



Investment & Financial Services Association Ltd

ACN 080 744 163

14 June 2002

The Secretary
Senate Select Committee on
Superannuation and Financial Services
Parliament House
CANBERRA ACT 2600

Dear Ms Morton

Reference:

the adequacy of the tax arrangements for superannuation and related policy to address the retirement income and aged and health care needs of Australians

The Investment & Financial Services Association represents Australia's leading investment managers and life insurance companies. Our 100 members hold more than \$670 billion in assets under management on behalf of nine million Australians who have superannuation and managed funds.

Our submission on this reference is attached. We would be pleased to appear before the committee at its convenience.

The press notice placed by the Committee indicated the inquiry 'will focus on people's standards of living in retirement and the factors that contribute to that'. We have shaped this submission accordingly.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Lynn Ralph', with a long horizontal flourish extending to the right.

Lynn Ralph
Chief Executive Officer



Investment & Financial Services Association Ltd
ACN 080 744 163

**SUBMISSION TO
SENATE SELECT COMMITTEE ON SUPERANNUATION
JUNE 2002**

OVERVIEW

Reference:

the adequacy of the tax arrangements for superannuation and related policy to address the retirement income and aged and health care needs of Australians

The Investment & Financial Services Association represents Australia's leading investment managers and life insurance companies. Our 100 members hold more than \$670 billion in assets under management on behalf of nine million Australians who have superannuation and managed funds.

The key points made in this submission are:

- ***Adequacy Target:*** The appropriate minimum replacement rate target for retirement incomes should be of the order of 75-80% of late working life consumption expenditure, which approximates to 60% of gross income.
- ***Savings Gap:*** Current policy settings (including the age pension) will not deliver this level of retirement income for most retirees, and compulsory superannuation alone will fall far short of the mark.
- ***Perceptions Gap:*** There is a significant gap between Australians' perceptions of an adequate income in retirement and the level of retirement income that would eventuate from current compulsory and voluntary contributions to superannuation.
- ***Consequences:*** Failure to meet retirees' income expectations may well result in political pressure, or indeed a political auction, for ad hoc policy responses such as: an increase to the age pension benchmark; and/or further tax concessions for the retired.

- **Strategies and Solutions:** Solutions to address the adequacy gap are not simple, but must be explored.
 - Additional compulsion could meet significant resistance, but remains an area worth further consideration because of its wide impact.
 - Voluntary saving has a significant role to play, particularly in later life ‘catch-up’ contributions. Removal of annual employer contribution limits, and breaking the employment nexus completely on voluntary contributions, would assist people in building up discretionary retirement savings.
 - Wind-back of front-end taxes would assist in closing the adequacy gap.

Additional comments made in this submission include:

- **Flexibility and simplicity:** The taxation and regulation of superannuation is overly complex and inflexible. Simplification could increase understanding of superannuation, assist some people to save through superannuation, and reduce administration costs. Areas of particular focus could include the following:
 - There are unnecessary and counter-productive rigidities in the transition from work to retirement.
 - Inappropriate restrictions on access for non-superannuation savings to retirement income products should be removed.
 - Annual contribution limits should be removed to allow flexibility in contributions, which would particularly benefit women and those with broken work patterns.
 - There are myriad contribution categories to be checked and tracked - activity with a cost. It could be said that the hardening of these categories is slowly blocking our system.
- **Income Streams:** Growth Pensions should be introduced as a matter of priority, to give retirees access to higher return investments in complying income streams.
- **Fees and Charges:** Recent research shows that fee levels are falling in retail superannuation. The sector is characterised by wide competition, wide choice among and within retail offerings, and transparency in disclosure of fees and charges.
- **Education:** There is an important role for education in discretionary saving (both additional employer contributions from salary packaging and voluntary contributions) and in the promotion of a wider savings culture.

ADEQUACY

General comments on adequacy

There is a wide consensus that current policy settings within the Australian ‘three pillar’ retirement incomes policy framework are not sufficient to deliver adequate income in retirement to a large number – perhaps most – Australians. The level of compulsory contributions, the Superannuation Guarantee (SG) at 9% from 1 July 2002, will not deliver a retirement income to match retiree expectations.

This gap between expectation and reality has been demonstrated in a wide range of research. The critical point is that adequate retirement incomes - at the levels generally accepted (see below) - will not be achieved by a significant proportion of the retiring population for some decades. This gap will cover the baby boomer cohort, who begin retiring from 2002.

A consequence of this expectation gap is that, if it is not addressed in prospect, electoral pressure from disgruntled retirees may drive policy responses in the future. The likelihood of a political auction for the grey vote under those circumstances is quite high. If that auction eventuates, it has the potential to increase the cost of retirement income provision (age pension in particular) beyond the 4.6% of GDP predicted the Intergenerational Report 2002-03 (IGR) – figures from the Retirement Incomes Task Force (RIM) and its successors. Political pressures could also result in increases in the concessional tax treatment of retirement incomes, reducing revenue in the same fiscal periods that higher levels of income support are required.

Adequacy targets

IFSA’s view is that target replacement rates for retirement incomes should be in the range of 75 to 80% of pre-retirement consumption expenditure, as a minimum.

The widely accepted measure for adequacy in retirement income has been the rate of replacement of pre-retirement income, net of taxes and transfer payments. Numbers widely regarded as an acceptable level of adequacy include a replacement rate of pre-retirement gross income of the order of 60%, and 75-80% of pre-retirement consumption expenditure. Some attitudinal research has found that people currently saving for retirement have an expectation of the same standard of living in retirement as in working life – which could imply a replacement rate as high as 100% of pre-retirement consumption expenditure.

A more expansive discussion of adequacy targets is included at Appendix 1 – Living Standards in Retirement.

The adequacy gap

Current policy recognises that most retirees will continue to rely on a mix of private savings and public income support in retirement. The adequacy levels proposed here (and by a wide range of groups and commentators) will require significant private savings: RIM calculates that the full age pension on its own, at 25% Male Total

Average Weekly Earnings (MTAWE) on a gross income basis, represents about 37% of Average Weekly Earnings (AWE) on a consumption basis.

It is clear that retirement savings (compulsory and discretionary) will have to contribute very substantially to retirement income to achieve levels retirees themselves will regard as adequate. In the ANOP research conducted in 2001, 7 in 10 indicated they would require at least 60% of AWE, and 5 in 10 wanted about 100% of AWE. Other research shows similar expectations.

The RIM has projected a replacement rate (average across retirement) of around 65% of final year of working life consumption expenditure from full SG (including age pension), based on 30 years work at Average Weekly Ordinary Time Earnings (AWOTE). This measure is still short of the 75 – 80% benchmark, and it is also somewhat inflated by real growth in the age pensions. The same case would only show a replacement rate of 54% if the first year of retirement income were used, rather than an average across retirement.

The relative merits of benchmarks to assess adequacy are discussed in Appendix 1.

Importance of the Age Pension safety net

A strong and sustainable safety net is critical to the overall adequacy of retirement incomes. This is the ‘first pillar’ or our retirement incomes policy and sets a floor below which retirees do not fall. The minimum benchmark for age pension, currently set at 25% of male total average weekly earnings (plus GST compensation), is important. In addition to ensuring that the least able to save for their retirement do not lose touch with retirement income standards across the community, the benchmark provides an important income component for the vast majority of retirees, for whom at least a part pension will from a vital component of their retirement income. IFSA considers that a benchmark, tested at least periodically to ensure it remains relevant, should be retained to keep the first pillar effective within the overall policy framework.

Background: long term outlook for public and private savings

Demographic changes have implications for Australia’s future level of both public and private savings. A fuller background discussion is at Appendix 2 – Social Change. A background to superannuation saving is at Appendix 3 – Saving through Superannuation.

The Government’s first Intergenerational Report makes a valuable contribution to our understanding of the scale of the intergenerational problem Australia faces in the next four decades. The Report projects the impact of demographic changes on public savings, i.e. the gap each year between revenue and outlays,¹ with a budget surplus until 2016-17, after which the deficit will grow to 5% of GDP each year from 2042.

¹ Revenue is assumed constant from 2005-2006 at 22.4% of GDP (slightly lower than the 23% in 2001-02, while outlays will grow from 23.5% of GDP in 2001-02 to 27.4 per cent of GDP in 2042.

This is a significant burden to transfer to the next generations of taxpayers, notwithstanding the measures announced in the 2002-2003 Budget to curb growth in the costs of pharmaceuticals and disability payments, albeit after extending eligibility to a greater number of older Australians in the previous year.

The major areas of the Budget that increase with an ageing population are health spending and income support payments to individuals. Both are significant contributors to the pressure on public savings over the next four decades.

Health spending in 2001-2002 was equal to \$27.5 billion. Spending could double from double from 4 per cent of GDP today to 8.1 per cent of GDP in 2042. A substantial part of this increase is due to the growth in the cost of the Pharmaceutical Benefits Scheme (PBS) – a projected increase from 0.6% of GDP in 2001-2002 to 3.35% of GDP in 2042. Just as population growth and ageing account for only a minor part of the recent growth in health spending,² the main factors cited as underlying these growth projections are the impact of the growing cost of new health technology, increasing use of medical services and consumer demand and expectations. Future policy intervention could significantly reduce fiscal expansion in health - it is often suggested that supply leads demand in the health arena.

Assistance to the aged, principally the income payments and residential care, was \$28.8 billion in 2001-2002, including assistance to veterans and their dependants.

Age and service pensions alone are expected to increase from 2.9% of GDP in 2001-2002 to 4.6% of GDP. These projections assume that growth in superannuation savings partly offsets the cost of income support.³

The cost of aged care is expected to rise from 0.7% of GDP in 2001-2002 to 1.8% of GDP in 2042.

Governments, now and in the future, have a number of options to finance any shortfall in public savings by:

- imposing higher taxes on the contemporary generation of taxpayers;
- cutting benefits to current and future generations of retirees, for example by holding the ratio of spending on the aged to GDP constant;
- targeted policy intervention to reduce future cost;
- transferring the cost to future generations of taxpayers, through increasing government debt.

While there are policy options such as to reduce benefits or to tighten eligibility and targeting of assistance it is likely that the majority of older Australians would continue to rely on a mix of public and private savings to sustain living standards in the future⁴

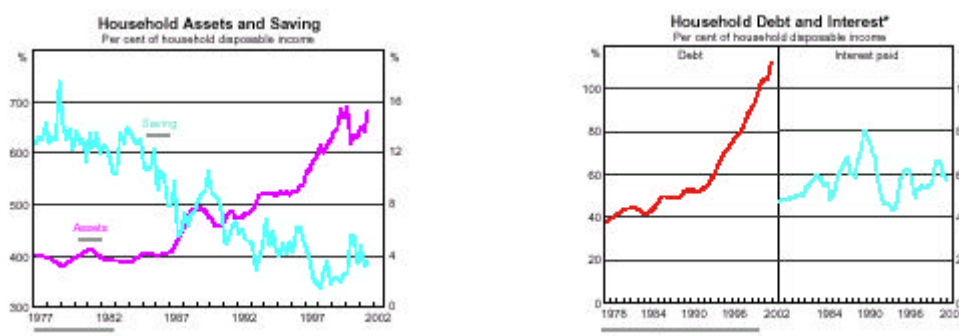
² Budget Statement Number 2 page 1-12

³ RIM Taskforce-Rothman

⁴ RIM work

Private savings

While there are measurement problems, the trend in household savings is downward.



The message from these RBA charts is that Australians are saving about a third as much of their income as they did 25 years ago, while the value of their household assets as a percentage of disposable income has increased by 70%.

Contributions to superannuation have a major benefit as they are long term savings.

Returning to the financing gap, as a rule of thumb every 3% increase in total gross superannuation contributions is the equivalent of lifting savings by 2% of GDP, or \$14 billion in today's dollars. Compare this with the \$87 billion gap in today's dollars, and it is apparent that growing superannuation has a major role to play.

FISCAL SUSTAINABILITY – ELECTORAL PRESSURE

IFSA is concerned that failure to meet retiree expectations could well lead to future political pressure, or indeed a political auction, for ad hoc policy responses such as: an increase to the age pension benchmark; and / or further tax concessions for the retired.

