated contributions to superannuation may be unnecessary. We believe that the Panel’s review of the retirement income system will be enriched by considering these issues, and that the general understanding of the system will be improved by making them more salient.

Consultation questions

The retirement income system

- 1 Are there aspects of the design of retirement income systems in other countries that are relevant to Australia? `

There are a number of potential lessons that Australia can learn from alternative systems in different countries. Our experience suggests, however, that comparative statistics need to be interpreted with care, given often subtle differences.

Reforms and the Gerontocracy

International experience demonstrates that the level of pension benefits has a distinctly political dimension. Political disruption can follow attempts to reduce benefits even when they appear to be unfairly generous.¹ This is not only true for the large pay as you go (PG) schemes in some European countries², but also for the funded DB schemes in the Netherlands, where the rules allow for a reduction in benefits when investment returns are inadequate.³ One explanation for the difficulty in reducing or otherwise changing the level of benefits lies in the disproportionate political influence of the “gerontocracy”,⁴ whose views can be exploited for political purposes.⁵ While the level of benefits in Australia is relatively low, the recent campaign against the removal of franking credit refunds illustrates the power of the lobby group – regardless of one’s views on the merits of the campaign.

This is however, only part of the story. Figure 1 from Hagemeyer and Woodall ⁶, shows the benefit cutbacks and other reforms that had been made by 2012 in the EU to mitigate demographic aging. They make the point that the apparent “pension crisis” has largely been addressed by the reforms, but also point out that benefits have often been reduced for the most vulnerable, reducing some to

¹ See OECD (2019), *Pensions at a Glance 2019: OECD AND G20 INDICATORS*, p35 for more examples.

² Notably France: https://en.wikipedia.org/wiki/2019%E2%80%9320_French_pension_reform_strike.

³ See <https://www.reuters.com/article/us-netherlands-pensions/netherlands-spares-pensioners-cuts-in-2020-as-funds-rebuild-ratios-idUSKBN1XT1W0>.

⁴ See Mulligan, C. B., & Sala-i-Martin, X. (1999). *Gerontocracy, retirement, and social security* (No. w7117). National Bureau of Economic Research.

⁵ Donald, M.S., ‘Comment on the adequacy of superannuation’ (2007) 25 (1) *Jassa* 25 – 26.

⁶ Hagemeyer, K., & Woodall, J. (2014). How should the adequacy of pension coverage be balanced against financial sustainability? *Australian Journal of Actuarial Practice*, 2, 21-31.

poverty. One might conclude that the political power of the gerontocracy resides mainly with its wealthier members.

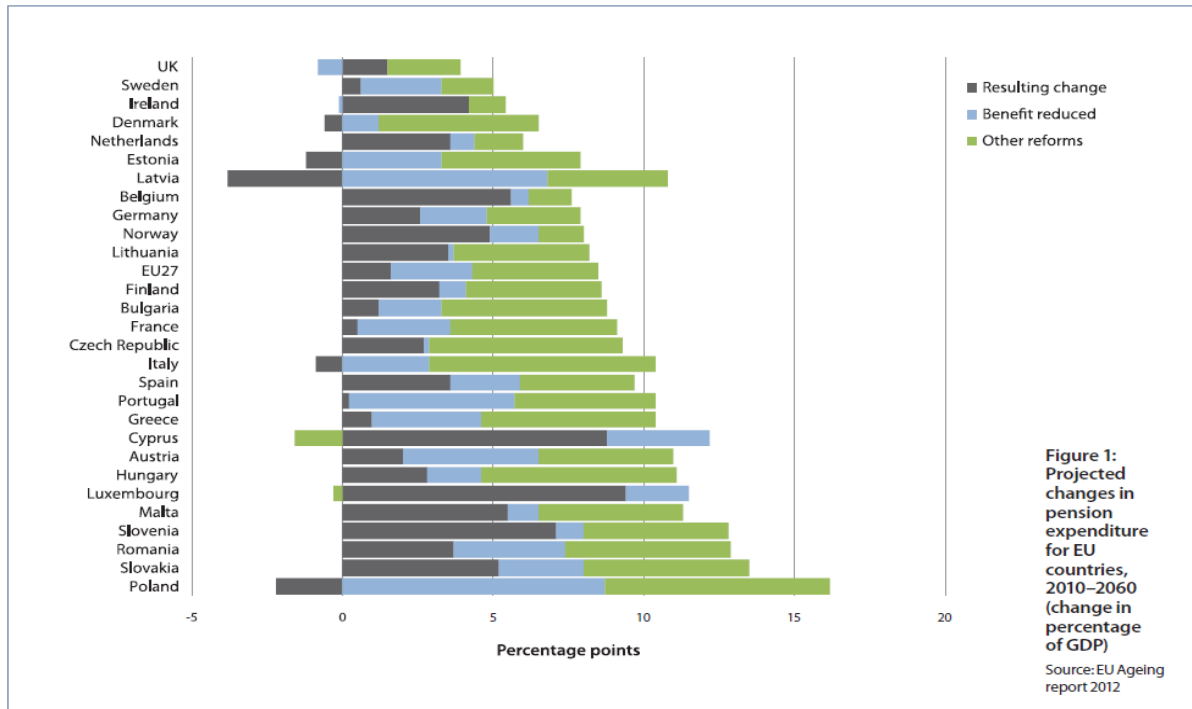


Figure 1: Pension reforms in Europe

The marketing costs of choice

Lessons can also be learnt from the “Chilean model” of compulsory membership of private schemes, which have proved expensive to administer and have resisted various attempts at reducing costs.⁷ The privatization/competition model may have provided something of a template for the fund choice introduced in Australia, which is a source of significant marketing and administrative costs. On this score, it should be noted that obtaining contributions from small companies and the self-employed is necessarily more difficult and expensive than from larger employers. The Panel is referred to the detailed discussion in OECD (2019)⁸.

Annuitization and compulsion

Of the countries that have moved away from compulsory lifetime incomes, the UK allows encashment of a person’s superannuation at retirement, the so-called UK “pension freedom”. But retirees do face a significant disincentive in that any lump sum payment in excess of 25% of the balance is taxed at the person’s marginal rate. There is state funded free “guidance” available.⁹ By 2019, only 12% of retirees were buying annuities,¹⁰ but 54% took a lump sum, 89% of whom were withdrawing less than £30,000. For those not taking lump sums, 13% of those who took professional

⁷ See Borzutzky, S., & Hyde, M. (2016). Chile's private pension system at 35: impact and lessons. *Journal of International and Comparative Social Policy*, 32(1), 57-73, and https://www.superannuation.asn.au/ArticleDocuments/359/ASFA_Chilean_tender_model_paper.pdf.aspx?Embed=Y.

⁸ See Chapter 2 in note 1.

⁹ <https://www.pensionwise.gov.uk/en/appointments>.

¹⁰ <https://www.fca.org.uk/data/retirement-income-market-data>.

advice bought an annuity, but this rises to 54% of those receiving the independent state funded guidance (and 41% with no apparent advice or guidance). Receiving professional advice appears to reduce the likelihood of choosing an annuity over a drawdown arrangement by 75% to 80% - the impact being higher for those larger balances. While there may be a selection effect, it seems likely that advisors are biased against annuities. An obvious explanation is the income they expect to receive for future advice from those who choose drawdown arrangements. The Financial Conduct Authority's review into the pension freedoms found that "around half of our full encashment cases might have followed a different path as a result of seeing our examples". As they put it:

Many respondents had a 'penny drop' moment during these discussions, which made them start to question whether they had acted too hastily, without understanding all the facts.¹¹

The lack of enthusiasm for annuities is also discussed under question 3, below.

Replacement rates - New Zealand's example

New Zealand is unique among developed countries in neither requiring contributions into an earnings-related scheme nor means testing their equivalent of the Age Pension.¹²

Although there are many reasons why Australia and New Zealand are not directly comparable, one might legitimately investigate the impact of the current retirement income on standards of living in old age. On a comparison of net replacement rates, which reflect Pillar 1 and Pillar 2, OECD (2019)¹³ shows New Zealand net replacement rates as higher than in Australia. We note, however, that Mercer (2019)¹⁴ scores Australia higher than New Zealand on household saving, household debt and home ownership, which may be considered to reflect Pillar 3. However, these measures are current and include non-retirees, whilst the net replacement rates are forecasted. Since the evidence is counterbalancing, not properly time-adjusted and includes non-retirees, it is therefore unclear which retirement income system results in a more consistent standard of living from pre-retirement to retirement.

Impact on the Macro Economy

The Panel has not specifically mentioned the interaction between the retirement system and the macro-economy, but it can be noted that one of the original justifications for superannuation was that the savings generated would enable Australia's economy to grow without building unsustainable foreign debt.¹⁵ One other international lesson is that the impact on foreign investment and economic growth appears relatively minor. For instance, Australia, with its large superannuation system, is in a marginally better position with a net international debt of 50% of GDP vs 65% for New Zealand, which has relatively little in funded pension assets.¹⁶ Another comparison can be made

¹¹ <https://www.fca.org.uk/publication/market-studies/retirement-outcomes-review-interim-report-annex3.pdf>.

¹² <https://theconversation.com/what-australia-can-learn-from-the-new-zealand-retirement-system-77719>

¹³ See note 1.

