SUBMISSION IN RESPONSE TO THE TREASURY'S DISCUSSION PAPER 'RETIREMENT PHASE OF SUPERANNUATION'

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Introduction

We welcome the discussion paper. Finalising the retirement phase for Australia's superannuation system is long overdue; it is essential to ensuring the system achieves its overall purpose.

The Government's proposed objective is 'to preserve savings to deliver income for a dignified retirement, alongside government support, in an equitable and sustainable way'. With our colleague, Professor John Piggott AO, we made a submission[1] in March 2023 in support of legislating an objective for superannuation and suggested only minor changes to the wording the Government proposed. The emphasis on delivering income and on 'dignified retirement', implying both adequacy and security, can only be achieved if the retirement phase of the system is finalised with an appropriate design and associated governance. Superannuation savings certainly need to be preserved to retirement age, but they then need to be converted into income, drawing on the capital as well as any continuing returns.

The discussion paper's introduction highlights that Australia's system for compulsory retirement saving is 'unique and world-leading'. It is certainly unique in its reliance on defined contributions but, pending settlement of the retirement phase, the reference to 'world-leading' should be heavily qualified. While Australia's system avoids the main weakness of many overseas systems based on defined benefits of rising costs for future generations, and also offers greater flexibility and choice, it does not yet deliver the secure, regular, indexed incomes those overseas systems provide, ensuring retirees can maintain their pre-retirement standard of living for the rest of their lives. And the Australian system involves significant transaction costs and presents retirees with highly complex decisions to make. It has also created a large industry with its own interests that are not always fully aligned with the interests of its members and their families. Moreover, as we, with John Piggott, outlined in our analysis of the 2021 Intergenerational Report[2], there is a real risk of increasing inequality amongst future generations, contrary to the proposed objective's emphasis on being 'equitable', unless the retirement phase of the Australian system is fixed.

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[1] Podger, Piggott and Breunig, 2023. 'Submission on Legislating the Objective for Superannuation'. 9 March 2023

[2] Podger, Breunig and Piggott, 2023. 'Retirement Incomes: Increasing Inequity, Not Costs, across Generations is the Intergenerational Problem', in Podger *et al* (eds), *More than Fiscal,* 2023, ANU Press, Canberra.

The failure so far to address these significant shortcomings is due in large part to the very different perceptions generated by Australia's emphasis on defined contributions and other countries' emphasis on defined benefits. In Australia, individuals understandably focus on the superannuation savings they have accumulated, and they look to achieve best value from those savings when they retire; their funds are strongly pressured through competition to do likewise in what they offer. Overseas, people do not consider the monetary capital value of their entitlements and whether this might have been directed differently to provide better value for them personally, but on the level and security of the benefits they receive; consideration of costs and value for money is left to the system's insurers, mostly governments. A telling illustration of these different perceptions under the different systems despite having the same underlying objective is the total lack of concern overseas that on early death there is no residual benefit other than a surviving spouse's pension; in Australia, there is no interest in a life annuity product without some residual benefit should the person die early (indeed, there is little interest at all in life annuities that commence on retirement).

Acknowledging these different perceptions, and the different priorities they lead to, is important, just as is appreciating that the underlying objective is the same. In settling the retirement phase of our system, and the rules and guidance that should apply, we need to beware of being blinkered by the perceptions our approach generates. We need to moderate our emphasis on choice and competition and getting maximum value from every individual's accumulated savings, to ensure adequate attention to the system's ability to offer all Australians security in retirement by effectively managing longevity, inflation and market risks, making it easy for people to receive what they and their families most need and minimising transaction costs.

In essence, we need to retain the key advantages of our defined contributions approach while also delivering retirement incomes that broadly reflect those provided by defined benefit systems.

Supporting members to navigate retirement

It is the basic design of the Austraian system that makes 'Planning an income to see out one's retirement … inherently complex' as the discussion paper states. Helping retirees to confidently make these decisions should be an essential component of the system.

A first step is to ensure retirees, and those approaching retirement, see their accumulated assets as their retirement income, not their nest egg.