While the age pension will remain a critical component of retirement income for most retirees, the increased cost over the next few decades contributes significantly to the demographic increases in government expenditure outlined in the IGR. If there are non-demographic increases to age pension outlays, or to tax concessions on retirement incomes, these will have a further impact on fiscal sustainability. IFSA is not advocating for or against such changes – merely pointing out the consequences.

Recent Federal budgets have seen a range of measures, which have increased the reach of social security payments and taxation concessions for retirees extended up the income scale. For example, the reduction in the income test withdrawal rate from 50% to 40% associated with the introduction of the GST increased the proportion of the over 65 population from 83% to 85%, on government figures.

The 2001 Federal Budget significantly increased the reach of the tax rebates available to retirees. This measure was estimated to cost revenue over \$306 million in its first year of operation, fluctuating slightly over the forward estimates period to \$307million in 2004-05. Its long-term impact may well be significantly higher.

Disaffection among retirees about the adequacy of their incomes could well lead to a political auction for the grey vote. Many of these changes would be likely to have their most significant impact at the time fiscal pressure is greatest.

Possible responses to a disaffected grey vote could include:

- Increased tax concessions on retirement income, such as converting the current rebate to a genuine threshold or even a lower income tax scale for retirees (defined by age or other characteristics);
- Reductions in age pension means tests; and/or
- Increases to the basic age pension benchmark.

As with the increases to tax rebates, these concessions might have a small initial impact compared to their long-term effect.

We have not included this comment to raise undue alarm about the non-demographic pressures on retirement incomes outlays and revenues. What we consider should be recognised is that, if the expectations of a large number of retirees about their retirement living standards are not met, there will be electoral pressure to address their disaffection. It may not be possible to ignore an expectation ‘gap’ if it eventuates.

STRATEGIES TO FILL THE ADEQUACY GAP

The most critical point in consideration of strategies to improve retirement incomes adequacy is that any savings-based strategy must begin as soon as is feasible, if it is to have a marked effect within a reasonable timeframe. Many analyses, including this submission, identify a gap in retirement savings, both to adequacy benchmarks and in terms of retiree expectations: additional savings to fill this gap will need time to compound earnings if they are to have real impact.

Compelling contributions - the second pillar

One key question for retirement incomes policy is – having determined what is “adequate”, what strategies could achieve it. For instance, while there is general agreement that 9% SG alone will not deliver adequate retirement incomes, there is no such general agreement about the source of any additional compulsory contributions. There is, however, a wide community acceptance of the superannuation guarantee, which persists today⁵. The challenge may be to see whether this broad support would extend to additional compulsory contributions.

The impact of compulsory contributions - across the whole working population - means that the option of additional compulsory retirement saving deserves serious consideration.

Employer Contributions

IFSA recognises that there would be some current difficulty in achieving a political consensus to raise the level of compulsory employer contributions to superannuation.

The SG commenced in a context where the issue was access to superannuation as a benefit of employment, following the introduction of award superannuation in the 1980s. Award superannuation did not cover all workers, and the SG was proposed to extend coverage across the workforce, an objective it has largely satisfied.

The SG rate rose in a period of productivity and real wage growth, during which real wages grew in addition to the growth in compulsory superannuation contributions. The conditions that obtained during the introduction and growth of SG might well not apply to a possible future extension to the SG rates. We have already seen the question of SG increases beyond 9% become contentious. If compulsory employer contributions were widely perceived to reduce take-home pay, employees themselves might well oppose extension.

Employee contributions

The other source of compulsory contributions is individuals - realistically, employees, and possibly the self-employed. Simply compelling retirement savings directly from individuals would be a departure of some magnitude from established policy. Unless any such arrangement had broad political support, it is easy to see a proposal suffering as rapid as demise as did the reported Labor comments on increasing SG beyond 9%.

⁵ IFSA Retirement Savings – Desires and Drivers Research Project

While IFSA does not pursue this as policy, there may be some merit in considering a scheme with some level of compulsion individual retirement saving, in the context of some broader solution. It would seem that some element of partnering between government and private savings would be essential to overcome the (possible) perception that compulsion merely represents a tax ‘grab’.

Some more novel options could be considered, possibly using the same strategy as the SG – that is, increasing retirement savings while ensuring real take-home pay does not fall. For instance, an income tax cut could be directed to retirement savings.

Voluntary savings – The Third Pillar

Voluntary private savings represent the third pillar of Australia’s retirement incomes policy, yet we still understand little of what actually drives them. Voluntary personal contributions, and discretionary employer contributions, have an important role to play in achieving individual adequacy. This is particularly true where individual experience – such as a broken work pattern – differs from the collective.

IFSA undertook research into the drivers of retirement savings in 2001, as part of its Retirement Savings – Desires and Drivers project. Key findings are included in this submission, in this section and below.

Along with inferences drawn in a number of other research projects, the qualitative research found that perception of a retirement ‘gap’ did not appear to be a major driver of discretionary retirement saving. We did find that having an accumulation of savings appeared to focus people’s attention on the need to build retirement savings.

On barriers to voluntary saving, we discovered there were very low levels of planning the financial aspects of retirement, among pre-retirees. The main reasons for this included⁶:

- Other commitments eg children, home, too much debt, businesses being a drain on funds or drain on energy
- Poor ability to save/failure to think long term/other more immediate goals take priority eg extending/upgrading home
- Belief that they would always be able to earn an income/would want to work in some capacity
- Lack of disposable income to devote to saving (eg due to business failure)
- Life events intervening or reducing existing savings or investments (eg retiring earlier than expected due to ill health).

On reasons for voluntary saving, we found those who were pre-planning at all (the minority) tended to be those who displayed one or more of the following characteristics⁷:

⁶ IFSA Retirement Savings- Desires and Drivers Project – Qualitative findings

⁷ IFSA Retirement Savings- Desires and Drivers Project – Qualitative findings

- ❑ Looking forward to retirement (early retirement for some) because of lifestyle aspirations (reduce stress and/or pursue a hobby or low intensity small business interest).
- ❑ Encouraged by their employer to pay attention to their retirement financing (via education/provision of information or advice from the company's superannuation fund).
- ❑ In a very favourable superannuation scheme or one that otherwise encouraged higher employee contributions.
- ❑ Feared ill health, redundancy or a forced early retirement for any reason.
- ❑ Business failure or other severe denting of life savings to date
- ❑ Women for whom divorce or death of spouse had triggered them to plan for retirement.
- ❑ Sudden inheritance and associated realisation this is the only nest egg they have for retirement.
- ❑ Wealth accumulation occurring naturally. (eg by luck or good management a person finds themselves owning a successful business or earning a lot of money and needing to manage it).
- ❑ Wealth accumulation by nature or background.
- ❑ Children leaving home, triggering a realisation among parents that retirement is now a possibility and increasing the level of disposal income available for saving.

In quantitative research⁸, there was agreement with the statement that “*saving or investing for my retirement is important to me*”. We also found there was strong disagreement with the statement “*I live for today and don't worry about saving money*”. Despite these findings, behaviour or confidence does not appear to have changed: the sample overall neither agreed nor disagreed with the statement “*I feel confident I will have enough money in retirement to provide a good standard of living*”.

This is an area that will require further research attention in order to understand the role voluntary savings can play in retirement incomes adequacy. The Government's commitment to match the personal superannuation contributions of low-income earners may be a model for a wider scheme.

Taxation – impact on adequacy

IFSA has long supported the wind-back of front-end taxes on superannuation. These taxes remove savings from the system before they have had any opportunity to accumulate returns toward retirement savings. We do however, recognise that current revenue from contribution taxes supports worthwhile expenditures and programs.

There have been wide calls by most players in, and commentators on, the Australian superannuation system to reduce the burden of taxation on superannuation contributions and earnings. The impact of taxes at all three stages of the superannuation process has been well documented.

⁸ IFSA Retirement Savings – Desires and Drivers Project – Quantitative findings

We also note that the 1988 changes to the taxation of superannuation represented a bring-forward of future taxation revenues from retirement savings. As the IGR shows, there is a greater need for taxation revenues out into 2030 and beyond than there is in 2002 and the current forward estimates period. Unwinding some of the tax bring-forward achieved by the current rules, and returning that revenue to future years, would ameliorate some of the future fiscal drain outlined in the IGR.

Gradual removal of front-end taxes could increase adequacy for future generations of retirees without sudden and significant fiscal impact on Commonwealth revenue.

Consideration of front-end tax impacts, and their removal, requires open access to the models used by the Commonwealth. The current debate on front-end tax removal is incomplete without a full fiscal analysis of the changes in revenue amounts and timing, and of future savings to outlays – and this analysis requires the data and models used by RIM.

TAXATION AND REGULATION ISSUES

Taxation - simplicity

The overwhelming complexity, and persistent uncertainty, of the tax treatment of superannuation has significant impacts on confidence and behaviour. IFSA research, released at our 2001 Conference, found that legislative change was a major turn-off to discretionary superannuation. “The government keeps changing the superannuation rules, and will therefore probably continue to do so”⁹.

There is considerable merit in the idea to remove the daunting complexity, which persists in superannuation because of the grandfathering provisions on earlier concessional treatments. This is an idea that would require much further work, but one worth exploring. For instance, the previous concessional treatment available to an individual could be calculated at a point in time, appropriately indexed to retirement, and retained via a central system such as the RBL system maintained by the ATO. As superannuation funds have at best partial information, it is not sensible or cost-effective to manage this information via funds’ member records.

IFSA does not have a specific answer to propose, short of this work being undertaken, but would be keen to explore what administrative complexity could be sensibly lifted from superannuation funds. We would note that access to RIM modelling could assist an open debate on options to achieve this simplification.

Regulation - flexibility

The current tax and superannuation rules, particularly on concessional limits, tend to work against the sort of flexibility people may now need to achieve adequate retirement savings from less traditional labour market participation patterns.

Concessional limits

IFSA suggests that the broad lifetime concessional limit concept be retained, though we recognise some technical issues need to be addressed, and that the annual deduction limits be removed.

The most obvious limit to flexibility are the annual contribution limits, which seem unnecessary given the lifetime limits effected by the RBL regime. IFSA supports the concept of a lifetime limit on concessional treatment of retirement savings, and while there are technical issues with the RBL system, a lifetime limit on concessional treatment is an appropriate concept to the current superannuation regulation regime.

Older workers seeking to make up for periods out of the labour market, but who are not yet over 50, may wish to put more of their salary into superannuation than the current limit. The rigid annual deduction limits on employers operate to restrict this opportunity. The 2002-3 limit for deductible contributions under age 35 is \$12,671, and under age 50 is \$35,138.

⁹ Retirement Savings – Desires and Drivers Project - Qualitative findings

Women returning to the labour market after parenting are particularly affected by this limitation. The same argument would apply to a younger woman who wishes to contribute a significant amount to superannuation ahead of a career break for parenting.

Government has been keen to argue that superannuation is a tax-preferred savings vehicle at individual level, even after the maximum surcharge is applied, yet seems reluctant to allow flexibility into contributions to encourage those who can, to contribute more when they are able to.

Transition to retirement

Many rules in tax and superannuation legislation appear to assume that a person retires once, and once only, and that on a day they have selected in advance.

This single-case assumption pervades the regulatory system, and has such outworkings as:

- an income stream, once commenced, cannot be suspended if the purchaser returns to work – it must be commuted and re-started;
- an income stream, once commenced, cannot be topped up by new monies, even by later release from other superannuation accounts – it must be commuted, added to, and a new income stream commenced. This is particularly perverse in account-based products, where the design would readily accommodate new amounts.
- The release of benefits rules do not allow someone to continue in the same employment – say on a part time or project basis – and draw the benefits that they had accumulated up to the change in the nature of their employment.

Restrictions on voluntary contributions – the employment nexus

It seems very few people are now unable to make personal contributions to superannuation, though among these there may be significant groups excluded more by omission than conscious policy. Further expansion of the categories of people able to make contributions in the 2002 Budget heightens the issue.