¹⁴ <https://www.mercer.com.au/our-thinking/mmgpi.html#contactForm>

¹⁵ John Dawkins, 'Security in Retirement—Planning for tomorrow today', Statement by the Honourable John Dawkins MP, Treasurer of the Commonwealth of Australia, 30 June 1992, 1-33; Michael E Drew and John D Stanford, 'A Review of Australia's Compulsory Superannuation Scheme After a Decade' (Discussion Paper No 322, University of Queensland School of Economics, 2003) 4.

¹⁶ https://en.wikipedia.org/wiki/Net_international_investment_position

between Belgium (unfunded retirement system with net foreign investments of 43% of GDP) and the Netherlands (funded system with net foreign investments of 69% of GDP).¹⁷ GDP income per head similarly does not appear to be significantly different between these two pairs, or others such as Germany, France and Italy with PG schemes, and Japan and the UK with funded schemes.

Moral hazard for governments

The provident funds to be found in some ex-British colonies¹⁸ provide a couple of potential lessons. On the negative side, considerable investment losses illustrate how assets accumulated on government balance sheets are often dissipated if not squandered. Even the otherwise apparently successful Central Provident Fund of Singapore has provided interest returns significantly below rates of salary increase, meaning the benefits do not replace pre-retirement income¹⁹. The funds are deposited with the central bank (Monetary Authority of Singapore, MAS), and have been indirectly used to invest in two sovereign wealth funds. The total returns from these have been significantly higher than the interest rate paid on CPF Ordinary Accounts.²⁰

Lest it be thought that this issue only affects ex-colonies, Myers (1993) reports that the American social security system was unified with the government budget in 1969 in order to give the appearance of smaller budget deficits. He quotes "a now famous colloquy on the senate floor several years ago, (where) Senator Daniel Patrick Moynihan (D, NY) said that this procedure represented 'fraud'. The late Senator John Heinz (R, Pa) replied and disagreed strongly, terming it 'embezzlement'".²¹

Purpose of the system and role of the pillars

- 2 Is the objective of the Australian retirement income system well understood within the community? What evidence is there to support this?

Lump sum focus

We agree with the Consultation Paper that there appears to be an insufficient understanding of the importance of using superannuation to create an income stream in retirement, perhaps linked to an

¹⁷ Comparisons of other economic statistics are relatively favourable to New Zealand and to the Netherlands, suggesting perhaps that Belgium's unfunded retirement benefits have a cost, but this weak evidence. See <https://countryeconomy.com/countries/compare/australia/new-zealand> and <https://countryeconomy.com/countries/compare/belgium/netherlands?sc=XE15>

¹⁸ Kaseke, E., Midgley, J., & Piachaud, D. (2011). The British influence on social security policy: provident funds in Asia and Africa. *Colonialism and Welfare: Social Policy and the British Imperial Legacy*. Cheltenham, UK and Northampton, MA, USA: Edward Elgar Publishing, 144-159.

¹⁹ This is shown by McCarthy, D., Mitchell, O. S., & Piggott, J. (2002). Asset rich and cash poor: retirement provision and housing policy in Singapore. *Journal of Pension Economics & Finance*, 1(3), 197-222.

²⁰ The opaque nature of these funds is set out in Chapter III of Asher, M. (1999). "South East Asian provident and pension funds: Investment policies and performance." National University of Singapore. The GIC has returns only 3.7%pa over the past 20 years (https://en.wikipedia.org/wiki/GIC_Private_Limited), but the more aggressive Temasek Holdings has yielded 15% since inception in 1974. (<https://www.temasekreview.com.sg/overview/performance-overview.html>). The asset allocation is not clear, but currently almost Temasek is almost as large a GIC.

²¹ Myers R J (1993); Social Security's Financing Problem: Realities and Myths. *Journal of the American Society of CLU & ChFC*, March, 38

inability to understand the notion that superannuation is about maintaining living standards in retirement and not capital accumulation.

Although this can be blamed on financial illiteracy within the community, we would also highlight the delays caused by ASIC, as relevant regulator, in agreeing to permit funds to provide members with realistic projections of their retirement income.²² While some funds are now illustrating projected benefits, the industry has still not caught up with the approach taken for insurance savings policies in the eighties, where more than one projection was given in order to illustrate the impact of investment risks. Explaining the delay is difficult, but important to understand given the prominence of the lump sum focus.

There may be lessons to be learned from the experience of other countries, and indeed from pre-Wallis Australia. The UK regulator sets detailed rules on projections²³, and the South African Life Offices Association had an agreement that was binding on life insurers, subsequently changed to a code of conduct.²⁴ The Australian projection rules were set by the Insurance and Superannuation Commission (ISC), which was replaced by APRA and ASIC in 1998, while the Life Offices Association of Australia (LOAA) was subsumed into the Financial Services Council. The reasons were similar: the Wallis Review²⁵ noted that most financial services were provided by conglomerates and took the view that there was sufficient convergence for them all to be regulated similarly. The disappearance of the ISC and LOAA, and the fact that many of the larger life companies were now subsidiaries of banking groups, also meant that regulators, industry bodies and the companies themselves have been less focussed on longer term products. In addition, such regulation was inconsistent with the broadly de-regulatory thrust of the Wallis reforms.

In our response to next question, we suggest that this short-term perspective continues to hold and is reinforced by the incentives inherent in the structure of the industry.

Preventing poverty

It is common to suggest that a key element of the Age Pension is to prevent poverty.²⁶ While this is not entirely a misperception, it obscures the difference between two objectives: addressing poverty and providing a pension related to income standards prior to retirement.

The objective of poverty relief does not only apply to retirees but to the unemployed and disabled, and to those with inadequate access to housing. It is therefore largely beyond the remit of the Review. It seems that the Age Pension provides a modest but adequate income for those who own their homes²⁷. The inadequacy of rent assistance is clearly an issue for pensioners who do not own their own homes, but there are many non-pensioners in receipt of rent assistance so it is a much

²² It took more than a decade to agree first that illustrations could be given under certain circumstances, and then that the Age Pension could be included:
https://www.actuaries.asn.au/Library/Events/FSF/2008/FSF08_8d_Wickham_Benefit%20Projections%20Working%20Group.pdf and then another https://www.actuaries.asn.au/Library/AAArticles/2012/Actuaries-OCT2012-WEB_P4-7.pdf.

²³ <https://www.fca.org.uk/publication/research/rates-return-fca-prescribed-projections.pdf>.

²⁴ <https://www.iol.co.za/personal-finance/life-assurance-industry-scraps-the-bia-995209>.

²⁵

https://www.aph.gov.au/About_Parliament/Parliamentary_Departments/Parliamentary_Library/pubs/rp/RP9697/97rp16.

²⁶ <https://www.superguide.com.au/retirement-planning/age-pension-alleviating-poverty>.

²⁷ The similarity between the modest ASFA standard and the Age Pension provides some indication of this.

wider issue. It may also be more appropriate to think of this objective as the maintenance of personal dignity – as in the Actuaries Institute Green Paper²⁸ - rather than relating it to some minimal poverty standard.

Economic perspectives

From a macro perspective, Asher (2014)²⁹ provides the following table comparing two views of the pension fund “myths” that appear to be widely held – sometimes even by industry experts with relatively little exposure to academic research that has not been widely distributed. While they relate primarily to the benefits of funding vs PG schemes, a number relate more broadly to the political economy of retirement income systems and the potential for regulatory capture. Highlighting the existence of these myths makes salient the different way in which differing ideological presuppositions can interpret the “facts”.

²⁸ <https://actuaries.asn.au/Library/Miscellaneous/2019/RetirementIncomesGreenPaperFinal.pdf>.

²⁹ Asher, A (2014) Guest Editorial, Australian Journal of Actuarial Practice, 2-4.,
<https://actuaries.asn.au/Library/AJAP/2014/AJAPVolume2.pdf>

Table 1: Two sets of 10 myths about retirement funding

Orszag & Stiglitz (2001)		Barr (2002)	
Macroeconomic myths			
Myth 1	Individual accounts raise national saving.	Myth 4	Funding reduces public pension spending.
Myth 2	Rates of return are higher under individual accounts.	Myth 9	Funding is better if real returns exceed real wage growth.
Myth 3	Declining rates of return on pay-as-you-go systems reflect fundamental problems.	Myth 1	Funding resolves adverse demographics.
Myth 4	Investment of public trust funds in equities has no macroeconomic effects.	Myth 3	There is a direct link between funding and growth.
		Myth 2	The only way to pre-fund is through pension accumulation.
		Myth 5	Paying off debt is always good policy.
		Myth 7	Funded pensions diversify risk.
Microeconomic myths			
Myth 5	Labour market incentives are better under individual accounts.	Myth 6	Funded schemes have better labour market incentive effects.
Myth 6	Defined benefit plans necessarily provide more of an incentive to retire early.	Myth 8	Increased choice is welfare improving
Myth 7	Competition ensures low administrative costs under individual accounts.		
Political economy myths			
Myth 8	Corrupt and inefficient governments provide a rationale for individual accounts.	Myth 10	Private pensions get government out of the pensions business
Myth 9	Bailout politics are worse under public defined benefit plans.		
Myth 10	Investment of public trust funds is always squandered and mismanaged.		