Proposal 1. We strongly support the introduction of a standard reporting arrangement for fund members aged over 45 or 50 which expresses their accumulated savings as the likely retirement income they would generate. The standard reporting arrangement should be regulated, perhaps based upon:

- The current accumulation
- The likely accumulation at age 67 given the current contribution level (at current prices) and some standard real interest rate

- The CPI-indexed life annuity that those accumulated savings could fund at age 67 (at current prices).

This reporting should be compulsory at least annually from age 45 or 50, together with tools (subject to standards regulation) to allow members to test how variations to their contributions or to their retirement age might affect their likely retirement income. The reporting should also explain that, at retirement, options other than life annuities are available but that retirees need to consider carefully how best to manage longevity, inflation and market risks.

We also support better guidance, education and communication particularly at retirement.

Proposal 2. We support the measures listed on pages 10 and 11 of the discussion paper, particularly the establishment of a free and impartial guidance service for retirees in or approaching retirement. We also support the inclusion of SMSFs in the retirement income covenant: their omission might be perceived as endorsement of SMSFs as vehicles for wealth accumulation and tax avoidance rather than retirement incomes. In many cases, such inclusion would probably entail the transfer of funds to a body more expert in retirement income products.

The role of funds in supporting members to navigate retirement is considered in more detail in the later sections of the discussion paper (and this submission). In essence, the covenant should lead to retirement income products which would effectively replace the current practice of the minimum drawdown rates being the default arrangement for far too many retirees.

Proposal 3. Consistent with their covenant obligations, funds should offer at least three standardised retirement income products likely to be in their retired members' best interests: one for those likely to be eligible for maximum rate age pensions (which will meet most if not all the longevity risk protection they need), one for those likely to be eligible for some age pension now or in their later retirement years (but wanting a secure lifetime income above the age pension), and one for those unlikely to be eligible for any age pension (and hence needing a product that delivers income well above the pension which is adequately protected against longevity and inflation risk as well as market risk).

The inherent complexity facing retirees is due not only to the Australian superannuation system's reliance on defined contributions. A major factor is the role of the age pension and its means test. Even when the superannuation system reaches full maturity, around 60% of those over 67 (and a higher proportion of the very old) are expected to be in receipt of some age pension with around half of these on a part pension. The very nature of the age pension system – providing minimum income protection in old age – makes its interaction with the superannuation system complex. It focuses on the needs of couples, not just individuals, and is concentrated on those with most need. This suggests that, even if changes were made to the policy settings to reduce complexity (see below), support will be needed to help retirees find whether they may be entitled to an age pension and how best to combine such entitlement with their superannuation retirement product.

The discussion paper identifies some light touch and more active approaches to such support.

Proposal 4. We firmly support more active approaches, complementing funds' covenant obligations, to assist members to identify any likely age pension entitlement and to identify the most appropriate superannuation product to combine with their age pension. Funds should be able, with members' consent, to access information on partners' superannuation and personal details as well as other information on assets, and link with Services Australia assessments (they should also be able to link with any Aged Care assessments).

This will not be sufficient, however, as the current age pension means test presents almost insurmountable difficulties for those eligible for some age pension but with assessable assets above the assets test threshold (and for funds in designing retirement income products for these members). The assets test taper provides an incentive to divest some of their assessable assets not necessarily consistent with achieving the best retirement income (similarly, it may discourage additional savings in pre-retirement for some members). Australia is alone in having separate income and assets tests on their social assistance for older people, and the two tests are not consistent with each other.

Proposal 5. There is a strong case to merge the income and assets tests for age pensions. This would be consistent with the Henry Review on Tax and Transfers. Appropriately designed[3], it could also provide encouragement to include life annuities as a major component of the retirement income products funds offer under the covenant.

The discussion paper also asks what 'good' looks like for how funds support and deliver income to their members in retirement. We would emphasise the reference to 'dignified retirement' in the proposed objective for superannuation, and the importance of retirement income products that offer security and a decision-making process that can be undertaken easily and with confidence. There would also be advantage if 'good' was linked to some benchmark of the adequacy of the retirement income (including any age pension). Internationally, the most common benchmark for the protection of living standards in retirement is around 70 percent of pre-retirement income; given the tax-exempt nature of our superannuation benefits, an equivalent Australian benchmark would be between 50 and 60% of gross pre-retirement income in most cases.