Rather than stating who may not contribute, superannuation regulations contain multiple categories of people who can. This seems to result in complicated systems and costly administrative processes, all of which come at cost to fund members saving for their retirement. All can be traced to the original employment nature of superannuation – the employment nexus.

The obvious and simple solution – to remove the employment nexus from personal superannuation contributions – warrants exploration. It would not be difficult to assess who would benefit, who (if anyone) might lose, and to scope the costs and benefits to superannuation fund members, superannuation funds, and retirees. Assessing Commonwealth fiscal cost and benefit might be more involved, but it would allow reasoned consideration of the issue.

Non-superannuation savings and income streams

The tax rules also effectively exclude non-superannuation savings from allocated retirement income stream products. The design of these products facilitates the orderly drawdown of capital across retirement, and limits inappropriate tax deferral. As such, these products are important to help retirees achieve adequate income across their whole retirement, and this exclusion militates against adequacy.

It seems to be difficult to quantify the fiscal benefit of this exclusion, if any, and as such it is hard to justify its continuance. The exclusion is not present in social security rules for asset test exempt annuity products, for the reason that retirement income streams meet the policy objectives of retirement incomes policy no matter what the source of the purchase price.

As an aside, we understand that an argument is sometimes voiced within the social security administration that allowing non-superannuation monies into allocated products would imply an assets test exemption. However, we see no logical basis for such an argument. This submission does not advocate asset test exemption for existing allocated products – IFSA has only sought (a degree of) exemption for growth pensions.

The rules excluding non-superannuation monies from retirement income stream products should be removed. If it is appropriate to retain some limitations in order to prevent misuse of this access, these could be implemented in conjunction with removal of the existing impediments.

RETIREMENT INCOME STREAMS

Distortions in current rules

The current tax and social security treatment of retirement income streams also contributes to inadequate retirement incomes. The current rules for complying income streams – broadly, those that qualify for the higher pension Reasonable Benefit Limit (RBL) and that are exempt from the social security assets test – heavily favour interest-based investments. This distortion has been canvassed in IFSA’s submission to Government supporting the recognition of Growth Pensions – copies were provided to the Senate Committee on 4 May 2001. It arises from the restrictions placed on complying products – chiefly that income paid cannot vary, except for indexation.

If this distortion were removed, and retirement income streams which include growth assets were recognised, IFSA has calculated that a retiree with \$100,000 to invest in a 15 year income stream would receive around \$30,000 more in real terms than \$100,000 invested in a 15-year CPI-indexed guaranteed pension or annuity.

The distortion towards interest-bearing investments affects capital markets, reducing the allocation of retirement savings to economically productive equity (and other) investments. This impact reduces the efficiency of the economy overall, and the impact will become larger as higher future levels of retiree savings are forced into interest-based investments.

A copy IFSA’s proposal for Growth Pensions is at Appendix 4.

Consumer preferences in income streams

IFSA’s Retirement Savings – Desires and Drivers research project asked retirees and pre-retirees (aged from 45 to 5 years post retirement) to rank a range of income streams features, both independently and as paired trade-offs, on a zero to 10 points scale of importance.

Pooling risk

The results were surprising in some respects. Above all other features, respondents singled out pooled lifetime (longevity) risk as their most disliked feature.

- The most important single attribute of retirement income stream products, was that “the balance of the fund goes to the estate or to your partner if you die early” (mean importance score 9.2).
- The least important feature among the paired attributes was “Income is a guaranteed amount, paid for life, but if you die early no further money may be paid to your estate” (mean importance score 2.8)

Guarantees

Guaranteed income aspects were given very high importance in the single attributes, but fared less well when balanced against trade-offs. Single attribute importance scores were:

- Guaranteed income for life (mean importance score 8.7)
- Income indexed against inflation (mean importance score 8.2)
- Guaranteed level of payment each month (mean importance score 8.1)

When put in context - “Level of income is guaranteed but income is lower because low risk investments used” – the score drops (mean importance score 5.4)

Overall, the group seeking this security comprised 5% of the sample. This generally accords with the market share of lifetime products.

Transparency

“Transparency” aspects of income streams were rated as having high importance:

- Receive regular account statements, showing balance (mean importance score 7.9) – compared to
- No account statements, but you are paid a set amount of income each week or month (mean importance score 5.0)

Control

“Control” aspects of income streams were given similar importance:

- Can choose initial investment mix (mean importance score 7.7)
- Can change investment mix (mean importance score 7.7)
- Can switch to another fund manager easily (mean importance score 7.6)

Some care must be used in dealing with ‘control’ aspects – in the qualitative phase we found a wide range of meaning among pre-retirees and retirees. Taken together, the attraction of transparency and control aspects does much to explain the popularity of allocated income streams.

Adequacy and sustainability in income streams

IFSA is of the view that there are a number of issues in the current treatment of income streams that warrant some consideration from the perspective of long-term adequacy. We draw these to the committee’s attention for further examination: the modelling resources to explore these questions, and to test policy responses, rest with government rather than in the community.

Much of tax and social security regulation of income streams is based on a single mean life expectancy. While this is true on average, it does not address the simple statistical principle that half of retirees will outlive mean life expectancy. Since life expectancy is a distribution, there is some merit in reshaping rules to recognise the

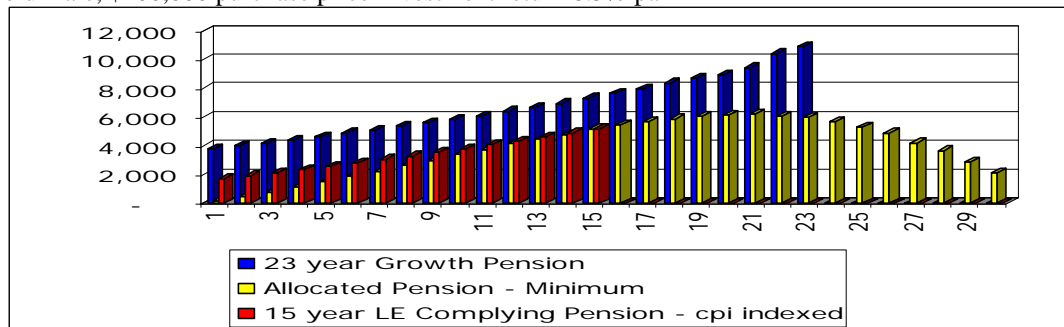
spread of life expectancy. We recognise that this may not be desirable where resulting rules may allow inappropriate or indefinite tax deferral.

Once simple consequence is that the current drawdown factors for allocated products drop to low numbers after mean life expectancy. This eventually forces retirees to draw a significant proportion of the account, however long the account holder may expect to live. It may not be desirable to reduce the minimum drawdown factors significantly early in retirement – say up to age 75 – to limit tax deferral. However, once a retiree is approaching the mean life expectancy of her or his age 65 cohort, say around age 80, remaining life expectancy can be quite long indeed relative to that mean. It seems a little counter-productive to then require annual drawdowns that will rapidly exhaust the remaining capital.

It would make considerable sense to model the consequences of applying longer life expectancies to the drawdown factors of allocated products. This would allow a sensible trade-off between prolonged income drawdown and the risk of creating inappropriately large estates.

IFSA has proposed a similar approach to life expectancy for its growth pension proposal – extending the term from 15 to 23 years. IFSA’s modelling showed that there was still a positive benefit for the retirees, and savings to pension outlays, in taking the growth pension rather than a life expectancy income stream.

65 year old male, \$100,000 purchase price Investment return 8.5% pa



OTHER ISSUES

Fees and Charges

Fees on retail superannuation funds are falling, in an industry characterised by wide competition and wide choice among and within retail offerings.

IFSA supports the Financial Services Reform Act (FSR) regulations on fee disclosure. The flat dollar amounts provided in these regulations allow full comparability of ongoing fees across investment types.

IFSA opposes the use of long-term projections in fee disclosure. We believe these are misleading and against the spirit of the Corporations Law. Long-term projections also raise the prospect of who should indemnify investors if (when) reality diverges from projection.

A full discussion of IFSA's position on fees and charges is at Appendix 5. IFSA's recent research on fees and charges is also included with this submission.

Simplicity

There is little doubt that the superannuation system as it stands is complex and cumbersome. Complexity dampens retirement incomes in two ways:

- higher administration costs are incurred to run complex systems with many components to be tracked; and
- lower understanding arises from higher complexity (which borders on incomprehensible at times) and leads to lower confidence in superannuation, which we suggest results in lower levels of voluntary saving.

Simplicity in taxation treatment is a similarly worthwhile goal. The multiple application of taxes, and the proliferation of different components of superannuation which have, or have had, different taxation treatment all add to the incomprehension experienced by ordinary Australians seeking to understand their superannuation.

There is considerable scope for simplification of the complex rules and treatments surrounding the remnants of the employment nexus that persist in legislation. Few groups remain in the community who are effectively excluded from superannuation. Yet, rather than define who cannot contribute, there are a plethora of categories of people who can contribute. All these categories must be checked and tracked, and all this activity comes at a cost – one could say we have a system being slowly blocked by hardening of the categories.

Education and savings culture

IFSA's research, and the wide range of other research cited in this submission, highlights the gap between desire or intention, and understanding of consequences of

inaction. There is also an evident gap in people's knowledge and awareness about saving, superannuation and investment generally.

This gap could be addressed by a well targeted campaign to educate people about retirement saving at points in their lives when they would be most likely to absorb, and possibly respond, to new information and understanding. IFSA has long supported the development of measures to help grow a savings culture in Australia.

A well-constructed and targeted education program on these issues could only assist in improving voluntary savings for retirement.

Non-superannuation saving

IFSA supports the development of a simple, transparent long-term savings vehicle with tax benefits (in timing and possible final level of tax payable) as an adjunct to superannuation.

Superannuation, particularly since the 1999 preservation rules, locks up money for retirement that individuals and families might require earlier access to. Insurance bonds currently provide for medium/long-term savings, however the tax payable on these can be difficult for individuals to assess, particularly so for periods less than 10 years. At present, re-draw mortgages and re-gearing of housing equity appear to provide the only simple, tax-effective vehicle for such saving.

IFSA research¹⁰, with a number of other studies, shows Australians are saving for their retirement outside as well as inside superannuation. A significant reason for this is that superannuation is preserved for a longer period and as such is less useful to individuals and families who need medium to long-term savings for other lifecycle needs, such as reduced employment income and higher costs in parenting, or unexpected loss of employment.

A medium/long-term savings vehicle, based on managed investments principles, could easily be structured so that the tax differences were only in timing, and also allow a fiscal benefit to government from compounding investment earnings. Such a vehicle would contribute to a savings culture, as people could see more immediate outcomes for their savings decisions.

Health Care

A number of solutions to increasing health care cost have been canvassed in the wider context of the retirement cost debate.

IFSA would merely note that many of the cost increases noted in the OGR are not demographic, but related to supply or demand in the health care market. These cost increases lend themselves more readily to policy solutions in the health field.

¹⁰ IFSA Retirement Savings – Desires and Drivers Qualitative Report

A number of proposals have been made to deal with demographic costs, including partial pre-funding. Some proposals share with the SG the aim of reducing the impact of demographic change on future funding requirements rather than seeking to replace current mechanisms entirely. While we see merit in a targeted strategy, and in pre-funding some of the demographic cost, we do not have a view on the particular merits of any one solution.

Aged Care

IFSA is not in a position to comment on the wider issues in aged care provision.

We can make some comment on the issue of extensive care – nursing home care, as it once was. We note that this level of care is only required by between three and seven per cent of the aged population, yet most aged people would be concerned about the cost impact should it fall on their family or themselves. This sort of problem – wide concern, but low eventuality – lends itself to insurance-like solutions.

What is more, there would be a significant gap, on average, between retirement and entry to extensive care. This delay would allow a modest sum at retirement to compound to a more substantial amount by the time it is called upon. While we are not in a position to recommend a scheme, it does seem clear that an insurance solution warrants exploration for extensive care costs. Again, we see merit in limiting such a scheme to funding the additional demographic funding requirement rather than replacing the current funding mechanisms entirely.

Appendix 1 Living standards in retirement

This appendix further explores adequacy and the gap in people's expectations of their standard of living in retirement. The current and succeeding generations of older Australians will have very different retirement incomes, largely determined by their experience of superannuation.