3 In what areas of the retirement income system is there a need to improve understanding of its operation?

The costs associated with the provision of choice

The provision of choice within a retirement income system can be justified on the basis that, if designed carefully it can promote personal liberty and spur product innovation. At a systemic level it can promote the satisfaction of heterogeneous needs and preferences. The provision of choice does however typically increase operational costs and, through fragmentation, undermines the achievement of economies of scale. The international experience of marketing and other costs that accompany the provision of choice within a pensions system was briefly described in Question 1. We here submit that the Panel ought to ensure that the true costs of providing choice at various points within the superannuation system be expressly weighed against the benefits of providing that choice. This will both provide a more nuanced understanding of the value of different types of choice to the architecture of the system and ensure that assessments of the costliness of the system can correctly attribute the sources of cost between system design and system implementation.

The growth in influence of the financial sector³⁰

A number of observers see the increased funding of social security systems as contributing artificially to the growth of the finance industry, both ideologically and in its share of GNP. Rajan and Zingales³¹ document its contribution to economic development, but note the role of private interest groups in obstructing development in various countries of the world during the late twentieth century. They suggest that one way of limiting the power of such interest groups is “public awareness of the hidden costs of policies that ostensibly promote economic stability”.

Blackburn (2003) has a particular critical perspective on the Australian system:

With the lopsided recovery of the 1990s the financial services industry became more aware of the inherent limits of the pool of voluntary savers in the domestic market. Part of the answer lay in exporting the ‘Anglo-Saxon’ model, its ‘equity culture’ and flourishing private pension funds. ... The World Bank alternative was centrally to comprise a novel solution to the problem of sales resistance – citizens were to be forced to buy savings schemes from commercial providers.³²

Crucially, however, there is increasing evidence that beyond a certain point financial sector growth contributes negative outcomes for a modern capitalist economy, such as income inequality and economic volatility.³³ We submit that in addition to these economic externalities, which are important and ought therefore not to be ignored, the growth in the financial sector has promoted an

³⁰ Parts of what follows are taken from Asher A (2014) “Redistribution and capital market impacts of social security retirement systems: principles and scope for actuarial involvement” *The Australian Journal of Actuarial Practice* 2:13-20.

³¹ Rajan, R. G., & Zingales, L. (2003). The great reversals: the politics of financial development in the twentieth century. *Journal of Financial Economics*, 69(1): 5-50. The results confirmed by a recent IMF paper: “Finance and Inequality,” IMF Staff Discussion Note, SDN/20/01.

³² Blackburn, R., 2003. *Banking on Death, or, Investing in Life: The History and Future of Pensions*. Verso.

³³ Research linking financialisation to inequality is presented in Huber, Evelyne; Petrova, Bilyana; Stephens, John D. (2018) : *Financialization and inequality in coordinated and liberal market economies*, LIS Working Paper Series, No. 750, Luxembourg Income Study (LIS), Luxembourg. More generally, see Thomas I. Palley, 2007. “Financialization: What It Is and Why It Matters,” Working Papers wp153, Political Economy Research Institute, University of Massachusetts at Amherst.

ideological shift in policy discourse in which epistemologies familiar to that sector have achieved greater influence than is desirable. We note, for instance, the ways in which concepts such as ‘risk’ and ‘adequacy’ are now understood in ways that ignore valuable sociological contributions to such concepts, the obsession with budget surpluses stripped of any discussion about the role of government and the ‘compliance calculus’ identified by the Hayne Royal Commission as the way in which many financial organisations deliberate on questions of right and wrong. These ‘financialised’ perspectives are not necessarily undesirable, but their shortcomings become dangerous when they eclipse other alternative perspectives. Nor is a strong and persuasive financial sector a bad thing; the danger arises when it (as with any sector) is allowed to unduly dominate policy deliberations.

The discussions below highlight certain aspects of this risk.

Regulatory capture

One important dimension of the growth of influence of the financial sector is the way in which it facilitates rent seeking. Rent seeking requires regulatory capture, described by Kay as³⁴:

“...regulation that is at once extensive and intrusive, yet ineffective and largely captured by financial sector interests. Such capture is sometimes crudely corrupt, as in the US where politics is in thrall to Wall Street money. The European position is better described as intellectual capture. Regulators come to see the industry through the eyes of market participants rather than the end users they exist to serve, because market participants are the only source of the detailed information and expertise this type of regulation requires. This complexity has created a financial regulation industry – an army of compliance officers, regulators, consultants and advisers – with a vested interest in the regulation industry’s expansion.”

This echoes Adam Smith’s emphatic warning over 200 years ago:

The interest of the dealers, however, in any particular branch of trade or manufactures, is always in some respect different from, and even opposite to, that of the public. To widen the market and to narrow the competition is always in the interest of the dealers. ... The proposal of any new law or regulation of commerce which comes from this order, ought always to be listened to with great precaution, and ought never to be adopted till after having been long and carefully examined, not only with the most scrupulous but the most suspicious attention.

Taylor et al (2017)³⁵ explore regulatory capture in the Australian superannuation in more detail. It seems incumbent on regulators and policymakers to maintain scepticism about the recommendations of the financial industry and its professions, even of the “fact-base” they submit as part of this Review.

Appointment of trustees

One implication of the above is set out in Blackburn’s summary of the views of Peter Drucker:

Drucker believed that it was wrong for banking institutions to manage pension funds since it involved them in conflicts of interest. He did not believe that it was either desirable or possible for banks to construct so-called ‘Chinese Walls’ between their business loan

³⁴ <http://www.johnkay.com/2012/07/22/finance-needs-stewards-not-toll-collectors>.

³⁵ Taylor, S., Asher, A. and Tarr, J.A., 2017. Accountability in regulatory reform: Australia’s superannuation industry paradox. *Federal Law Review*, 45(2), pp.257-289.

departments and their money management departments. In his view, pension funds anyway need trustees who were independent of banks and employers and who truly represented the interests of employees whose savings they managed. Only trustees of this sort would have the legitimacy and autonomy needed to act in the long-term interests of pension fund beneficiaries, persuading them, when necessary, to raise contribution rates to ward off inflation and to ensure investment-led growth sufficient to anticipate the rising proportion of the retired and the consequent dis-savings problem. (12)

This clearly challenges trustees of bank-owned trustees, who are called upon to exercise great efforts to escape the intellectual capture of the financial industry, but all those who have experience in the industry are affected. Some further arguments in favour of democratically elected trustees are made in Donald and LeMire (2019)³⁶ and in a Conversation article.³⁷ Crucially these papers point out that the current fetishism around ‘expertise’, narrowly defined as financial literacy and finance industry know-how, impoverishes the decision-making of the institution and undermines its legitimacy. They argue for a richer form of expertise and engagement that values a variety of relevant perspectives without ignoring the important role that purely financial expertise has to play.

Liquidity vs long term investments and life annuities

Liquidity is often seen as a good proxy for effective markets, but although more liquid assets can be generally be shown to yield a lower cost of capital to capital recipients, they equivalently yield lower returns for investors.³⁸ Some investors will be prepared to pay for liquidity, but it has less value for superannuation fund members, who have long investment horizons.³⁹ Illiquid “bottom drawer” instruments (that would be used to match life annuities) exactly match cash flows and obviate the need for most trading, hedging and the financial planning necessary to meet bullet repayments.⁴⁰ The problem arises because the cost of liquidity is paid to those market makers who create and participate in investment markets. They therefore have a vested interest in the creation of liquidity, and their views – and even those of academic researchers into liquid markets – are inevitably clouded by these interests. This bias can feed through into others unaware of the self-interest underpinning the views. An illustration is given by Stiglitz⁴¹, explaining why capital indexed bonds (TIPS) took so long to introduce in the USA:

... Treasury turned to bond traders - their natural clientele - for advice. The experience in England from the perspective of bond traders was that these bonds were a failure; that is, people bought them for their retirement and did not trade them. Without trades, where were

³⁶ M. Scott Donald and Suzanne Le Mire, (2019) Independence in Practice: Superannuation Fund Governance through the Eyes of Fund Directors. UNSW Law Journal, 42(1), 300 – 334.

³⁷ <https://theconversation.com/democratising-super-would-bring-more-independent-voices-to-the-negotiating-table-84690>

³⁸ Liquidity and its creation is discussed by Amihud, Y., Mendelson, H., Giovanninni, M. and Mayer, C., 1991. How (not) to integrate the European capital markets. European Financial Integration, pp.73-111 and Amihud, Y. and Mendelson, H., 1991. Liquidity, asset prices and financial policy. Financial Analysts Journal, 47(6), pp.56-66.

³⁹ See <http://www.lawcom.gov.au/project/pension-funds-and-social-investment/>.

⁴⁰ For a more detailed argument, see Asher, A and E Rajadurai (2018) Investing Superannuation for the Public Good: Creating new markets to benefit members & fund necessary investments, The McKell Institute. https://mckellinstitute.org.au/app/uploads/FINAL_Superannuation_2018_WEB.pdf

⁴¹ Stiglitz, J. 1998. 'The Private Uses of Public Interests: Incentives and Institutions' Journal of Economic Perspectives 12.2, pp. 3-22

their commissions? Of course, from the perspective of someone trying to create an instrument to enhance retirement security, this was ideal: we did not want a gambling instrument.

We also draw the Panel's attention to other indicators that long term investment is currently being neglected by investment markets. Internationally, Bank of England researchers report on the myopia of investment markets,⁴² while locally, Ringrose has long criticised regulators and funds for their focus on short term investment risks, rather than the risks to long term incomes.⁴³

It seems obvious that banking-style preferences for liquidity are inapplicable to the more variegated liability profile of different aspects of the superannuation system. We submit that the size of the superannuation system means that these variegated preferences ought to inform both public finance policy and regulatory policy.

⁴² Haldane, A. G., and Davies, R., 2011. The short long.