Supporting funds to deliver better retirement income strategies

Table 1 in the discussion paper demonstrates the tardiness and resistance to resolving the retirement phase of the superannuation system despite the wealth of evidence about the need to do so. Even the covenant obligation taking effect from July 2022, despite its importance, only requires funds to develop, publish, implement and regularly review a retirement income strategy: it does not require funds to offer products that are in their members' best interests as had been intended by the earlier suggestion of comprehensive

[3] See Andrew Podger and David Knox presentation on the possible design of a merged means test to the December 2019 CEPAR Conference (copy available on request).

income products in retirement (CIPRs). And as the discussion paper highlights, the availability of such products remains limited and the take-up of products involving longevity insurance (one of the stated objectives of the mandated strategies) remains extremely low.

The discussion paper seems to pin its hopes for appropriate products on a ‘competitive, comparable and transparent’ market. We are not fully convinced. We strongly suspect that many retirees just want good guidance on a suitable product and do not wish to make the effort to explore the market either on retirement or later; at most, many might consider varying their mix of products and investment profiles, but few will examine options to switch funds (moreover, switching funds after purchasing products including longevity insurance – a key component of most ‘good’ products - might not be easy).

If we are correct (and evidence from CEPAR research suggests we probably are), the measures outlined in the discussion paper will not be sufficient, worthy as they are. We are also conscious of the challenges involved in making comparable assessments of funds’ retirement income products.

Proposal 6. The standardised product disclosure framework suggested in the discussion paper should be adopted, but in addition consideration should be given to other measures to press funds to offer products in their members’ best interests (see next section in particular). The framework should be used, not so much to ensure market competition, but to protect retirees from funds that do not offer and deliver ‘good’ products. Reports should guide retirees to funds with ‘good’ products, particularly ‘good’ standardised products.

The covenant arrangement refers to three objectives: maximising retirement income. managing risks and having some flexible access to savings. We are concerned that the last objective is continuing to receive priority, driven by the continuing focus on accumulated savings; it is not an objective at all in defined benefit systems. The failure to give sufficient priority to products which manage risks efficiently is also encouraging retirees to keep too much money in reserve. Better guidance to retirees, and to funds, would ensure better informed choices about the balance between these three objectives.

Proposal 7. In particular, the Government should clarify how its Medicare and aged care policies provide protection against the risk of high costs associated with serious health problems, and the likely limits to out-of-pocket costs those policies entail beyond those which can be reasonably met from regular incomes and home ownership (including health insurance premiums, living expenses and accommodation costs). We have not done any detailed work on this, but note that the aged care system has lifetime caps on individuals’ costs of care (around $78,000) which very few people ever reach; the Government, with advice from PHI funds, might also be able to provide guidance on likely limits to major out-of-pocket medical costs requiring access to capital for both those relying upon public hospital care and those with PHI using private hospital care. Our suspicion is that in very few cases more than $50,000 would be involved.

The discussion paper refers to possible regulatory barriers to innovation and equitable social security and taxation treatment. We do not have expertise in this area but are concerned that regulatory requirements may be contributing to the failure of funds to offer attractive prices for life annuities (including deferred annuities). The suggestions in the next section of the discussion paper (and this submission) might help in this regard.

Making lifetime income products more accessible

The discussion paper rightly highlights three risks that retirement income products should manage: market risk (or, to use the term in the covenant, 'investment and sequencing risk'), inflation risk and longevity risk. Managing these well is essential to achieving the 'dignified retirement' referred to in the proposed objective. The paper goes on to highlight that individual circumstances are different and there is no one size fits all approach. That may be true, but it is not clear that every effort should be made to tailor products to every individual's circumstances. As mentioned, we believe many retirees just want assurance that the products they purchase from their savings will deliver reasonable security and a reasonable income. That is most likely if funds offer standardised products they believe to be in the best interests of members in major categories of circumstances, with a limited range of optional variations for each category.