1.1 Income of pre-war generation retirees

Those already past retirement age (65 for men and 62 for women) are the least likely to rely on superannuation for an adequate standard of living in retirement. This generation includes all those born up to and during WW11- the pre-war generation. They were born before and up to the end of WW11, with the youngest now aged in their mid to late 50's.

This generation grew up with a universal age pension, and may broadly perceive the age pension to be a reward for a productive working life. This would have been reinforced by the various grandfathering arrangements that are in place for superannuation savings prior to 1983.

Notwithstanding the introduction of successive assets and income tests, the age pension remains the principal source of income for over three-quarters of the current generation of retirees.

- Research by NATSEM shows that over 80 per cent of the population of qualifying age rely on a social security pension or similar payment, as their principal source of income.
- Gross incomes of individuals on age pension are about 50% higher than the basic pension rate and are about half of the incomes of the prime age working population (before tax).

The impact of superannuation on the income of this generation is small but growing, as the growth in coverage of superannuation starts to take effect.

NATSEM research shows that incomes from superannuation pensions and annuities now provide the main income source for almost 9% of the aged in 1995-96. This low figure disguises the lump sums that are taken and converted into income earning assets- shares, bonds, cash deposits etc. If these are added the figure relying on superannuation or investment assets solely increases to 15%, although this will have fallen somewhat in recent years with the decline in interest rates.

One feature of Australia's combined age pension and superannuation systems is that the income distribution of the aged in Australia is more equal than international norms. Nearly two-thirds of Australia's retired people fall into the third to fifth equivalent after tax income decile, indicating that while most of Australia's elderly are not poor, neither are they rich.

Minimum living standard in retirement

The age pension in 2001-2002 is \$10,900 for a single person. A single person can earn up to a cut off point of \$30,900, and still qualify for a part pension. This cut off point, after which no pension is payable takes effect at 70% of AWE.

- The RBL sets a maximum cap on the amount that can be accumulated and taken as a lump sum- equal to 12 times AWE while the pension RBL is equivalent to a pension income of 25times AWOTE.

The real value of the age pension increased by some 70% between 1970 and 2000; with most of this increase occurring during the early 1970's. Since the mid 1970's the pension has been indexed, initially to the CPI and since 1997 to male total average weekly earnings (MTAWE).

A broad political target level, backed by legislation, has seen the pension maintain its relativity with earnings at 25% of average earnings over the whole period and now maintained by indexation.

In addition to the age pension, full pension recipients can be entitled to other subsidies from Federal, State, Local Government and community programs, such as pensioner health card benefits and transport subsidies, and reduced co-payments on pharmaceuticals.

Adequacy for current retirees

Using an income replacement measure, NATSEM has calculated that the current generation of retirees is living on an income ranging from an equivalent to 25% AWOTE on a full pension to a total income on average of 50% AWOTE.

Treasury, using a consumption replacement rate, has estimated the current value of the full pension as 37% of pre-retirement consumption levels.

Both are valid methodologies but can give differing results, depending in part on the discount rate.¹¹

A recent OECD study suggests that the income of this generation of retirees is low by comparison with international norms, even allowing for differences in these schemes. The OECD consensus is for a 70-80% disposable income replacement rate, equivalent to a 60% gross income replacement rate.¹²

Superannuation balances for this group are small on average, and any additional income to the age pension will come from part time work and/or contributing to superannuation up until 75 years of age.

¹¹ RIM

¹² OECD

Work by RIM in 1999 suggests that simply raising the age pension to 30% of AWE would increase the costs of the age pension from 3% of GDP in 1999 to 6% of GDP by 2049.¹³

1.2 The baby boom generation

Almost half of all people below retirement age expect to retire between 55 and 65 years of age.¹⁴

Yet while these generations will work less in their lifetime, they also expect to be more self-reliant. These optimists include:

- the baby boomers, those born between 1946 and 1960;¹⁵
- the post baby boomers, those born after 1960.

The oldest baby boomers reach 55 and begin to retire from 2001, while the youngest are in their early 40's. The youngest will have retired by 2025, at aged 65.

Two thirds of people in the ANOP 2001 survey felt that they were personally well prepared financially for retirement, compared with only half in the 1989 study.

Only three in ten baby boomers expect to receive the age pension, while the earlier survey found that 51% of non-retired people expected to receive the age or veteran's pension.

Their expectations are based on optimism about the value of their savings through the Superannuation Guarantee (3 in 10, 32%) and on the increasing value of their own home (2 in ten-23%).

The problems with this are that not many will want to sell their home to create an income stream and so it depends very much on the capacity of the SG. Only 18% plan to sell their home as part of their financial plans in retirement.

While many have expressed confidence in their savings and financial planning to give them an adequate income in retirement, a large number do not know how much income they will need in retirement.¹⁶

In contrast, the reality is that in twenty years time at least six in ten of this generation will be receiving at least a part pension in retirement.

"there is a marked difference between the perceptions that many people now have about the rosy prospect of retirement and the harsh reality of the financial future that actually awaits them".
Rod Cameron ANOP 2001

¹³ Bacon/RIM/1999

¹⁴ ING

¹⁵ In some cases the group born between 1960 and 1965 are included in the baby boomers

¹⁶ ING survey

The gap between outcomes and aspirations

When asked what income would be adequate in retirement, baby boomers responded as follows:

- In the ANOP survey, 9 in 10 say that they needed more than \$20,000 per year to live on in retirement, to 50% of average earnings¹⁷. Some 7 in 10 say that they will need a minimum of \$30,000 to live on in retirement, or two thirds of average earnings. Baby boomers also think they will need a higher living standards in retirement - 5 in ten want at least \$40,000 in retirement (AWE) and 3 in 10 want \$50,000 minimum (1.2*AWE)
- In the ING survey over 35% stated they needed up to \$500 per week in retirement (up to 2*AWE) and in excess of 16% claimed they needed between \$500 and \$1,00 per week (between 2 and 4 times AWE).

NATSEM has looked at the income and wealth of people in the 50 to 64 years old age group.

Replacement rates

There are 2.7 million Australians aged between 50 and 64 years of age with an accumulated wealth on average of \$240,000.

Most of the wealth of this group is tied up in the family home, and they are unlikely as retirees to want to sell their home to finance their living standards in retirement.

The average superannuation balance of this group is estimated to be \$56,000. These low balances are not nor surprising as widespread superannuation coverage did not become a reality until the 1990's, when the oldest of this group in their mid-fifties. The oldest baby-boomers in this group were 46 when the Superannuation Guarantee was introduced, at a 3% contribution rate.

A \$56,000 lump sum paid into an allocated annuity by a 65 year old male to last till he is 80 years of age (around the life expectancy of males) will provide only \$100 per week.

This group also has additional private savings, other than the family home of on average \$58,000, that could be used to provide a retirement income.

If this total amount was used to buy an annuity, the total income could be as much as \$21,300 in today's dollars, or the equivalent of 50% of AWE. This is below the international norm for gross income replacement rates of around 60% of AWE, and is at the minimum end of the baby boomers range of expectations.

¹⁷ We have followed the convention of using AWOTE as the appropriate measure of average earnings. This is male, average, weekly, ordinary time earnings

These averages disguise some important differences in the distribution of this wealth.

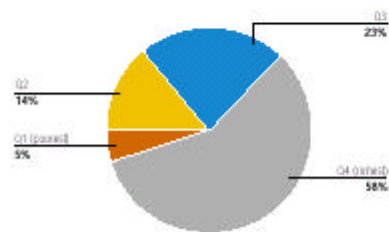
The top 25% of this group owns almost 60% of the wealth of people aged 50-64 (see the Pie Chart)

Table 4: Estimated distribution of assets for 50 to 64 year olds, by wealth quartile, January 2002

Family Type	Cash deposits (\$'000s)	Shares (\$'000s)	Home (net) (\$'000s)	Rental Properties (net) (\$'000s)	Superannuation (\$'000s)	Wealth (\$'000s)
Q1 (poorest 25%)	3	0	21	0	21	47
Q2	7	1	83	2	37	131
Q3	14	4	137	12	57	223
Q4 (richest 25%)	55	77	265	52	111	559
Top 5%	156	268	391	126	163	1,103
Average for 50-64 year olds	20	21	127	17	58	240
Average for all adults	14	14	77	10	35	149

Source: NAISEM

Figure 6: Estimated proportion of total personal wealth of 50 to 64 year olds, by quartile, January 2002



Data source: NAISEM

The poorest 25% of this group have just only \$24,000 in wealth, excluding the family home, of which \$21,000 is in superannuation.

“And herein lies the problem- that is a massive gap in expectations for the younger, boomer members of the 50-64 year old age group about the kind of lifestyle they may want when they retire and their ability to fund it”

There is some time to boost their savings - but not much.
AMP Andrew Mohl

1.3 Post baby boom generations

The post baby boom generations appear in research to expect to be increasingly self-reliant in retirement. The question is whether they will achieve the standard of living in retirement that they expect.

There are a number of studies that explore potential scenarios of outcomes under the SG system using various levels of lifetime rates of superannuation contributions.

Treasury’s Retirement Income Modelling TaskForce has done extensive modelling of scenarios in recent years. The most recent publicly available results are a 1997 paper.

- Using the examples of hypothetical individuals, and based on an annuity investment strategy in retirement, Treasury found that at 0.5AWOTE, the consumption replacement rate was 107%, falling to 57% at 2*AWOTE.
- In their aggregate analysis Treasury, compares the experiences of those retiring now, with those retiring in 30 or 40 years. For those with a long period in superannuation disposable income replacement rates are expected to rise from 45% now to 59% per cent by 2038. For the total population, disposable income replacement rates rise from just under 60% now to about 70% from 2030.

This confirms that baby boomers can expect a maximum of between 45 and 60% consumption replacement rate, while the following generations can do better after 2030.¹⁸ Even then, with the uncertainty inherent in these models, the SG system only just approaches the 70-80% OECD band.

This confirms what the broad conclusions reached by a number of researchers, which is that only someone who:

- has contributed to superannuation at 9% for 40 years
- takes their superannuation evenly divided into a lump sum and a pension (on current income and assets tests)

will come close to the same standard of living in retirement as when they were working.¹⁹

To achieve living standards, that meet expectations and that are comparable with OECD norms, requires increased superannuation contributions. The following table indicates how much addition contributions would be required to meet expectation levels of retirement income.

To achieve a disposable income replacement rate of 75- 80% the rate of contribution has to be higher for shorter working lives and higher as income increases. It is clear that a 9% contribution rate is very much a minimum.

Years of Work	40	35			30
% Of AWE	100%	70 %	100%	150%	100%
Contribution Rate	12%	9%	14%	15%	17%

Contribution rates need to be lifted by a range from 3-8% if people are to meet their indicated retirement income goals. In particular high-income earners and baby boomers, with fewer years of high rates of contribution need to significantly increase their contribution rates.

¹⁸ Income replacement rates tend to be lower than consumption replacement rates.

¹⁹ Fitzgerald, Natsem, ASFA

Surveys show that there is a significant group who don't know what they need in retirement. One way of addressing this is to provide greater use of target superannuation ready reckoners.

For any given amount already saved, and a target income in retirement, these tools can be used to estimate a target rate of contributions over the remaining working years. Changing the superannuation rules, to allow greater contribution catch ups could led to increased contributions and a greater sense of ownership of superannuation fund members.