<http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2011/speech495.pdf>

⁴³ https://www.pc.gov.au/__data/assets/pdf_file/0009/228690/subdr107-superannuation-assessment.pdf, and https://www.pc.gov.au/__data/assets/pdf_file/0004/228694/subdr107-superannuation-assessment-attachment2.pdf

4 What are the respective roles of the Government, the private sector, and individuals in enabling older Australians to achieve adequate retirement incomes?

Government

The role of government can be understood as the creation and management of collective action, the provision of public goods and ensuring that people are not exploited by others. Adam Smith, perhaps sets out a minimum:

According to natural liberty, the sovereign has only three duties to attend to; three duties of great importance, indeed, but plain and intelligible to common understanding:

First, the duty of protecting society from the violence and invasion of other independent societies;

secondly, the duty of protecting, as far as possible, every member of society from the injustice and oppression of every other member of it, or the duty of establishing an exact administration of justice; and

Thirdly, the duty of erecting and maintaining public works and certain public institutions which it can never be in for the interest of any individual, or small number of individuals, to erect and maintain; because the profit could never repay the expense to any individual or small number of individuals, though it may frequently do much more than repay it to a great society.

The second duty covers regulation, with the objectives set out above as preventing greedy exploitation. This covers ASIC's role, and APRA to the extent it regulates the trustworthiness and competence of trustees.

The third duty covers what can be called public and common goods; the distinction being the first are "non-rivalrous" - as for example the sponsoring of research the results of which are available to everyone. Common goods such as public health need to be rationed in some way. Poverty relief is a common good, which can be explained alternatively by:

- the view that all people have a right to a certain minimum standard of living;
- a common compassion for the people concerned;
- the Rawlsian perspective⁴⁴ that we would want the poorest in society to be as well off as possible if we were ignorant of where we would end up;
- a pragmatic view that the poor will otherwise occupy public space and otherwise interfere with the activities of those in no need of welfare.

As discussed above (page 6), it is suggested that the Panel does not really have to address the debate between these views; but merely to assert that the Age Pension (and subsidies to Age Care) should be sufficient to produce a standard of living at least as high as those on other welfare payments.

The superannuation system is clearly more than poverty relief, and could be seen as a common good that addresses market failures that might arise if private institutions could not provide the products because of moral hazards or the inability to raise sufficient capital to absorb potential losses. There

⁴⁴ Rawls, J. (2009). A theory of justice. Harvard university press.

are limited moral hazards and capital requirements in the Australian superannuation system, so it is not obvious why contributions should be mandated. Without any obvious justification for compulsory contributions, Willmore⁴⁵ makes the arguments that compulsory contributions should be abandoned, offering New Zealand as an example that little if anything is lost thereby. The argument from myopia is patronising, open to Blackburn's refutation⁴⁶ that it suits the financial industry, and particularly inconsistent if retirees are allowed take lump sums. Willmore does not however consider some other arguments that may have validity:

- Compulsion is popular because people want a pre-commitment device to savings. This view however would also lead to a level of mandated annuitization. It is suggested that it would also be better implemented by auto-enrolment both before and at retirement – so not limiting the freedom of the minority unfairly. Both mandatory contributions and auto-enrolment also reduce the costs of distribution and so offer much better value for money.
- An alternative perspective can be to see compulsory superannuation as a tax intended to reduce the cost of the Age Pension. Privatization of the funds accumulated for this reason can be seen as a way of ensuring that succeeding governments do not expropriate them for other purposes. The policy implications of this view would be that lump sums should be more heavily taxed – or included in the means test. It is inconsistent with a lack of compulsory annuitization. The question of the fairness and efficiency of the means tests is addressed in our response to consultation question 14.
- A third argument can be constructed from differing social perspectives. Within generations, our personal enjoyment of retirement would be reduced not only if our own standard of living was impaired, but also if members of our social circle were reduced to poverty and unable to continue to participate in the same way as formerly. Between generations, Gonzalez⁴⁷ suggests that one reason for the growth of monasteries in the middle ages was to provide a place where older leaders could make way for younger generations. Institutionally, while compulsory retirement is now seen as unfair, the existence of appropriate retirement benefits clearly facilitates organizational renewal and makes it much easier to retire those whose energy and skills are no longer adequate for their roles. This view has an ancient provenance. The earliest pension systems were provided for the military, as successful rulers require mechanisms to promote loyalty and ensure older soldiers retired without fomenting rebellion.⁴⁸ The same argument was made for the introduction of company-sponsored pension schemes.⁴⁹ Similar arguments were also made for the introduction of the centrally controlled, earnings-related pensions in Bismarck's Germany.⁵⁰ Further policy implications of this argument would be the maintenance of a fixed retirement age for pension benefits –

⁴⁵ Willmore, Larry, *Three Pillars of Pensions? A Proposal to End Mandatory Contributions* (June 1, 2000). United Nations DESA Discussion Paper No. 13. Available at SSRN: <https://ssrn.com/abstract=233586>

⁴⁶ See note 31

⁴⁷ Gonzalez, Catherine G., "An Historical Perspective on the Church and the Elderly," *Journal of Religion & Aging* 6 (1989), 63–73.

⁴⁸ The first recorded is probably the Roman scheme: Phang, Sara E., *Roman Military Service: Ideologies of Discipline in the Late Republic and Early Principate* (Cambridge, MA: Cambridge University Press, 2008).

⁴⁹ Blackburn, see note 31, p48, quotes social reformer and chairman of the eponymous family company, Seebohm Rowntree, suggesting that pensions paid from a fixed retirement age are likely to be cheaper than retaining older staff at wages that no longer reflect their productivity

⁵⁰ Scheubel, Beatrice (2013) *Bismarck's Institutions: A Historical Perspective on the Social Security Hypothesis*. Tuebingen: Mohr Siebrek Ek., p78

while permitting work beyond such ages for those who still have a contribution. (This argument is related to the view that retirement of older workers opens up opportunities for younger workers. This view is not sustained by research⁵¹, although it must obviously apply in some organizations with a fixed number of personnel positions and recent increases in retirement age have coincided with significant youth unemployment.)

The government has a further role to play through the provision of infrastructure that allows markets to function properly. Two particular possibilities at the current time should be given more thought:

- The collection and distribution of data (consistent with the protection of privacy). The suggestion made by the Actuaries Institute⁵² that the information on myGov (Household structure, health, income and assets) could be provided in a standard electronic format to each taxpayer, who could then use it for financial planning. It is envisaged that such information could be provided to financial planners so significantly reducing the costs of financial advice, and make it more widely available.
- Markets function better if people can compare service providers in a consistent fashion. Although there are relatively numerous comparison sites (for superannuation as well as insurance and other ancillary services), but the successful ones are able to extract high prices from those who participate. Aggravating the costs, a large proportion of their revenue is paid to the search engines (particularly Google) to ensure that their sites rank sufficiently highly. The product providers are not able to collaborate to compete with Google and the comparison providers because of competition regulation. A change to the competition regulation or state provision are alternatives.

Private sector

There is an ongoing debate as to whether the sole purpose of business is to make a profit, or whether it has a social purpose in meeting people's needs. Milton Friedman⁵³ is perhaps the best-known for the expression of the former view with Peter Drucker's of the latter:

*Profit is not the explanation, cause, or rationale of business behavior and business decisions, but rather the test of their validity. ... It is irrelevant for an understanding of business behavior, profit, and profitability, whether there is a profit motive or not. ... We do not learn anything about the work of a heart specialist by being told that he is trying to make a livelihood, or even that he is trying to benefit humanity. The profit motive and its offspring maximisation of profits are just as irrelevant to the function of a business. ...*⁵⁴

The needs for a retirement income include the need for advice as to how much to save and where to invest. Such advice needs to take into account the management of risk. It should also offer

⁵¹ For instance - Eichhorst, W., Boeri, T., De Coen, A., Galasso, V., Kendzia, M., & Steiber, N. (2014). How to combine the entry of young people in the labour market with the retention of older workers? IZA Journal of European Labor Studies, 3(1), 19 ff.

⁵² See

<https://www.actuaries.asn.au/Library/Submissions/Superannuation/2019/TreasuryRetirementRiskMetricsConsultation.pdf>

⁵³ Friedman, M. (1970) "The Social Responsibility of Business is to Increase Its Profits." *The New York Times Magazine*, September 13, <http://www.umich.edu/~thecore/doc/Friedman.pdf>.

⁵⁴ Drucker, P. F. (1975) *Management: Tasks, Responsibilities, Practices*. Mumbai: Allied, p60.

insurance and investment products and services that provide for the full range of members' needs in these areas.

- 5 The Panel has been asked to identify the role of each of the pillars in the retirement income system. In considering this question, what should each pillar seek to deliver and for whom?

As discussed in section 8 below, we see the main principle as equity, which can be considered to be a balance of trade-offs between equality, efficiency, just deserts, liberty and needs.

The primary aim of Pillar 1 should be to meet basic consumption *needs* and be seen primarily as a tool for poverty relief and public health. In our view Pillar 1 must therefore be set at a level that includes a minimum level of medical and aged care services. We recognise that the level of this Pillar may be outside the remit of the Review.