We strongly endorse the William Sharpe comment mentioned on page 22 and the following statement that longevity risk cannot be efficiently self-managed without access to appropriate financial products. Accordingly, the vast majority of retirees should be allocating a significant part of their superannuation savings to such products (only those for whom the age pension provides sufficient protection should not be directed towards such products).

The discussion paper lists obstacles to both the supply and demand for such products and offers some suggestions to address them.

Proposal 8. We endorse the suggestion of Government reinsurance (or longevity bonds) to make the price of longevity insurance products more attractive. But we fear this will by no means be sufficient to persuade retirees to allocate significant amounts towards such products, nor sufficient to facilitate rapid availability of life annuities.

We note in this regard that the introduction of indexed bonds in the early 1980s failed to lead to financial institutions offering indexed annuities as had been the policy objective at the time. There may therefore be some lessons to consider from that experience about the likely success of longevity bonds.

As the discussion paper notes, one obstacle to take-up by members is the perception of 'waste', a perception that never arises in overseas defined benefit schemes. Products with some reversionary benefit may counter this perception but, of course, only at an additional cost.

Proposal 9. An option not canvassed in the paper is for the Government itself to offer life annuities for sale at a price determined by the Commonwealth Actuary. This is not as radical as it might sound – it would be far less interventionist than overseas defined benefit schemes whose costs are met by current and future taxpayers, and less than that involved in the age pension (again funded by taxpayers).

A first step might be to offer indexed lifetime annuities within the existing Home Equity Release loan scheme. However, this is currently restricted to pensioners and to drawing on home assets. There seems no reason why a broader range of retirees should not be able to purchase an indexed annuity from the Government from their superannuation savings. Funds could then include such annuities in the standardised products they offer, with options for more sophisticated longevity protection products as they are able to develop them.

The discussion paper canvasses a variation of the former CIPRs idea in the form of 'standardised products' which would balance the three objectives set out in the covenant. While attracted to this suggestion, we remain concerned that for many the standardised product may give excessive priority to flexible access to capital with the risk of much higher inheritances than the retirees consciously intended.

The appendix to the discussion paper provides an illustration of the suggested standardised product. We strongly suspect it would need to have some basic variations related to members' likely eligibility for age pensions. We are also concerned that it still gives insufficient priority to longevity protection and excessive priority to access to capital (both the original capital reserve and the amount remaining in the account-based pension when the deferred annuity kicks in, or on earlier death). As a result, the retirement incomes system as a whole will not manage longevity risk as efficiently as it should.

Proposal 10. We endorse the suggestion of standardised products with the following variations and additions to those in the appendix:

- At least three major standard products related to eligibility for age pensions (broadly when the balance (with any partner's balance) is under the assets test threshold (currently around $450,000 for homeowner couples), or between that and when the assets balance means any eligibility for age pension cuts out (currently around $1,000,000 for homeowner couples), or when the balance exceeds that amount.
- A more limited minimum indexed capital reserve (say, $25,000)
- The default deferred lifetime annuity to operate from age 80, not 90, with options from age 65 (requiring a much more limited account-based pension)
- A minimum allocation to permitted lifetime annuity and pension products of, say, 50% where the balance is over $300,000 and 75% where the balance is over $800,000; permitted products to incorporate lifetime annuities (immediate or deferred) which may be combined with term annuities and/or account-based pensions, so long as together they deliver sufficiently secure incomes over members' full retirement years (this being the focus of the products being permitted).

Proposal 11. This last provision of minimum allocations to permitted lifetime annuity and pension products should apply universally, not just to standardised products. This would provide better assurance than the minimum drawdown rules that superannuation savings are directed to genuine retirement incomes, not just wealth accumulation.

Conclusion

The discussion paper contains many useful suggestions, but much firmer action is needed to ensure Australia's retirement income system meets its objective. There is serious risk otherwise that, far from having a world-leading system, we will fail to deliver what other countries' systems - ones Australian officials have long criticised – achieve in terms of adequacy, equity and simplicity. We need to change mindsets to ensure that the system is seen to be about delivering secure retirement incomes, not about accumulating wealth.

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