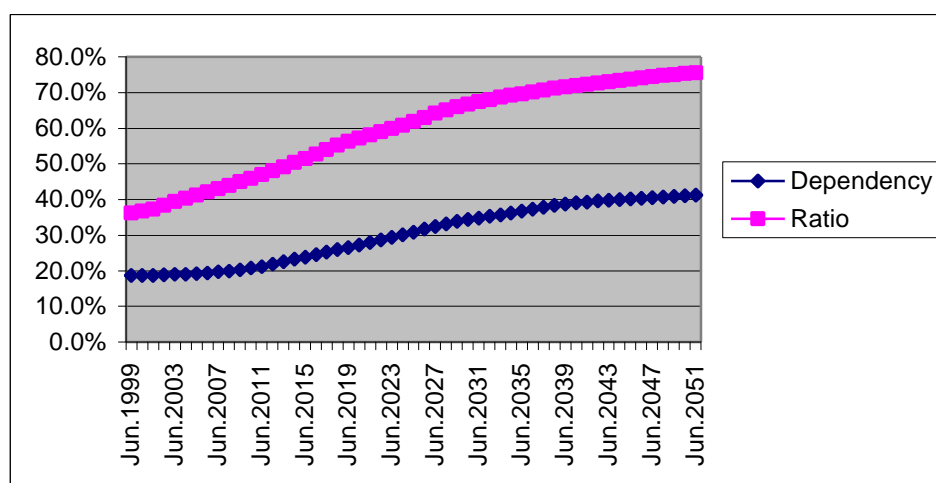
Appendix 2 Social Change

Demographic change

Australia's population is 19.7 million, of which 11 per cent of men and 16 per cent of women are of retirement age.²⁰ By 2042 this could increase to 22 per cent of men and 25 per cent of women.²¹ Over the same period the total population could increase by 38 per cent, with the number of people aged over 55 increasing significantly faster than the number aged under 55.

As a result of these trends the dependency ratio, or the ratio of the population of retired Australians to the working age population, will double (see Chart). The dependency ratio for older Australians to full time workers could increase from 30% now to 56% in 2042.

The proportion of the frail aged would increase by 2042. As a share of the population



over 65, the population over 80 could rise from 25% now to 33% in 2042.²² The frail aged by and large have greater and more expensive care needs, including residential care. The costs of financing the needs of this group of older Australians will increase as medical technology will increase the range of medical services and pharmaceuticals available to treat, and extend the lives of, the frail aged.

Both men and women are living longer in retirement.

Men and women retiring today at 65 could expect on average to live for around sixteen years and twenty-two years in retirement respectively.²³ If the trend continues for men to retire from full time work in their fifties, and women earlier, then people could expect to live as long in retirement as they have spent years in the workforce. This underlines the importance of measures that enable greater savings during the

²⁰ ABS figures estimate 1.1 million men over the age of 65 and 1.6 women over the age of 62.

²¹ ABS projections estimate 3 million men and 3.4 million women over the age of 65.

²² ABS estimates there will be 0.2 million men and 0.4 million women over the age of 80 in 2042.

²³ Life Tables 1980-82 (what is the most up to date reference?) figures, taking age 65 for men and aged 60 for women

working years, and permit combining part time work while contributing to superannuation as long as possible.

	2002	2042
Males	77.2	82.5
Females	82.6	87.5

The pressures on private savings

Australia is fortunate that it has a sound model to promote private saving for retirement through superannuation, one that is world recognised.

We are well down the path of supporting growth in superannuation, with Australia's growth in superannuation assets one of the fastest in the OECD.

Governments have reduced the reliance on universal aged care benefits, with extensive assets and income tests introduced through the 1980's. The age pension now has more of a role to play in poverty alleviation.

Yet there are long term trends that have a bearing on private savings behaviour, that add to the challenge in financing our living standards in retirement:

- the duration of working lives, men's and women's, impacts on lifetime earnings, and on potential savings to accumulate an adequate superannuation sum for retirement. Further people can expect to live longer in retirement. Together these factors suggest that the current rate of contributing to superannuation may not be sufficient.
- The proportion of single households in every generation is increasing, reducing the capacity to save during the working years, and adding to the costs of living in retirement compared with previous generations with a higher number of married couples.
- Private savings and wealth of Australians remains dominated by the value of their homes.

Working Lives

At the time the Superannuation Guarantee scheme was introduced by the Government in 1992, it assumed a working life of 40 years in modeling the impact of the SG on projected superannuation savings. Ten years later this assumption appears to be out of step with contemporary work force experience.

Early retirement for men is common, with an average retirement age from all work of 59 (ABS study). While women's workforce participation in the workforce is longer than it once was, as women's labour force participation rate has increased, women retire on average from all work at 44 years of age, considerably lower than the statutory retirement age. Overall according to a recent AMP-NATSEM Report, around 42% of people over 50 have left the full time workforce.

Living alone

The vast majority of Australians in the 50-64 age group are living in couples, a similar ratio to younger age groups. But there is a rise in the proportion of people living alone at every age group.

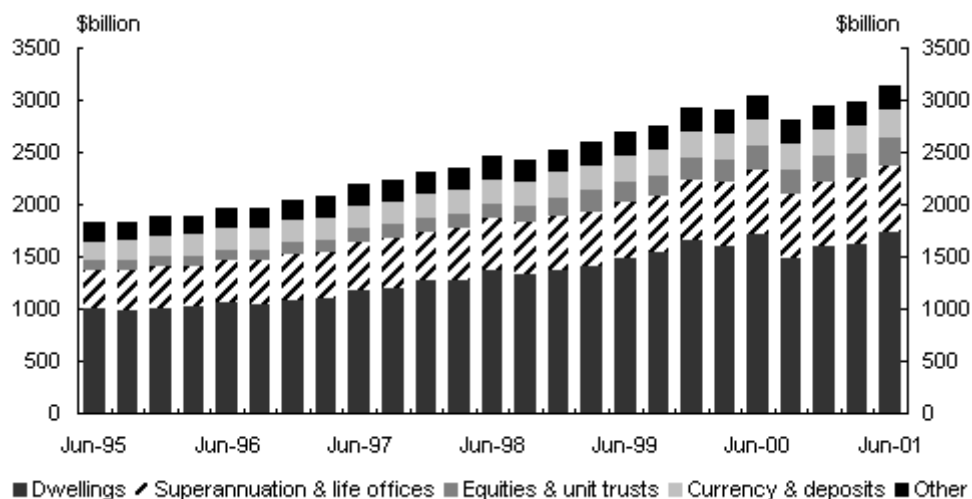
And the number of people living alone in retirement is significantly higher than for the rest of the population.

Twenty per cent of men and forty per cent of women over 65 live alone.

The growth in single person households, reflecting a higher divorce rate and women's longer lives, is likely to increase the number of people with inadequate superannuation and who will have to rely on a single income in retirement.

Housing Wealth

Chart 2: Household assets



Source: Treasury: ABS Cat. No. 5232.0 and RBA Statement on Monetary Policy

While there is no doubt that housing assets allow owners to have lower expenses and a better standard of living, it is wealth that tends to stay locked up until very late in life, and only then may be realized with downsizing. In many cases people are reluctant to leave the family home. In this context reverse mortgages were not popular when introduced in Australia in the last decade, and even in the US, they have taken 10 years to achieve only a small market penetration.²⁴ As a result housing assets are often passed on to the next generation.

²⁴ ABA information

Appendix 3 Saving through Superannuation

This Appendix reviews the current state of play in Australia's superannuation system. This sets a context for the discussion in the rest of the submission on closing the gap in financing adequate living standards for older Australians in retirement.

A brief history of superannuation

The history of Australia's superannuation system is relatively recent.

Participation in superannuation falls into three phases²⁵:

- post war voluntary superannuation;
- award superannuation from 1986; and
- the superannuation guarantee from 1992.

During the first phase superannuation was voluntary, tax advantaged, occupationally based and/or largely limited to certain groups. These included high proportions of public sector employees, males, full time workers and those in higher income white-collar occupations. By the mid 1980's less than half of the workforce was covered by voluntary superannuation arrangements, with coverage amongst women (25%) around half that of men (50%).

Most superannuation funds were employer sponsored and defined benefit schemes i.e. a specified amount payable based on years of service. Contributions were tax free, as was the investment income. Benefits taken as income were taxed at marginal rates while only 5% of lump sums were taxable.

The first compulsory superannuation introduced into Australia was in 1986 as part of the Accord agreement between the Hawke Labor Government and the unions. At the time assets under management by superannuation funds were around \$50 billion. Industrial awards required employers to pay an amount equal to 3% of earnings into employees' superannuation. While contribution rates were low, award based superannuation had a significant impact on superannuation coverage of employees.

Immediately prior to the introduction of the Superannuation Guarantee (SG) legislation in 1992, total superannuation assets were \$165 billion. The Government expected the SG system to boost private savings by 2005 by 1% to 1.5% of GDP (or \$5.5billion).

The greatest impact was on the coverage of superannuation – after 1992 coverage rates rose to 90% of the workforce. With this shift too, contributory or defined contribution superannuation funds have become the norm where the final benefit depends on the investment return of the fund over time and not a promise by the employer.

²⁵ Bateman and Piggott 1997

This year, 2002-2003, the compulsory employer contribution rate will reach its peak at 9%, with the scheme applying to all but low-income earners. The self-employed, non-working spouses and children have access to different taxation incentives to encourage them to contribute to superannuation.

Changes in taxation arrangements were made progressively, starting in 1983 mini-Budget, introducing higher tax rates on lump sum benefits. Major changes were introduced in 1998, with a bring-forward of tax on contributions, investment income and potentially lump sums. This was followed by the surcharge for high-income earners on contributions introduced in the 1996-97 Budget. These changes, and the grandfathering arrangements to preserve existing entitlements, have greatly added to the complexity of the superannuation system is believed to have undermined community confidence in its ability to provide a benefit on retirement.

Superannuation trends

The most recent information on superannuation is available from APRA up to December 2001.²⁶

At the end of December 2001 total assets in superannuation funds were \$527 billion, with 23.7 million member accounts (see Appendix A).

- Most funds (98%) are small funds (230,500), with less than five members. These so called “do-it-yourself” funds have grown in number by over 360 per cent since 1994-95.²⁷ Analysis by the ATO suggests that the main reason for the significant growth in the number of these funds has been the desire for increased control of investments.
- Most members (98%) are in the other 3,438 funds. The top ten per cent of these retail, corporate and industry funds cover approximately 90% of all superannuation fund members. Most members are in retail funds and industry funds.
- The majority of assets are held in retail funds and public sector funds.
- In 2001, superannuation fund members made \$22 billion in contributions, while employers made \$28 billion in contributions, a total of \$50 billion.
- There has been no change in the expense to contributions ratio over the period from 1994-95, constant at 8%. The smaller funds nonetheless have significantly higher expense ratios at close to 20%.²⁸

In total superannuation savings are growing at a rate of over five per cent per annum, with increases in contributions and with investment income. Superannuation funds could reach \$1500 billion by 2010, three times the amount of funds today.²⁹

²⁶ APRA Superannuation Trends December 2001

²⁷ Funds were then APRA supervised

²⁸ Table 4e APRA

Annual taxation revenue from superannuation has grown significantly in the last decade, more than doubling increasing from 0.3% of GDP in 1991-92 to 0.7% of GDP in 2000-01.³⁰

- Tax on contributions and fund earnings have grown from \$1.1 billion in 1991-92 to \$4.1 billion in 2000-2001 (and are projected to remain around this level in the Budget forward estimates).
- The superannuation surcharge raised \$0.4 billion in 1997-98 rising to 0.7 billion in 2000-01 (and are projected to increase to 0.8 billion over the forward estimates).

Information on superannuation balances is available from a range of sources.

- According to the ATO, in 1999-2000 408,776 people received eligible termination payments. Not all of these people were of retirement age, some were simply changing jobs and rolling over their superannuation from one fund to another. These payments totalled \$8.7 billion or an average of \$21,322 per person.
- APRA data at December 2002 shows an average balance in small superannuation funds of \$185,000, \$54,000 in corporate funds, \$41,000 in public sector funds, \$13,000 in retail funds and \$6,000 in industry funds.
- A Report from AMP-NATSEM in May 2002 shows that an average superannuation balance of \$56,000 amongst the group aged 50-64 years of age.

These typical balances suggest that it is likely that older Australians will continue to rely on a mix of publicly funded age pension, earned income from part time work or retirement incomes in the next four decades.