The primary aim of Pillar 2 should be to assist all Australians to smooth their income across their working lifetime. The main principle is *just deserts*, which is achieved if greater contributions can reasonably be expected to lead to greater retirement benefits. Pillar 2 rules should promote *efficiency*, so should minimise leakage either in the form of costs or bequests. There is also the need to justify the infringement of individual liberty (discussed in question 4 above), and the need for advice (covered in question 11 below). Prudential regulation of the entities providing products in respect of this Pillar is justified by the compulsory nature of the system and by its importance in national capital markets and in social policy. Conduct regulation is required as a result of the facilitation and accommodation of choice within the system's design.

Pillar 3 can be separated into savings inside and outside the superannuation system. Savings inside superannuation should be treated in the same way as Pillar 2. Individuals ought to be allowed to save outside superannuation in whatever the retiree chooses; the principles being promoting in both cases are *liberty* and *just deserts*. Conduct regulation is justified by the importance of these savings for national capital markets and as by the need for consumer protection in the financial services industry as in other industries.

Home ownership and Reverse Mortgages

We note that the Panel has expressed an interest in reverse mortgages, and we agree that home ownership has a role in the retirement system.

In our view, reverse mortgages would be more popular if appropriately designed. Firstly, one needs to see the home as consisting of an element of pre-paid rent, the present value of which is equivalent to a life annuity that would pay such rent, and a residual element that forms part of bequests.

The residual element can provide security for a reverse mortgage. A major disadvantage of standard reverse mortgages is that the volatility of house prices can mean that the borrower can lose a share of the pre-paid rent. Although the no-negative guarantee protects those who are able to stay in their houses until death, there remains a risk should the homeowner need to move into an institution. The longevity risk could potentially be taken on by a life insurer, but current product designs would expose the insurer to house price risks, which would require considerable and expensive capital.

There have been various, relatively unsuccessful, attempts to offer shared equity reverse mortgages⁵⁵ that take on the house price risk. Our understanding is that these products have been successful in finding borrowers but had difficulty in attracting investors. There are enthusiastic investors in direct residential housing, but not through institutional structures (particularly life insurers providing reverse mortgages). There is therefore a need for housing investment to be redirected through institutional structures (such as managed investment schemes) to meet the need for reverse mortgages. Such investments would be particularly attractive to younger people saving for a house purchase, who are disadvantaged by increases in house prices, and are better off if they fall.

Investments through an institution would be a more liquid investment than buying houses directly. The investment would also be divisible, which would also reduce pressures for excessive gearing. Renters would also be better off to the extent that they would enjoy more secure tenure as they would not face owners who wanted to occupy the property themselves.

Institutional investment could perhaps be facilitated by ensuring that it enjoyed the same tax advantages (negative gearing) as currently available to investment properties.

We note that the CPF in Singapore provides a model of how retirement and other financial needs can be integrated, particularly its support for home ownership.⁵⁶

6 What are the trade-offs between the pillars and how should the appropriate balance between the role of each pillar in the system be determined?

See answers to Cohesion below.

The changing Australian landscape

7 Demographic, labour market, and home ownership trends affect the operation of the retirement income system now and into the future. What are the main impacts of these trends? To what extent is the system responsive to these trends? Are there additional trends which the Review should consider when assessing how the system is performing and will perform in the future?

We have nothing to add here.

Principles for assessing the system

8 Are the principles proposed by the Panel (adequacy, equity, sustainability, and cohesion) appropriate benchmarks for assessing the outcomes the retirement income system is delivering for Australians now and in the future? Are there other principles that should be included?

The outcomes *and processes* of the retirement income system should be just (equitable or fair). While there are many different approaches to the application of justice, it can be usefully applied to the design and evaluation of retirement systems by seeing it as maximising the objectives of meeting

⁵⁵ For instance, Rismark's Equity Finance Mortgage, Bendigo's Home Equity Loan, equikey.com.au

⁵⁶ See McCarthy et al. in note 19.

needs, equality, just deserts, liberty and efficiency, trading them off as necessary⁵⁷. These principles are present in principles proposed by the Panel, however, they appear to be expressed differently and they can be re-organised to conform to these more familiar aspects of justice.

The Discussion Paper used “adequacy” in much the same way as “needs” can be used. It refers to basic needs to avoid poverty (or maintain personal dignity) as provided by Pillar 1, as well as meeting “personal preferences and circumstances” as addressed by Pillars 2 and 3. A clear distinction should be made as the first requires financial resources from government, while the latter merely implies that the system should permit people to address their needs appropriately. It does not seem necessary for regulation to determine whether relative or absolute standards are more appropriate targets in retirement. They depend on individual preferences and circumstances.

We suggest that “equity” (justice) subsumes “sustainability” particularly if it is understood as requiring a balance between providing people with equal outcomes and giving people their deserts, which can be understood as “actuarial equity”⁵⁸. What is particularly relevant for “public confidence in the system” is that it requires the *perception* that the system is just, and that the perception is more a question of ensuring that it arises from a reasonable process rather than as a particular outcome.⁵⁹ Lack of confidence in the Australian system is therefore not to be seen as arising from any particular characteristics, but rather from the way in which changes have become politicized (often in election campaigns) and escaped the normal cost benefit analyses⁶⁰. The trade-off between the different principles is a political decision and cannot be made by experts, but parties need to recommit to the principle that major policy changes should be the subject of appropriate regulation impact studies and periodic reviews.⁶¹ Without wanting to downplay the role of ad hoc reviews such as the Retirement Income Review, there is a vital role such for an appropriately resourced public service that collects the relevant data and alternative views and provides the government of the day with the trade-offs that need to be made.

The recent review of public sector governance underlines its importance and is mildly critical of current performance:

Citizens have a right to know how their money is used and what difference that is making to their community and the nation – what outcomes are being achieved, how, and at what price. Insightful performance reporting goes beyond simply measuring activities. It goes to measuring outcomes and impacts (the value created by these activities). We believe that

⁵⁷ These principles are defined and applied to different aspects of the design of retirement systems in Asher, A (2015) “Working Ethically in Finance: Clarifying Our Vocation”, Business Expert Press, New York; Asher, A (2011) “Equity in Retirement: Are All Australians Getting a Fair Deal?”, The Economic and Labour Relations Review 22.3: 65-84; Asher, A (2010) “Innovation and Imperatives in Financial Security Systems”, Presented to the International Congress of Actuaries [https://www.actuaries.org/EVENTS/Congresses/Cape_Town/presentations/Pensions-Benefits-and-Social-Security-\(PBSS\).zip](https://www.actuaries.org/EVENTS/Congresses/Cape_Town/presentations/Pensions-Benefits-and-Social-Security-(PBSS).zip); Asher, A (2001) “The Appropriate Disposal of Retirement Fund Surpluses.” The South African Actuarial Journal, 1: 1-33; Asher, A (1998) “Effective and Ethical Institutional Investment”, British Actuarial Journal 4.V: 969-1027.

⁵⁸ This is where the discounted expected value of benefits equals that of contributions *ex ante*.

⁵⁹ See, for instance, Tyler, T. R., & Smith, H. J. (1995). Social Justice and Social Movements. Institute of Industrial Relations, UC Berkeley.

⁶⁰ See Taylor et al, note 35

⁶¹ Ibid

*internationally, the Australian Government should be a leader on this front. It needs to push harder to get there.*⁶²

A recent paper by retired public servants now engaged in research at ANU is more critical, saying that the previous “formal and centralised approach” within the civil service has been undermined by various changes since 1996⁶³. It goes on to show, as a case study, that while the adequacy of the unemployment benefit program took up 24 pages of the 1997-98 Department of Social Security Annual Report, it was not even mentioned in the 2017-2018 report.

The “effects on overall private savings” and “Individuals saving beyond their retirement needs” seem to refer mostly to liberty, in that government interference has forced people into superannuation. As discussed above under the “Impact on the Macro Economy” on page 4, the impacts appear to be insignificant.

When “cohesion” is discussed, there are references to “drivers, processes, and incentives” and “complexity”, which we take to be references to efficiency.

A principle which should have greater emphasis in this list is liberty. All government interventions in restricting people’s behaviour need to be justified. This particularly raises the issue of compulsion, the burden of compliance (because of unnecessary complexity, which also touches on efficiency) which includes individual interactions with Centrelink. It also relates to the principle of subsidiarity, which is that power should be devolved as low in an institutional structure as is consistent with equity and efficiency.

Efficiency is also a criterion that should receive more prominence in the list, but it is normally only considered after other principles have been met.

Table 1: Summary of this section

PANEL PRINCIPLE	JUSTICE PRINCIPLES (NOTING THE NEED FOR A FAIR PROCESS OF TRADEOFFS)
ADEQUACY	<i>Needs</i>
EQUITY	<i>All justice principle, including equality:</i> <ul style="list-style-type: none"> • Of outcomes • Horizontal and vertical
SUSTAINABILITY	<i>Just deserts</i> <ul style="list-style-type: none"> • Intragenerational and intergenerational
COHESION	<i>Efficiency</i>
Not mentioned	<i>Liberty</i> <i>Subsidiarity</i>

⁶² Alexander, E., & Thodey, D. (2018). Independent review into the operation of the public governance, performance and accountability act 2013 and rule. Department of Finance, p 11

⁶³ J. Rob Bray, Matthew Gray and David Stanton (2019) “Performance management and evaluation in Australia: Evidence base meets culture and politics.” presented to the China-Australia Dialogue on Public Administration 2019 Workshop, Sun Yat-Sen University, Guangzhou on 6 November.

9 How does the system balance each of the principles and the trade-offs between principles (e.g. sustainability and adequacy) under current settings? What is the evidence to support whether the current balance is appropriate?

We list some of the most salient failures and weaknesses in Table 2 below.

One item that we have not considered expressly elsewhere is the complexity of the system.

Regulatory complexity

Complexity is widely recognised as undesirable characteristic in a regulatory regime. It undermines comprehensibility and enforceability, diverts resources towards narrow compliance and creates barrier to entry.⁶⁴ The Panel might note Justice Rares's opinion that:

*the policy choice of using prescriptive drafting that most Commonwealth legislation has reflected over the last two or three decades needs urgent reconsideration. It has really significant impacts on the whole community in terms of comprehensibility, compliance costs and, to use a political catch cry, access to justice.*⁶⁵

However, there is more to it than that in the context under consideration here. Complexity has distributive implications as well. Specifically in a social security and retirement incomes context, complexity is unfair in that its burden falls more heavily on the less well-resourced, those who do not have the resources to secure independent advice tailored to their circumstances.

The sections of the Corporations Act relevant to Superannuation deserve special mention, with Justice Austin observing:

*The very mention of the Financial Services Reform Act 2001 will produce moans of despair. It is not just the excessive detail and complexity of the drafting, the devastatingly comprehensive abandonment of the principles of simplification, that causes difficulties; it is also the extent to which the legislative text is affected by regulations and ASIC modifications, adjustments that evidently became necessary because of flaws in the formulation of policy and legislative text.*⁶⁶

The SIS Act is similar. The Productivity Commission's 2001 review⁶⁷ commented that the legislation was "voluminous, complex and in some respects, overly prescriptive", and created unnecessary restriction of competition and compliance costs. Since then much of the Act has been made redundant by APRA rules and standards.

⁶⁴ For a recent discussion, see Prasanna Gai, Malcolm Kemp, Antonio Sánchez Serrano and Isabel Schnabel (2019) Regulatory complexity and the quest for robust regulation. Reports of the Advisory Scientific Committee European Systemic Risk Board (No 8 / June 2019). Also Charles S Spatt. (2012) Complexity of Regulation. Harvard Business Law Review. <https://www.hblr.org/wp-content/uploads/sites/18/2012/06/Spatt-Complexity-of-Regulation.pdf>

⁶⁵ Steven Rares J, 'Competition, Fairness and the Courts' (2014) 28(3) Commercial Law Quarterly: The Journal of the Commercial Law Association of Australia 17.

⁶⁶ Austin RP, "Opening Speech – Mergers and Acquisitions 2007" (University of New South Wales, Faculty of Law, 24 October 2007), http://www.supremecourt.justice.nsw.gov.au/Documents/Speeches/austin_speeches.pdf.

⁶⁷ Productivity Commission, Review of the Superannuation Industry (Supervision) Act 1993 and Certain Other Similar Legislation, Inquiry Report No 18 (10 November 2001).

Tax provisions are even worse to the extent that one needs to cross reference two Taxation Acts and the SIS Act and Regulations, which are replete with multifarious definitions.

The regulations governing means testing and the payment of the Age Pension and other benefits are also unnecessarily complex.

Although directed towards a slightly different policy objective, the Hayne Royal Commission also identified the simplification of regulation as a critical forward step.⁶⁸ Ironically, however, the introduction of the Financial Accountability Regime, the changes to the civil penalty regime and the encouragement of greater overlap between ASIC and APRA that Hayne recommend each further complicate the regulatory regime because their interaction with other current and proposed parts of that regime have not been considered carefully enough. Although we recognise the catalysts that inspired the recommendations made by Hayne, the urgency with which the government is currently implementing those recommendations is depriving the process of the opportunity to ensure that the regime is a coherent, integrated whole. We submit that the bi-partisan support for the recommendations expressed in the immediate aftermath of the Final Report ought to permit of a more careful, considered legislative programme than that which is currently underway.

Materiality

Unnecessary exceptions in regulation can emerge because of a failure to appreciate the materiality of the issue being addressed. Some examples can illustrate:

- ASIC and APRA both actively pursued superannuation funds for unit pricing errors in the years before 2008. In many cases, the costs of remediation exceeded the amounts remediated, and led to huge funds exchanging cheques for as little as \$20.⁶⁹
- An analysis of Age Pension data⁷⁰ found that that 82% of age pensioners had over 4 variations in their pension benefit amounts each year. 80% of these were for minor amounts of less than 3% of the payment. This would appear to be a reasonable measure of immateriality, so 10 million adjustments annually, which would have been processed by Centrelink, seem at least partly unnecessary and also a potential source of stress to beneficiaries.

Materiality applies to all pillars – determining the level of the Age Pension and the Superannuation Guarantee, details about means tests and taxation. The nature of needs and the extent of redistribution are complex and fluctuating; their measurement is inevitably somewhat simplistic, limited to a particular time and prone to error. Where attempts have been made at triangulation (measuring needs using different methods including surveys of the views of the poor and their neighbours), significantly different answers are obtained⁷¹. If it is true that pensions are invariably

⁶⁸ See pages 494-496 of the Final Report particularly.

⁶⁹ For a more detailed discussion see Asher, A and Trang Duncanson (2008), “Developing a Fair and Reasonable Unit Pricing Restitution Policy”, Presented to the Institute of Actuaries of Australia 4th Financial Services Forum. <https://actuaries.asn.au/Library/Events/FSF/2017/FSF085epaperAsherDuncansonFairUnitPricing.pdf>

⁷⁰ Preparatory to the later analysis in Asher, A, Meyricke R, Thorp S and Wu S. (2017) “Age pensioner decumulation: Responses to incentives, uncertainty and family need”, Australian Journal of Management 42(4), 583–607.

⁷¹ Appleton S & D Booth (2005) Combining Participatory and Survey-based Approaches to Poverty Monitoring and Analysis ; Barahona, C & S Levy (2005) The Best of Both Worlds: Producing National Statistics using Participatory

large enough to meet all essentials, there is then a strong argument for a pragmatic approach to measuring income and needs. Getting into too much detail represents a spurious level of care, and is an unwarranted interference in the lives of the regulated. Income – as defined by the tax collecting agencies - is probably an adequate measure of lifestyle for most purposes.

Determining an appropriate level of materiality is considered in detail in Asher and Duncanson⁷². Unit pricing is a fairly precise science, so it could be as little as 0.4% of \$20. The analysis of the difference between members of the best and worst performing funds in our response to question 14 below, suggests that the industry has not been particularly concerned about differences of up to 20% in final payouts. This may appear too high, but materiality measures of 5% and 10% are common limits in auditing⁷³ and could be applied to the impact on elements of government revenue as well the impact on individuals when evaluating the appropriateness of regulation.

Table 2: Summary of failures and weaknesses

PRINCIPLE	FAILURE OR WEAKNESS
ADEQUACY/NEEDS	Rent assistance inadequate for non-homeowners. Mandatory contributions are penal for those whose standard of living under pension age are less than after, and therefore does not meet needs. Failure to evaluate in a sustained manner.
INTERGENERATIONAL EQUITY / SUSTAINABILITY	Can be measured by a national balance sheet that includes natural resources.
INTRA-GENERATIONAL EQUITY	Requires a trade-off between equality and desert, which needs a holistic evaluation of all government programs involving redistribution.
COHESION	The means tests are incoherent, unfair and unreasonable complex.
EQUALITY	Egregiously fails to recognise difference between homeowners and others.
JUST DESERTS	Asset test penalises savings for middle incomes. Funds and advisors remain conflicted so people pay more than necessary and get poor advice. DC benefits provide dramatically different results for people with identical contribution histories.
LIBERTY / INTERVENTIONS	Benefits of compulsion are debatable. Means tests are highly intrusive Laws and regulations are unnecessary complex
SUBSIDIARITY	Super mergers between large funds are undermining it.
EFFICIENCY	Very small funds problematic Unnecessary complexity creates expenses Materiality not adequately recognised

Methods.

⁷² See note 69 above.

⁷³ Chewning Jr, E. G., & Higgs, J. L. (2002). What Does “Materiality” Really Mean? *Journal of Corporate Accounting & Finance*, 13(4), 61-71.

Adequacy

10 What should the Panel consider when assessing the adequacy of the retirement income system?

As above, we submit that the Panel ought to consider whether Pillar 1 meets needs for living with dignity, and is also consistent with other elements of the welfare system.

11 What measures should the Panel use to assess whether the retirement income system allows Australians to achieve an adequate retirement income? Should the system be measured against whether it delivers a minimum income level in retirement; reflects a proportion of pre-retirement income (and if so, what period of pre-retirement income); or matches a certain level of expenses?

As above, these arise from personal preferences and circumstances, and the main issue to consider is whether people have access to appropriate advice and products to make the relevant decisions. We highlight the liquidity constraints imposed on younger contributors facing the costs of children and mortgage payments – and the inadequacy of a system that largely ignores needs beyond average life expectancy.⁷⁴

Retirees also require appropriate products that provide cover throughout life – i.e., life annuities⁷⁵, and well-designed reverse mortgages.⁷⁶

12 What evidence is available to assess whether retirees have an adequate level of income?

As suggested in question 8 above, there is a need to measure poverty and ensure as far as possible that even the poorest can maintain personal dignity. It is suggested that this cannot be done without qualitative assessments of those with the lowest income standards. Such assessments would fall within the remit of the Department of Social Services.