²⁹ Rainmaker

³⁰ Budget Analysis Appendix E 5-33

Table 1b. Superannuation Assets — Fund Type
(\$ million)

	Corporate	Industry	Public Sector	Retail	RSAs ^{a,b}	Small Funds ^c	Sub-total	Balance of Statutory Funds ^d	Total Assets
1994/95									
Jun	48,556	10,119	51,649	52,165		20,147	182,635	46,757	229,392
1995/96									
Sep	51,798	12,931	53,389	54,970		21,865	194,953	42,938	237,891
Dec	53,385	13,894	55,306	57,328		23,555	203,468	44,018	247,486
Mar	53,762	14,477	56,649	59,231		25,194	209,314	42,894	252,208
Jun	56,357	15,193	58,673	62,154		28,213	220,590	42,151	262,741
1996/97									
Sep	55,714	16,261	60,496	66,952		30,071	229,493	45,543	275,036
Dec	57,570	17,224	63,103	70,147		32,412	240,457	45,359	285,815
Mar	57,576	17,983	64,135	72,272		34,135	246,101	51,983	298,084
Jun	62,187	19,893	71,013	78,094		36,141	267,327	54,242	321,569
1997/98									
Sep	64,009	21,359	73,912	82,478	326	38,419	280,178	55,891	336,069
Dec	63,581	21,818	73,623	85,722	335	39,931	284,674	56,210	340,884
Mar	64,888	23,177	77,564	87,529	350	42,944	296,102	54,166	350,268
Jun	65,671	24,331	79,744	91,053	551	46,169	306,968	53,974	360,942
1998/99									
Sep	64,297	24,904	78,342	96,093	591	47,885	311,521	51,987	363,508
Dec	65,439	26,561	83,531	102,803	655	51,536	329,870	45,426	375,296
Mar	66,962	28,332	86,105	107,736	672	54,761	343,897	42,863	386,760
^e Jun	68,137	29,780	95,257	112,288	727	60,904	366,365	45,854	412,219
1999/00									
Sep	69,441	31,107	96,026	117,757	758	63,954	378,285	43,191	421,476
Dec	73,421	33,361	103,517	126,395	2,659	66,369	403,063	48,502	451,566
Mar	75,049	34,957	106,110	131,708	2,889	71,959	419,783	46,006	465,789
Jun	77,368	37,130	110,855	138,097	2,808	75,099	438,548	51,455	490,003
2000/01									
Sep	72,523	41,425	108,589	140,860	2,926	77,481	440,879	55,040	495,919
Dec	71,582	40,757	108,360	144,451	2,900	79,118	444,268	55,949	500,217
Mar	70,776	41,863	107,840	147,515	2,976	81,245	449,238	54,030	503,268
Jun	73,635	44,600	113,989	156,560	3,092	86,623	475,406	48,470	523,876
2001/02									
Sep	68,523	43,904	103,251	155,325	3,183	85,330	456,331	47,629	503,960
Dec	72,978	47,130	109,829	170,403	3,184	93,506	493,847	33,866	527,713

Notes: a Includes both RSAs (Retirement Savings Accounts) and RSA look-alikes.

b The increase in assets of RSAs during the December 1999 quarter was due to a restructuring of one superannuation fund to include an RSA lookalike

c Small Funds refers to superannuation funds with less than 5 members and includes Small APRA Funds (SAFs) and Self-Managed Superannuation Funds (SMSFs), which are regulated by the ATO. In December 2001, assets of SMSFs totalled \$90.9 billion (source: ATO)

d The Balance of Statutory Funds is the remaining superannuation assets residing in life office statutory funds after the assets explicitly known to reside in other fund types have been allocated. These assets include products (e.g. deferred annuities) which are regulated solely under the Life Act.

e During the June 1999 quarter, three Public Sector funds received \$8.4 billion in exceptional employer contributions.

SOURCE:APRA

Table 3. Income and Expenditure for Superannuation Funds
(\$ million)

	Contributions		Benefits		Transfers		Net Contribution Flow	Operating Expenses	Net Investment Income ¹	Other Changes ²	Net Growth ³
	Member	Employer	Lump Sums	Pensions	Inward	Outward					
1994/95											
Jun	1,940	4,590	3,203	989	3,268	2,749	2,876	554	6,313		
1995/96											
Jun	2,411	5,617	3,959	1,026	4,179	4,501	3,320	465	3,854	4,568	11,270
1996/97											
Jun	2,979	5,201	3,900	1,128	14,535	11,720	6,084	862	15,886	-5,025	16,272
1997/98											
Sep	3,266	5,175	4,811	1,096	14,318	12,261	4,592	530	6,703	2,086	12,651
Dec	3,475	5,228	4,943	1,090	6,015	3,963	4,724	565	1,623	-1,285	4,437
Mar	3,103	5,125	3,744	1,142	4,863	3,008	5,106	542	9,752	-2,888	11,428
Jun	3,919	6,115	4,128	1,200	6,155	4,228	6,638	555	4,494	290	10,865
1998/99											
Sep	4,360	5,405	4,578	1,173	6,672	4,832	5,865	590	-709	47	4,553
Dec	4,105	5,198	4,485	1,305	6,541	4,149	5,705	595	14,565	-1,306	16,349
Mar	3,886	5,222	4,267	1,241	6,470	4,149	5,802	681	7,857	1,014	14,027
Jun ⁴	6,389	14,502	6,248	1,295	7,053	4,829	15,648	669	3,631	3,859	22,498
1999/00											
Sep	4,942	4,883	5,698	1,076	21,892	17,142	9,436	778	2,083	1,179	11,920
Dec	4,897	4,821	6,127	1,190	11,417	9,105	6,713	777	15,896	3,145	24,776
Mar	4,606	5,562	5,981	1,285	9,275	5,480	6,387	867	12,227	-1,039	16,719
Jun	5,954	6,018	5,430	1,583	9,980	6,580	9,260	852	10,655	-617	18,785
2000/01											
Sep	5,738	4,580	6,349	1,819	9,475	8,344	7,480	943	6,880	-11,026	2,321
Dec	6,405	5,969	5,698	1,648	12,215	9,549	6,732	597	-293	-2,454	3,389
Mar	6,209	6,449	5,586	1,482	10,748	8,878	6,541	950	596	-1,187	4,970
Jun	6,784	6,052	6,907	1,814	13,182	9,068	9,952	1,050	15,084	1,392	28,188
2001/02											
Sep	6,975	6,003	7,144	1,554	12,482	6,912	9,770	968	-33,207	-4,670	-19,075
Dec	6,185	6,502	5,497	1,650	11,088	7,111	8,540	956	24,248	5,884	37,515

Notes: This table reflects the income and expenditure of all funds explicitly regulated under the SIS Act. Income and expenditure items relating to the Balance of Statutory Fund assets (i.e. assets regulated solely under the Life Act) and RSAOs are not included in this table.

¹ Net Investment Income is the income derived during the quarter from the investment activities of the fund.

² Other changes are calculated using residual analysis based on Net Growth, Net Contribution Flow and Operating Expenses. Operating Expenses include administration, investment and all other non-tax expenses explicitly paid by funds.

³ Net growth does not include the balance of statutory funds.

⁴ During the June 1999 quarter three public sector funds received \$6.4 billion in exceptional employer contributions.

APRA Superannuation Trends - December Quarter 2001



IFSA POSITION PAPER COMPLYING ACCOUNT BASED INCOME STREAMS (GROWTH PENSIONS)

FEBRUARY 2001

Background

In its 1997 Budget, the Federal Government announced that it proposed to introduce a new class 'complying' superannuation pensions and annuities, which would receive favourable social security and tax treatment.

The Investment and Financial Services Association (IFSA) has consistently supported the public policy objectives behind this proposal:

- increase competition in the provision of 'complying' income stream products;
- increase overall incomes of retirees through better internal yields from a wider range of 'complying' product and risk types;
- continue the objective that 'complying' products facilitate the orderly drawdown of capital over retirement;
- limit inappropriate opportunities for tax deferral and asset test avoidance (including e.g. use of 'complying' products to shield assets from taxation and asset testing while preserving assets into estates); and
- increase downward pressure on purchase costs through a wider choice of 'complying' income stream products.

Draft legislation to this effect was released in 1997 and after some industry consultation the *Social Security and Veterans' Affairs Legislation Amendment (Budget and Other Measures) Bill 1997* was enacted. Means test rules for a new class of 'life expectancy' products took effect from 20 September 1998.

At the time the exposure draft of the legislation was released, Treasury committed to release a discussion paper to address a range of issues, including the appropriateness of account-based (or allocated) products. This paper has not been issued to date.

Complying Income Stream Products

In this paper, 'complying' indicates that a product qualifies for the following regulatory treatment:

- assessed toward the pension (rather than lump sum) Reasonable Benefits Limit (RBL); and

- exempt from the social security assets test; and

Complying income streams also share treatment with other income streams:

- exempt from income tax on its earnings (prior to distribution), and
- assessed under the social security income test rules for income streams (as opposed to the rules for managed investments).

Shortcomings of the current income stream offerings

It is IFSA's view that the policy aims of the 1998 income stream rules are not being achieved in full. A transparent account-based income stream, invested in a balanced portfolio, would round out the options available to retirees.

The current social security and superannuation rules prevent the development of these products by requiring that annual payments in complying account-based income streams do not vary, except for indexation. Tested against the policy intentions outlined above, this particular rule appears to be a provision of technical regulation, rather than an expression of policy. Alternative rules could be developed to meet the same policy objectives without preventing the development of new products.

- While the rule does help to ensure the orderly drawdown of capital, IFSA proposes other measures in this paper, which would achieve the same effect.
- The rule also limits access to asset test exemptions to those income streams that exhaust capital during the retiree's life expectancy (or lifetime). IFSA proposes measures in its model, which would similarly – and more directly – guarantee that capital is used up within a retiree's life expectancy.

If the legislation is not amended to allow account style products backed by balanced portfolios, we consider that retirees affected by the assets test will continue to have strong incentives to take out either:

- complying income stream products backed by interest bearing securities, which produce historically inferior returns in comparison to balanced portfolios; or
- complying income streams, with complex benefit designs, effected through SMSFs. In these arrangements, estate planning is a key consideration: surplus assets remain in the reserves of the SMSF after the death of the pension recipient. This reserve is then paid to other members of the fund (who tend to be the family of the member) and the nil RCV rule is effectively circumvented.

The benefits of any improvement on the current law in this regard should be assessed against any cost to Government (either in terms of loss of revenue or increased social security expenditure). In a later section we provide comment on the means by which Government costs might be constrained.

The current rules produce distortion in resource allocation, and thus are economically inefficient. Since life expectancy and lifetime products are backed (in the main) by interest securities, the effective investment is in debt, rather than in equity. Income streams backed by balanced portfolios would have an appropriate level of investment in equities, and hence would be more economically efficient. Experience with allocated products shows that, without the distorting effect of the 'no variation in payments' rule, retirees prefer to invest in a balanced and economically efficient portfolio.

The introduction of the current rules has not produced any real increase in the number of income stream providers. The market for complying income streams is still limited to a small number of providers, reflecting the capital requirements required to operate a guaranteed income streams.

The case for complying account based products

A complying account-based income stream is one where:

- retirees invest a lump sum in one or more of a range of investment portfolios (including balanced or growth asset portfolios), the value of which would be reflected in an account balance;
- the recipient is required to draw a specified proportion of the account balance as income in each year, so that the account is exhausted on the life expectancy of the recipient;
- the account cannot be closed (“commuted”) except in limited circumstances, such as to purchase another complying income stream (as for current complying products).

While a complying account-based income stream would have much in common with the basic design of an allocated pension or annuity, IFSA believes it would meet the public policy objectives outlined earlier in this paper. That is, it would have significantly tighter constraints on income than ordinary allocated income streams, and importantly would not allow access to capital (except in limited circumstances, as described).

Account-based or allocated products have strong attractions for retirees over guaranteed (term certain) or lifetime products. They are simple, transparent (especially for fees) and give a sense of investment ownership and control. Most importantly, they provide a means for ordinary retirees to use a balance of growth and defensive assets to generate income while facilitating the orderly drawdown of capital across retirement. Retirees who purchase account-based products overwhelmingly select balanced portfolios.

As a result, allocated products have been able to attract retirees away from lump sums where term (including life expectancy) and lifetime products have not. Regulatory recognition of allocated products has been critical to this success.