We note that they would need to be longitudinal studies if they were to measure the effectiveness of welfare programs. The HILDA dataset has been a great success and provides some insights but has some significant shortcomings when it comes to retirees particularly. The sample excludes people in institutions, not all the relevant data is collected (leisure and medical costs are excluded), and the data is not reliable given that it relies significantly on self-reporting. Prospective panel studies that follow a population may however suffer from contamination from the collection data (which may

⁷⁴ Asher, A, Adam Butt, Gaurav Khemka and Ujwal Kayande (2015) Formulating Appropriate Utility Functions and Personal Financial Plans, Presented to the International Actuarial Association, Oslo (June)
<http://www.actuaries.org/oslo2015/papers/PBSS-Asher.pdf>

⁷⁵ For a summary of the arguments and appropriate products, see Asher, A (2012) “The lifetime harvesting plan: smoothed annuities with sharing of mortality, and averaging of investment”, Presented to the Actuaries Institute Financial Services Forum risks
<http://www.actuaries.asn.au/Library/Events/FSF/2012/FSF2012PaperAnthonyAsher.pdf>; Asher, A (2011) “Developing a harvesting plan: optimising retirement spending in the face of economic, social and personal risk”, 19th Annual Colloquium of Superannuation Researchers, 14-15 July 2011 – UNSW.
https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2415057

⁷⁶ See page 16, above.

mean people are more careful and less likely to fall prey to abuse) and will in any event take many years to produce results.

Thought might therefore be given to a retrospective study using Centrelink data to identify people of interest, and then interviewing those concerned, their families and those who have provided financial and social services. This would ideally include Centrelink, financial institutions and health and social work service providers – including Medicare.

Equity

13 What should the Panel consider when assessing the equity of the retirement income system?

As for answers to questions 8 and 9 above.

14 What factors and information should the Panel consider when examining whether the retirement income system is delivering fair outcomes in retirement? What evidence is available to assess whether the current settings of the retirement income system support fair outcomes in retirement for individuals with different characteristics and/or in different circumstances (e.g. women, renters, etc.)?

There are a great many factors that influence the outcomes each individual receives from the superannuation system. Some of these are widely recognised, such as the career trajectory, salary levels, contribution levels and sequencing risk.

As discussed above, we are not sure that it is helpful to isolate the impact of the retirement system when considering issues of poverty prevention or redistribution. Poverty is discussed in section 2. Redistribution (to those with lower incomes, or even lower superannuation balances) is a similar issue. As put the Actuaries Institute:

Expressed more generally, taxation and social security payments, including support in retirement, should be considered holistically over a person's lifetime. Some parts of the system may be less progressive than others in the interests of financial security and efficiency (as defined above) – provided the system, as a whole, is fair.⁷⁷

One factor that is not widely discussed is the lottery that is fund performance. Even if APRA is successful in weeding out perennial underperformers, there will still be a performance differential of several per cent each year across MySuper products (for instance). Predicting the winners and losers once factor such as fees and costs have been addressed is not possible. So individuals with exactly the same contribution histories in the accumulation phase invested in different MySuper products will get different payouts from the superannuation system through no fault of their own. This clearly offends against the principles of equality and desert. We submit that this factor ought to be expressly recognised alongside the other factors more familiar to the fairness debate (gender equity, income re-distribution etc.).

To illustrate and provide some sense of materiality, we have simulated gross investment returns for 100 funds assuming they have the same asset allocation but different active management portfolios. This generates a distribution of outcomes around the benchmark asset allocation. We then

⁷⁷ <https://actuaries.asn.au/Library/Miscellaneous/2019/RetirementIncomesGreenPaperFinal.pdf>

calculated the resulting account balance at age 67 for a male who enters the workforce aged 18 with initial taxable earnings of \$40,000. Further details of the assumptions and model structure can be found in the Appendix .

The results for the 10,000 simulations can be seen in Table -3 below. The dollar amounts are inflation-adjusted so they are expressed in today's dollars. The account balances have been converted to a lifetime income using Challenger's current inflation-adjusted liquid lifetime annuity conversion rates and to an inflation-adjusted annuity with different discount rates using ASFA's modest and comfortable lifestyle recommendations.

As can be seen, retirement outcomes from Pillar 2 can vary quite significantly despite the individuals making precisely the same contributions, with the same person in the top performing fund:

- achieving an account balance and lifetime annuity 16.7% higher than the individual in the worst performing fund;
- or an inflation-adjusted annuity that lasts 17.8% to 25.7% longer than the worst performing fund

These results are sensitive to the assumptions used, including the effective tax rate on investment earnings and the assumed standard deviation of relative performance in gross returns (i.e. the divergence in fund returns). Therefore, we have presented sensitivities to these parameters in

Table 4 below, which shows the percentage by which the account balance in the top performing fund exceeds the worst performing fund.

One way of addressing this inequity would be to increase the effective tax rate on investment earnings. Taxing post retirement investment income would have the most impact, but could lead to many people withdrawing from superannuation so is unlikely to be effective. If applies pre-retirement, taxes on contributions could be reduced to offset the impact. Extending the range at which the means tests operate will also reduce the differences.

Other solutions may include having one fund, rather than many, or intervening in the investment management decisions of superannuation funds to ensure they are more consistent. The experience of other countries suggests neither of these solutions are desirable; some sovereign wealth funds have been subject to significant abuses – as noted above.

We are not suggesting a change to the taxation of investment earnings, but we do however submit that this source of differential experience, on top of those associated with different work histories, reinforce the need to see the superannuation system as one element only of retirement incomes policy.

Table -3 Results for 10,000 simulations

	Account balance at 67	Lifetime annuity	Years on ASFA modest living standard assuming different real discount rates			Years on ASFA comfortable living standard assuming different real discount rates		
			1%	2%	3%	1%	2%	3%
Fund Rank:								
100	\$462,017	\$20,061	18.0	19.8	22.3	11.1	11.7	12.4
99	\$467,121	\$20,282	18.2	20.1	22.6	11.2	11.9	12.6
75	\$488,857	\$21,226	19.1	21.2	24.1	11.8	12.5	13.3
50	\$499,071	\$21,670	19.6	21.8	24.9	12.0	12.8	13.6
25	\$509,543	\$22,124	20.0	22.4	25.7	12.3	13.1	14.0
2	\$532,988	\$23,142	21.1	23.7	27.5	12.9	13.8	14.8
1	\$539,114	\$23,408	21.3	24.0	28.0	13.1	14.0	15.0
Mean	\$499,121	\$21,672	19.6	21.8	24.9	12.0	12.8	13.6
Range:								
1 to 100	\$77,097	\$3,348	3.3	4.2	5.7	2.0	2.2	2.6
2 to 99	\$65,867	\$2,860	2.9	3.6	4.9	1.7	1.9	2.2

Table 4: Percentage by which the account balance in the top performing fund exceeds the worst performing fund for different effective tax rates on investment earnings and standard deviations of relative performance in gross returns

		Standard deviation of relative performance in gross returns				
		0%	0.5%	1%	1.5%	2%
Effective tax rate on investment earnings	0%	0.0%	11.6%	24.6%	39.1%	55.3%
	5%	0.0%	10.8%	22.9%	36.2%	50.9%
	10%	0.0%	10.1%	21.2%	33.4%	46.8%
	15%	0.0%	9.4%	19.6%	30.6%	42.9%

15 Is there evidence the system encourages and supports older Australians who wish to remain in the workforce past retirement age?

We have nothing to add here.

- 16 We are not aware of any such evidence. We might suggest that it is important that the system is equitable, and that perverse incentive effects exist only when it is not. To what extent does the retirement income system compensate for, or exacerbate, inequities experienced during working life?

We have nothing to add here.

- 17 What are the implications of a maturing SG system for those who are not covered by compulsory superannuation?

Contractors and small business owners who fail to accumulate assets within or without their businesses may be left with only the Age Pension on which to rely in retirement. Requiring them to contribute would reduce their ability to invest in their own businesses which would have negative impacts on them and the economy. See also the OECD discussion mentioned in note 8.

Sustainability

- 18 What should the Panel consider when assessing the sustainability of the retirement income system?

The retirement income system is sustainable as long as it does not place an unfair burden on the economy and future generations. To assess this, a national balance sheet, which includes natural resources, is required – as argued by the World Bank.⁷⁸

- 19 What factors should be considered in assessing how the current settings of the retirement income system (e.g. tax concessions, superannuation contribution caps, and Age Pension means testing) affect its fiscal sustainability? Which elements of the system have the greatest impact on its long-term sustainability?

We have nothing to add here.

- 20 How can the overall level of public confidence be assessed? What evidence is available to demonstrate the level of confidence in the system?

We have nothing to add here.

Cohesion

- 21 What should the Panel consider in assessing whether the retirement income system is cohesive?

Means tests

Australia is the only country in the Mercer survey⁷⁹ with both an assets test and an income test for the Age Pension. The two means tests are confusing and complicated. They also make planning much more difficult for retirees.

The assets test was introduced to ensure that certain assets held by retirees were not excluded from the application of the means tests thereby improving the fairness of the system. However, such a

⁷⁸ <https://openknowledge.worldbank.org/handle/10986/29001>

⁷⁹ See note 14.

desire does not require the application of two tests. The income test is preferable, if there were to be one means test, and it is the system used in most other retirement systems. In order to reduce the Age Pension (which is an income) any assets test has to convert the assets into the equivalent of an income. Given that the income test is currently set at 50% of income, the current assets test is equivalent to deeming the income from the assets at 15.6% p.a. (twice 7.8% p.a. of \$3 per \$1000 per fortnight).