Regulatory recognition of account-based products as complying income streams (appropriately constrained) is likely to be acknowledged as another milestone in the development of policy to encourage retirees to choose long term income streams.

An account-based product has other advantages over an interest-bearing product:

- Historically, balanced portfolios produce significantly better returns than interest bearing ones over investment periods of 15 years or so.
- These superior returns would generate a greater level of self-sufficiency for retirees.
- In practice, competition between providers of complying interest-bearing products is somewhat limited. Availability of complying account-based products would open the market up dramatically to a broad range of balanced portfolio managers.
- In IFSA’s view, complying account based income streams sit well with the Government’s proposals for freedom of choice of fund and of portability of benefits. Regulatory recognition of these products would broaden an individual’s choice of providers and choice of investment options in the benefits phase of superannuation. Whether or not superannuation fund choice is able to be implemented, it would be disappointing if whatever choice exists for pre-retirement superannuation fund members is limited at retirement by restrictions which impel retiring superannuants to skew the allocation of their superannuation savings towards interest-bearing securities to an undesirable degree.

A complying account-based income stream would have the following advantages over a SMSF complying pension:

- transparent allocation of income and capital, since the complex administration necessary to produce the desired estate planning result would be unnecessary;
- full application of the account balance towards provision of income during the life of the income stream recipient;
- no difficulties in the tax treatment of reserves (which have arisen in relation to defined income streams);

- no income deferral, since the special pension valuation factors for account-based products (see below) ensure income is drawn down over life expectancy; and
- availability to retirees who do not have their savings in the superannuation system (if non-superannuation annuities were to be allowed).

IFSA's Specific Solution

IFSA proposes that the rules for complying products be broadened to include a new complying product category. Products recognised would have the following features:

- **non-commutable** except in defined circumstances (as with current complying products);
- **no residual capital value** upon expiry of term of the product
- **term** to be life expectancy at the investor's age either upon purchase of the product or at some earlier age, such as life expectancy at age less eight years, (basis used by the Australian Government Actuary for asset test value of an income stream, that is, for a 65 year old, use the life expectancy of a 57 year old); and
- **income** payable each year determined by reference to a pension valuation factor as set out below (i.e. no drawdown between maximum and minimum values). That is, the total amount of the payment to be made is determined in accordance with the following formula:

$$\frac{AB}{PVF}$$

where: **AB** = the amount of the annuity or pension account balance
PVF = the maximum pension valuation factor determined by the following formula:

$$\text{Payment valuation factor} = \frac{1-v^n}{i} \text{ (limited to a minimum of 1)}$$

where **n** = the client's life expectation factor less the number of years elapsed
v = $\frac{1}{1+i}$
i = a factor to be set by the Commissioner. (A factor of 0.06 is recommended)

Example using current life expectancy as basis for term

Mr Jones is 65 and invests \$100,000 into an account-based complying pension on 1 May 2001. His life expectation factor is 16.21 (round up to 17).

His payment for 2000-01 is calculated as:

$$\begin{aligned} n &= 17-0 = 17 \\ i &= 0.06 \\ v &= \frac{1}{1.06} \end{aligned}$$

$$PVF = \frac{1-(1/1.06)^{17}}{0.06} = 10.5 \text{ (rounded to 1 decimal place).}$$

$$\text{Payment} = \frac{100,000}{10.5} \times \frac{61}{365} = \$1,590 \text{ (rounded to nearest \$10).}$$

On 1 July 2001, the PVF would be recalculated, but as Mr Jones has only been in the pension for 2 months, his time elapsed is still 0 years (to the nearest year), so $n = 17 - 0 = 17$. The PVF will not change from 10.5.

In 1 July 2002, he has been in the product 1 year and $n = 17 - 1 = 16$. The PVF will be:

$$PVF = \frac{1-(1/1.06)^{16}}{0.06} = 10.1 \text{ (rounded to 1 decimal place).}$$

Example using life expectancy at current age less eight years

Usage of life expectancy at current age less eight years (rather than life expectancy at current age) has the advantage of allaying concerns retirees may have about income running out too early.

Mr Jones is 65 and invests \$100,000 into an account-based complying pension on 1 May 2001. The life expectation factor at age 57 is 22.52 (round up to 23).

His payment for 2000-01 is calculated as:

$$\begin{aligned}n &= 23 - 0 = 23 \\i &= 0.06 \\v &= \frac{1}{1.06}\end{aligned}$$

$$PVF = \frac{1 - (1/1.06)^{23}}{0.06} = 12.3 \text{ (rounded to 1 decimal place).}$$

$$\text{Payment} = \frac{100,000 \times 61}{12.3 \times 365} = \$1,360 \text{ (rounded to nearest \$10).}$$

On 1 July 2001 the PVF would be recalculated, but as Mr Jones has only been in the pension for 2 months, his time elapsed is still 0 years (to the nearest year), so $n = 23 - 0 = 23$. The PVF will not change from 12.3

In 1 July 2002, he has been in the product 1 year and $n = 23 - 1 = 22$. The PVF will be:

$$PVF = \frac{1 - (1/1.06)^{22}}{0.06} = 12.0 \text{ (rounded to 1 decimal place).}$$

Alternative approaches to variations in annual payments

Current social security assessment rules require that payments do not vary from year to year (except for indexation). FaCS has expressed a concern that annual payments from account-based products could vary – and in particular that payments could decrease in the year following poor investment returns.

The first and most important point is that overall returns from income streams invested in balanced or growth portfolios generally exceed returns from interest-bearing securities. This is true to a very high degree of probability in the long run and, depending on the portfolio selected, it can hold in short-run scenarios as well. This means that both retirees and pension outlays will benefit in the long run. Pensioners will have higher overall income and income assessed under both social security and income tax rules will be higher than for interest-bearing securities.

In terms of individual impact, retirees would be able to select products or portfolios which best suit their needs. Market volatility does not appear to be an issue for individuals purchasing allocated products, and should not be any more troublesome for complying account-based income streams.

Government risk from volatility in complying account-based income streams should be more than outweighed by benefits. The fixed formula for income drawdown (as opposed to current allocated products) means that higher returns will be directly translated into higher assessable income for both tax and social security. The social security income test deduction rules also set a floor below which low returns cease to have an effect on outlays. Government has a

fairly simple long-run trade-off between return and volatility – with the benefit of a cap on down-side risk (through the income test rules).

There are a range of options to limit the effect of volatility on revenue and outlays. IFSA suggests that volatility is not a major issue, on the basis that:

- retirees can select a portfolio based on their income needs and risk tolerance; and
- government would benefit by accepting small volatility for revenue and outlays benefits, as well as to retain simplicity and transparency in assessment rules.

However, IFSA accepts this is a question for Government to resolve and would be happy to explore any options with Government.

Stochastic modeling indicates that, even in the short-term, there is a strong likelihood that the income level from a complying account-based product will exceed income from an indexed conventional complying life expectancy product.

GOVERNMENT COSTING CONSIDERATIONS

IFSA understands Government is concerned that this proposal may have fiscal costs. This could occur in two ways.

- **Assets test:** age pension outlays would rise if asset tested retirees, *who would not otherwise take up asset test exempt income streams*, are attracted into complying account-based income streams. This potentially includes:
 - retirees who would not receive any age pension under the assets test, but who would be bought under the assets test cut-out point on purchase of a complying account-based income stream; and
 - retirees who receive age pensions under the current means tests, but who would received an increased rate of pension on purchase of a complying account-based income stream.
- **Income test:** age pension outlays would rise if income tested retirees, *who would not otherwise take up income streams which qualify for deductions based on full purchase price*, are attracted into complying account-based income streams. (As we point out below, this would occur extremely rarely – if at all)

This concern appears to be based on a perception that account based products are likely to be significantly more popular than the current range of complying income streams. Complying account-based income streams may be more attractive than life expectancy or lifetime products (with their attendant investment asset allocation limitations), or SMSFs (which face significant administrative complexity to produce similar outcomes). However, this attraction does not necessarily lead to higher pension outlays.

This fiscal concern is likely to be misplaced in at least 3 significant respects.

- IFSA anticipates there will be substantial substitution from current assets test exempt incomes streams.
- Complying account-based products are highly likely to increase the amount of income assessed under the income test, actually reducing outlays. This would occur when retirees choose complying account-based products over other asset test exempt income streams. Higher income flow from these products will reduce pension payments under the income test - and retirees will have higher overall incomes.
- Recent growth in SMSFs as a means to provide complying pensions, backed by balanced or growth asset portfolios, has already extended the reach of complying income streams under the existing law. This trend looks set to increase. As this occurs, the substitution effect from complying account-based pensions becomes larger because more purchasers of complying account-based products would receive the same means test treatment anyway. (See ***Policy and Fiscal risk from SMSFs – below***)

IFSA welcomes the opportunity to explore the size of the substitution effect, and to test the outcomes of the two countervailing fiscal influences (increased take-up of asset test exempt products against increased income assessed from complying account-based income streams). IFSA understands that Treasury and FaCS have made some estimates of future income stream demand, based on income data.

In addition to testing the likely substitution effect, IFSA believes it is possible for the Commonwealth to develop rules, in partnership with industry, which encompass complying account-based products at an acceptable level of fiscal risk. A range of constraints could be imposed to limit potential fiscal exposure – without risking potential fiscal gain.

Substitution from current assets test exempt income streams

The size of the substitution effect between asset test exempt product categories is a critical question - the higher the substitution effect, the lower the Commonwealth fiscal risk from complying account-based products. Based on trends discussed earlier, IFSA believes the substitution effect among potential purchasers of complying account-based income streams will be close to complete.

Interest-based income streams (life expectancy and lifetime) could be expected to have a significant substitution effect, due to higher income and greater transparency of account-based income streams. IFSA believes that a very high proportion of life expectancy products are purchased primarily for their assets test exemption, not because of their intrinsic attraction to retirees. The proportion of lifetime products purchased for assets test reasons might be somewhat lower (due to the effect of adverse selection on longevity risk), however these products are purchased by a very small proportion of retirees.

Substitution is also likely to occur from SMSF asset test exempt income streams. IFSA members report that retirees generally find the administrative burden of SMSFs to be higher than they would wish in retirement. However, in the absence of alternative products invested in balanced portfolios, retirees appear ready to trade off administrative complexity for higher return. The capacity to avoid the "no residual capital value" rule for asset test exemption presents an additional incentive (See **Policy and Fiscal risk from SMSFs – below**).

Support for a high to complete substitution effect from current complying income streams flows from the increase in education and marketing effort for these products. Extensive marketing and education programs, combined with widely available software tools to demonstrate complying income streams, suggests that most retirees who could use current complying products to reduce their assets test exposure would already be doing so. There is a similar story for SMSF complying income streams. Since these retirees form the target group for complying account-based income streams, higher levels of take up of current complying products leads directly to a higher substitution effect.

'New' take-up of complying account-based income streams

The obverse of substitution between current assets test exempt income streams is to examine what 'new' take up of assets test exempt income streams might occur if complying account-based income streams are introduced. As set out above, 'new' take-up occurs if retirees who *would not otherwise* purchase a complying income stream, purchase a complying account-based product.

IFSA believes new take up will be miniscule compared to substitution from current complying income streams. Complying account-based income streams would represent a definite improvement over life expectancy products for almost all retirees, and over lifetime products for many retirees (depending on anticipated longevity). However, it is highly likely that most, if not all, retirees would select a complying product in any case. Reasons for selecting complying lifetime or life expectancy products, even on a 'second best' basis, are outlined above. Motivations for choosing (lifetime) pension deliver through SMSFs are discussed below.

IFSA does not believe there will be significant substitution between allocated products and complying account-based income streams. Retirees who hold allocated products yet still wish to reduce their assessable assets would already be doing so by means of lifetime or life expectancy income streams. This means substitution would be occurring between currently asset test exempt income streams and complying account-based income streams. Where the assets test is not an issue, the greater flexibility of allocated products – with the same degree of investment transparency and control – would them stronger attraction for retirees.

Potential 'new' purchasers of complying account-based income streams, after these two groups are excluded, are:

- retirees who would have purchased a complying product (life expectancy, lifetime or SMSF), but for barriers in either of
 - low yields and/or lack of transparency (life expectancy and lifetime products), or
 - administrative complexity (SMSFs); and
- retirees who would not have purchased a complying product, but would consider a complying account-based income stream.