There are essentially three alternative coherent approaches to converting assets into income.

1. Most generous is to allow pensioners to retain their assets and only count the investment income as available for consumption. This is what is done with the current income test where a deeming rate is used. The main deeming rate is 3.25%, which, while penal for fixed interest investments, is generous for equity investors – but we it has been investigated and we can take it as being a fair rate under current circumstances,
2. Less generous is to regard the assets as available for spending over a limited period and reducing benefits accordingly. The shorter the period, the lower the rate of generosity. Spread over a fortnight, the assets would all be treated as income. The current assets test, effectively calls for the assets to be spread over about 7 years ($1/.156=6.3$, but interest will be earned over that period). If people spend their assets more quickly, their loss of Age Pension under the asset test is less than it would be under the income test. If they spread their assets over a longer period, the loss is greater under the asset test.
3. An in-between alternative, in which one spreads the assets over the individual or couple's expected lifetime using an annuity rate appropriate to the pensioner, their partners and any dependents. This would vary by age, and possibly by gender and relationship status and so would be fairer. This method would also be consistent with the view that superannuation assets are intended to be fully consumed over the life time. By way of example, a home-owning 95 year old couple with \$800,000 in financial assets is wealthy; a 65 year old couple in the same circumstances can barely afford a lifestyle equal to the Age Pension.

We submit that there is a good argument for using method 3 rather than the arbitrary term used in method 2 to all financial assets, including assets that may not be producing any income such as holiday houses, collectables or gold bullion.⁸⁰

22 Does the retirement income system effectively incentivise saving decisions by individuals and households across their lifetimes?

The retirement income system does not effectively incentivise saving decisions by individuals and households; the assets test on the Age Pension creates significant *disincentives* to save for retirement or drawdown appropriately during retirement for both singles and couples. The disincentives are highest for those closest to the asset test thresholds. The Panel has already noted the analysis in Asher and de Ravin⁸¹ and their attention is also drawn to Asher's earlier submission on the issue⁸².

⁸⁰ This can be done by dividing the value of the assets by the Pension Valuation Factors (PVFs) in Column 4 of Schedule 1A of the SIS Regulations for singles; higher PVFs should be used for couples.

⁸¹ Asher A and De Ravin, J (2018) The Age Pension Means Tests: Contorting Australian Retirement. Presented to the Actuaries Institute Financial Services Forum, April.

⁸² Asher, A (2017) Discussion Paper: Social security means testing of retirement streams.
<https://engage.dss.gov.au/wp-content/uploads/2017/03/Discussion-Paper-response-20170206.pdf>

23 What evidence is available to show how interactions between the pillars of the retirement income system are influencing behaviour?

The calculations in Asher et al (2014)⁸³ suggest that retirees subject to the asset test withdraw 10% of their assets each year more than those who are not.

24 What is the evidence that the outcomes the retirement income system delivers and its interactions with other areas (such as aged care) are well understood?

While the answer to the previous question shows that there are many who do understand the system, the misconduct revealed by the Hayne Royal Commission illustrates that there are aspects of the system not fully understood by many consumers, companies and regulators.

We would draw particular attention to the role of Refundable Accommodation Deposits, which are a source of unnecessary concern for many retirees and are a poor source of funds for providers.⁸⁴

25 What evidence is there that Australians are able to achieve their desired retirement income outcomes without seeking formal financial advice?

We think this unlikely, but the Hayne Royal Commission and the UK experience mentioned on page 3 above, suggest that advisors may not always provide guidance that is in the best interests of their clients. There is perhaps an argument for suggesting that superannuation funds should be compelled to provide a level of disinterested advice.⁸⁵

26 Is there sufficient integration between the Age Pension and the superannuation system?

It would be surprising if there was. Responsibility for the two systems is divided between two government departments and three agencies, with aged care being the responsibility of a third department. The following point applies internationally:

There appears to be a wide gap between the people in the departments responsible for social security and those for taxation. The best of the former are motivated mainly by compassion, the latter by efficiency; they come from different intellectual disciplines, read different newspapers and journals, appear likely to vote for different parties and are advised internationally by different agencies. The International Labour Office (ILO) advises the former and the World Bank and International Monetary Fund (IMF) interact with the latter.⁸⁶

This paper goes on to suggest that within the confines of their brief, the departments and agencies meet many of the criteria of justice. The combination however does not.

The Actuaries Institute Green Paper makes the following recommendations:

The lack of coordination of government policy could be addressed in a few ways.

⁸³ See reference in note 70.

⁸⁴ See Actuaries Institute note 28, page 31.

⁸⁵ Members of the Actuaries Institute are preparing a Dialogue paper on this issue.

⁸⁶ Asher, A (2006) "Means Tests: an evaluation of the justice of imposing high rates of claw-back on those of modest means", Presented to Institute of Actuaries Financial Services Forum
http://www.actuaries.asn.au/IAA/upload/public/fsf06_paper_asher_means%20tests.pdf

Option 1: Legislate objectives for the retirement system

Coordination could be facilitated by legislation that sets out the objectives of each element of the retirement system and the principles for integration between them. Such principles could lead to the reform examples included in this Paper of a unified means test for the Age Pension and aged care and rules for approaching the questions of inter-generational and intra-generational equity.

Option 2: Set up a coordinating body

A more flexible approach would be to ensure coordination of policy development by setting up an inter-agency group to make recommendations to government. It should have a wide remit to address structural issues as well as changes in parameters. This body should include representation from the departments of Aged Care, Australian Government Actuary, Health, Social Services, Treasury and Veterans' Affairs.⁸⁷

⁸⁷ See note 28, p31

Appendix

The main point of the model is to demonstrate how performance relative to benchmark may generate horizontal inequity. We therefore begin by explaining the model of gross returns used to generate returns for each fund, then outline the assumptions used to project the member's balance.

Annual gross returns for each fund were simulated using the following structure:

$$r_{i,t} = r_{b,t} + rr_{i,t}$$

Where:

- $r_{i,t}$ is the annual return for fund i at time t
- $r_{b,t}$ is the annual benchmark return at time t , which is assumed to be normally distributed.
- $rr_{i,t}$ is the annual relative return at time t , which is assumed to be normally distributed.

$r_{b,t}$ and $rr_{i,t}$, $r_{b,t}$ and $r_{b,t+1}$, $rr_{i,t}$ and $rr_{i,t+1}$, and $r_{b,t}$ and $rr_{i,t}$ are assumed to be independent. That is, it is assumed that there is no serial correlation, and annual benchmark returns and annual relative returns are independent. The benchmark portfolio is assumed to be a "balanced" fund.

The parameters used for the return distributions are shown below.

Table 5 Parameters used for the gross return distributions

Parameter	Value	Basis
Annual benchmark return ($r_{b,t}$):		
Mean	7.7%	Adopted from Ellis (2008) for default options, excluding conservative default options. ⁸⁸ APRA's heatmaps show a 5-year average <i>net</i> investment return of approximately 7.3%.
Standard deviation	7.0%	Adopted from Ellis (2008) for default options, excluding conservative default options. ⁸⁹ APRA's heatmaps cannot be used to estimate this parameter, as APRA reports 5-year averages rather than relative performance in individual years
Relative return ($rr_{i,t}$):		
Mean	0.00%	Ellis (2008) ⁹⁰ reports that the industry gross investment returns underperform the benchmark by 0.1%. APRA's heatmap reports a 0.02% underperformance for net investment returns. 0.00% has been assumed for neutrality.
Standard deviation (i.e. the 'standard deviation of relative performance')	0.75%	The standard deviation of 5-year average net investment returns relative to the Simple Reference Portfolio reported by APRA is 0.62%. This figure has been adjusted for expenses and taxes, which account

⁸⁸ Ellis, K., Tobin, A. and Tracey, B., 2008. Investment performance, asset allocation and expenses of large superannuation funds. *APRA Insight*, 3, pp.2-20.

⁸⁹ Ibid

⁹⁰ Ibid

		<p>for about 10% of investment returns on average according to APRA's fund-level statistics for June 2018 and 2019.</p> <p>Since the standard deviation is of a 5 year average relative to benchmark, it is likely an underestimate of the standard deviation of one year returns relative to benchmark due to the smoothing effect of averaging.</p>
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We then use the gross returns simulated for each fund from age 18 to age 67, with the following assumptions about the timing of cash flows:

- Contributions are assumed to occur in the middle of the year
- Expenses are assumed to occur at the end of the year, and are charged as a percentage of the account balance
- Taxes occur at the end of the year, and are a percentage of investment returns

In Table 6 below, we outline the remaining assumptions and our basis for them where appropriate.

Table 6 Parameters used for the member account balance simulation

Parameter	Value	
Age	18	
Retirement age	67	
Initial taxable income	\$40,000	
Contribution rate	9.50%	
Before-tax wage growth	3.00%	
Inflation	2.50%	Assumed to be the mid-point of the RBA's target band for inflation.
Tax rate on contributions	15%	
Expenses on account balance	0.75%	Estimated from APRA fund level statistics; June 2018 indicates 0.6%, June 2019 indicates 0.7%. In their heatmap, APRA reports an average of approximately 1.8% and 1.2% for balances of \$10,000 and \$50,000 respectively.
Tax on investment earnings	5.00%	APRA fund level statistics indicate a 1.5% and 3.0% for June 2018 and June 2019, respectively. However, these figures include pension accounts, which receive favourable tax treatment. Therefore, we have assumed 5%, and presented sensitivities to this assumption.