Possible cost constraints

IFSA does not believe, given the considerations discussed above and based on stochastic modeling, that there would be additional costs arising from recognition of complying account-based income streams. However, IFSA does understand that Government is concerned at the possibility of increases to age pension outlays. IFSA is happy to explore possible fiscal constraints within the broad public policy objectives set out at the beginning of this paper.

Since complying income streams would be exempt from the assets test, government may wish to explore the reach of these exemptions. IFSA's proposed model would not provide access to capital, except in the same limited circumstances as current asset test exempt products. This meets the policy test for exemption from asset testing. However, if government wishes to explore them, IFSA would be prepared to discuss options such as:

- an assets test exemption of less than 100%; or
- a ceiling on the total assets test exemption for individuals.

Cost constraints inherent in this proposal

There are some cost constraints inherent in IFSA's proposal for complying account-based income streams. These are discussed in more details earlier in this paper.

- The long-run level of income modeled for by these products is higher than that generated by current fixed income complying products.
- The long-run level of income generated by these products is likely to be considerably higher than the income generated by a typical self managed superannuation fund version (which involves reserving of assets).
- The fixed income drawing limits deferral of income derived by the underlying fund, in contrast to both allocated products and to SMSFs. Indefinite income deferral (available through SMSFs) is avoided altogether.

Policy and fiscal risk from SMSFs

At various points in this paper we have pointed out that there is considerable potential to use income streams delivered through SMSFs to avoid the income and assets tests. We have drawn attention to this potential because we believe that a significant number of retirees who may be attracted to SMSF income streams would actually prefer a complying account-based income stream. IFSA is also concerned that the possibility of widespread avoidance may threaten the integrity of retirement incomes regulation and public income support.

We have outlined above the means by which SMSFs can avoid the requirement of no residual capital value for assets test exemption. This is achieved by selecting an income rate that does not exhaust the capital contributed. The capital remaining on the death of the pensioner is distributed to family members via the reserves of the SMSF. (If the deprivation rules are applied to an excess asset value at the commencement of the pension, they will only apply for

[5] years, after which time the whole value of the assets contributed will be effectively exempt for the assets test.)

A similar outcome can arise if the assets backing a SMSF complying income stream outperform projections. A reserve then builds up in the SMSF, which can be passed on to other fund members, while the level of income assessed for social security remains low (or even zero).

The policy risk arising from these strategies is that the public policy objectives of the assets test exemption can be circumvented. Only limited draw down of capital occurs over the life of the retiree, and public income support has been provided at a level higher than to other retirees with similar resources. The fiscal risk is that pension outlays will be higher where the application of the assets test is limited or avoided, and tax revenues will be lower where the reasonable benefits limits are avoided or the value excessive benefits is limited.

This strategy can also be used to limit assessable income. Where a low level of income is selected, little or no income may be counted towards the income test, increasing outlays. Assessable income for tax may also be limited, reducing revenue.

Evidence of use of these strategies, and of increases in use of SMSFs for complying pensions, is largely anecdotal at this stage. IFSA is aware that FaCS has access to age pensioner data that would show any increase in SMSF complying pensions, and data that would show the amount of assets backing those pensions. Analysis of this data should give an indication of the degree of exposure to SMSFs as avoidance vehicles.

IFSA also notes that these strategies are the subject of open discussion in the financial advice community.

Further costing and consultation

IFSA would like to continue discussion with FaCS and Treasury to agree costing assumptions and examine the fiscal impact of complying account-based income streams. In this paper, we have explored a range of factors related to the fiscal cost or savings arising from complying account-based income streams. IFSA has data and modeling for some of these considerations, while some data is held by Government.

We have also raises a number of options to limit fiscal risk to the Commonwealth, which IFSA would like to explore further with FaCS and Treasury.

February 2001

Appendix 5 Fees and Charges

Introduction

More than nine million Australians hold life insurance, superannuation, and managed investments savings products and, currently, the total value of the funds in these products exceeds \$680 billion. With savings of this magnitude, and with the overwhelming majority of Australians now participating in this segment of the financial services industry, consumers are focussing increasingly on ‘value for money’ outcomes for the products and services, including superannuation products, on offer by funds managers and life insurance companies.

The financial services industry has devoted considerable resources to building relationships worthy of the trust of its superannuation consumers. It has done this by offering products and services that allow consumers to access risk management, diversification, investment expertise, and administration and custody at affordable prices. Vigorous competition amongst superannuation providers has ensured access by Australian consumers to the widest possible range of superannuation products and services, at the lowest cost. Intense scrutiny of the industry by government, regulators, media and research houses plays an important role in ensuring the transparency and integrity of the superannuation industry.

The industry also faces competition from do-it-yourself products and services e.g. setting up self-managed super funds. Such has been the level of consumer confidence in the products on offer, however, the segment of the managed investments industry has continued to experience strong demand in the face of competition from both self managed options and other retirement products.

According to consumer research, fees are one the major considerations for investors when making a decision to invest. Therefore, the industry has endeavoured to give consumers accurate and meaningful information on fees applicable to their products. Australians are relatively sophisticated consumers of financial services and products, however, so they tend to factor in a range of considerations when assessing value for money. Sweeney Research (July 2001) shows that fees (86% of respondents) rank with reputation of the manager (88%), long term performance (96%) and risk (88%) as being ‘very important’ and ‘important’ factors.

Industry commitment

Evidence of industry’s commitment to offering transparent products and services can be found in the IFSA Mission Statement:

“IFSA ‘plays a significant role in the development of the social, economic and regulatory framework in which our members operate, thereby assisting our members to serve their members better.

We achieve this mission by:

- Encouraging ethical and equitable behaviour through industry standards;

- Achieving simple and efficient regulatory standards;
- Creating level playing fields and competitive markets;
- Contributing to a strong economy and savings.
- Supporting its members by improving the public understanding of financial matters through a range of educational materials and activities.”

Tangible evidence of the industry’s efforts to achieve transparency and integrity in superannuation product and fee disclosure has been evident in a number of industry public policy initiatives. These include:

- Development and adoption of the industry standard Management Expense Ratio (MER), a standardised fee calculation and disclosure enabling investors to compare ongoing fees across all complying products, and to ascertain the cost difference between direct and indirect investment;
- Development and adoption of an industry standard Product Performance measurement, which requires all performance figures to be shown net of fees to enable comparability of investment returns across all products;
- Development of Simpler Managed Investment Prospectus with ASIC and inclusion of more consumer friendly fee disclosure – an initiative aimed at providing consumers with more user friendly and understandable point of sale documents;
- Submissions to government calling for the enhancement of fee disclosure in superannuation Product Disclosure Statements through the requirement for disclosure of fees in both percentage and dollar amounts;
- Distribution of free consumer education materials on understanding fees applicable to managed investments;
- Commissioning and release of statistical data on the levels and trends in fees (1999 and 2001 PFACS Rice Reports on superannuation and 2001 KPMG report). Attached to this submission is the 2001 PFACS report Rice Report entitled *Superannuation Fees and Competition*. This report includes clear evidence of the downward pressure on fees for the great majority of Australia’s superannuation contributors. Importantly the Rice report is based on data extracted from the annual reports and statements of a representative sample of funds in all segments of the superannuation industry. **This is significant because some other surveys used headline or maximum fee rates as stated in pre-sale material. This practice inflates fee levels and does not represent market practice.**
- Commission and release of consumer research into attitudes about fee disclosure, levels, and value for money of managed investments;
- Industry support for FICS , an independent complaints service, free of charge to consumers where complaints on fees and other matters can be resolved

- Media comment and materials to assist consumers to understand fee regimes in managed investment and superannuation products.

IFSA policy on financial product disclosure and fees

IFSA believes an effective product disclosure regime as being essential to maintaining market integrity, instilling investor confidence and ultimately generating greater national savings. Effective disclosure of fees is one of the factors integral to achieving more effective competition and efficient allocation of capital. In pursuit of this objective IFSA has invested considerable time and resources consulting government agencies, consumer groups, and other relevant stakeholders over the past several years, and in particular in developing its response to the CLERP 6 and FSR reform processes.

At all times IFSA has endeavoured to build a disclosure regime that will result in:

- more concise and comprehensible information;
- a highly competitively and open market which encourages innovative and flexible products and pricing;
- a strong commitment to accuracy of information (and avoidance of misunderstanding through inappropriate use of over simplification or illustrations),
- appropriate relative emphasis on factors critical to investment decision making process, eg. Returns, risks, as well as fees; and
- greater comparability between functionally similar products.

IFSA's fee disclosure policy includes:

1. IFSA members support the full disclosure of entry, ongoing, switching, transaction costs, abnormal costs, and exit fees for both superannuation and non-superannuation products –such fees should be disclosed as a percentage.
2. IFSA supports the disclosure of fees paid to financial planners for advice given where that fee is paid by way of either an entry fee, trail commissions, or other benefits paid to financial planners for both superannuation and non-superannuation products.
3. For both superannuation and non-superannuation products, IFSA supports the disclosure of an Ongoing Management Charge (OMC) with a conversion of the percentage OMC to a dollar cost per \$10,000 invested. This figure would include all fund costs incorporated in on-going fees

Why projections of fees and outcomes will not work

Projecting the impact of fees and their impact on lump sums is a most imprecise exercise. It is imprecise because the accuracy of the projections depends on the

assumptions that are made. In the exercise there are five variables that would need to be factored into the projection models, viz, the rate of return, the rate of inflation, the level of fees, the level of contributions and the level of risk associated with the investment.

Returns and risk

In relation to returns the following could be said:

- Some funds have higher rates of return than others – does the government simply dictate that all funds will use the single rate of return. This could disadvantage those funds that charge slightly more than the market but return better than average results. Conversely, those funds with lower returns would be given an unfair advantage;
- If the funds are made to use their historical returns this would be problematic as the newer funds would not have a history – if the recent returns only are used in arriving at rate of return this could be to their advantage or disadvantage; and
- The volatility or risk of the fund also needs to be somehow factored into the equation. In accordance with financial market analysis, there would need to be a risk-adjusted rate of return to take into account the exposure of the fund to operational failure, and also to take into account the year to year volatility of returns – some funds are more exposed to risk than others...APRA recognises this in its risk based system of prudential supervision.

Level of fees

In relation to fee levels that are imputed into the projection model the following can be said:

- There is an assumption that fees will be constant over the life of the product, with no allowance for fees to fall as balances grow or fees to change in the event that the individual moves to a new fund either as a result of fund merger, fund closure or change in employment.

Level of contributions

- This is a problematic area because it is difficult to predict what the average salary of an individual might be over his/her employment life and how their level of contributions might vary as they get older.

Who will underwrite the projections – moral hazard

The current debate in the UK and Australia on the use of past returns as a guide to future savings outcomes exemplifies the caution that needs to be exercised in developing a projection model. If some future lump sum is to be used in the fee impact exercise, it is only reasonable for consumers to have an expectation that when the period of the projection expires they will have a lump sum that is reasonably

proximate to the projection. In the event that the consumer's actual lump sum falls well short of such the projection one could expect the following questions to be asked:

- Should the fund be liable to make up the shortfall as they made a false and misleading estimate of the final lump sum – would issuers expect to be indemnified?
- Should the government be liable to make up the shortfall as it forced industry to adopt a model of fee disclosure that led to a false and misleading outcome?

The Labor position

When the SGC was introduced the then Labor Government introduced under its SIS powers the Determination 153 disclosure provisions. These provisions did not provide that funds should do projections of fee levels and their impact on lump sums. However, for regular super contributions plans offered by life companies the Labor GII guidelines did provide for a very limited range of products that certain projections be made. It was generally recognised that these projections led to some wildly misleading results. Labor has no current policy on projection.

ASIC position on projections

ASIC policy on projections for IPOs places imposes strict guidelines for the use of projections – with a large number of qualifications to be made including the need to conduct sensitivity analysis – it is unlikely that ASIC would want superannuation funds to be adopting projections a la IPOs.