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Ms Jenny Wilkinson
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The Treasury
Langton Crescent
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By email: superannuationobjective@treasury.gov.au

5 April 2016

Subject: **Consultation on the objectives for superannuation**

Dear Jenny

Mercer welcomes the government's invitation for industry consultation to define the objectives for superannuation. Defining clear objectives is important in both the short and longer-term if the overall system is going to provide an adequate and secure retirement income for all Australians.

Mercer believes it is critical that the objectives are defined with a total retirement income perspective and a long-term view. To do this properly we recommend defining the objectives of both superannuation and the age pension simultaneously, with a key factor being the inclusion in the objective of a desired level of total income from both superannuation and the age pension.

With this objective in mind, we recommend that the high level objective for the overall retirement income system should be:

> *to provide the vast majority of Australians*[1] *with an income throughout their retirement that enables their pre-retirement living standards to be maintained.*

Furthermore, we do not believe it is appropriate to state that superannuation should substitute or supplement the Age Pension. It is too vague. Whilst recognising that supplementation and substitution will occur, we need a clear and sensible line in the sand as to when superannuation income should move from supplementing the age pension to becoming a substitute for it. Similarly, some rationale and clarity around the rate of substitution is needed. We suggest some possible principles in the Attachment.

[1] This objective deliberately uses the term "the vast majority of Australians" and not "all Australians" as we do not believe that the Government should support, either through superannuation tax concessions or the age pension, the maintenance of lavish or expensive lifestyles.

Inclusion in the objective of a desired level of total income from superannuation and the age pension will provide a firm basis for policy decisions about the design of the age pension means tests, such as:

- at what point income from superannuation should move from supplementing the age pension to becoming a substitute; and
- the appropriate rate of substitution;

as well as informing decisions about the level of superannuation savings which should be compulsory (i.e. the SG requirements) and the level to which incentives should be provided to encourage people to voluntarily save through super.

We also believe the objectives of superannuation must include a whole-of-life approach, including reference to how longevity risk may be managed. Longevity risk is one of the biggest risks facing retired Australians as the length of their retirement is unknown and therefore ensuring their savings last as long as they do represents a challenge, both for individuals and for the design of the system. Retirees with longevity protection can draw down on their savings more confidently, consistent with the objective of super being to provide an income throughout retirement and not an estate planning vehicle.

We agree alleviating fiscal pressures on the government also needs to be addressed in the objectives. Mercer believes the costs of the Age Pension and the superannuation tax concessions need to be considered in combination over the longer term, as discussed in the report by the House of Representatives Standing Committee on Tax and Revenue in its 2015 inquiry into the Tax Expenditures Statement. The cost of super tax concessions to the government is only part of the overall cost of providing retirement incomes and should not be considered in isolation. Concentrating on only one component will adversely affect the development of a sound and sustainable retirement income system.

We have developed further the above ideas and concepts in the Attachment together with some comments about the subsidiary objectives mentioned in the FSI's Final Report and the Discussion Paper.

Who is Mercer?

Mercer is a global consulting leader in talent, health, retirement and investments. Mercer helps clients around the world advance the health, wealth and performance of their most vital asset – their people.

Mercer Australia provides customised administration, technology and total benefits outsourcing solutions to a large number of employer clients and superannuation funds (including industry funds, master trusts and employer sponsored superannuation funds). We have over $50 billion in funds under administration locally and provide services to over 1.3 million super members and 15,000 private clients. Our own master trust in Australia, the Mercer Super Trust, has around 230 participating employers, 213,000 members and $20 billion in assets under management.

Please contact me on 03 9623 5464 if you would like to discuss this submission.

Yours sincerely

Dr David Knox
Senior Partner

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Mercer welcomes the opportunity to respond to the Government's Discussion Paper on the Objective of Superannuation. Mercer strongly supports the proposal to enshrine the objective of the superannuation system in legislation, to serve as a guide to policy-makers, regulators, industry and the community about superannuation's fundamental purpose.

The Discussion Paper invites comment on both the primary objective recommended by the Financial System Inquiry (FSI), as well as on the subsidiary objectives put forward by the FSI. Our comments on these matters are set out below in Sections 1 and 2 respectively, followed in Section 3 by our comments on the location where the objective(s) should be enshrined.

Section 1 – Primary Objective

The primary superannuation objective recommended by the FSI (FSI Objective) is:

> *To provide income in retirement to substitute or supplement the Age Pension*

The need for a broader perspective

For the development of sound future policies, it is important that agreement is reached on the objective of the overall retirement income system as well as the objectives of each pillar within the system, together with an agreed understanding of the integration and relationships between each pillar.

We are concerned that the FSI Objective does not provide any indication of, or reference to, the desired outcome, namely the level of income which superannuation (or superannuation plus the age pension, for those eligible) should provide. Arguably any level of superannuation would meet the FSI Objective. It therefore provides little guide to policy makers as to the level of superannuation savings which should be compulsory (i.e. the SG requirements) or the level to which incentives should be provided to encourage people to voluntarily save through super.

In Mercer's view it is essential for the objective of the overall retirement income system to include a desired level of income in order to provide meaningful guidance to policymakers.
Secondly, we note that the FSI Objective makes it clear that superannuation should be designed to provide income in retirement. We strongly agree with this emphasis which we expect will support the direction of superannuation policy towards encouraging retirees away from lump sums and towards income products. On the other hand, it is worth recognising that many retirees have a need for capital (or lump sum payments) for a range of purposes during their retirement years. Therefore continued access to some capital from superannuation during retirement is a desirable outcome.

In our view the objective should more clearly include the message that the income from superannuation and the age pension should be designed to last the whole of the person's retirement period, resulting in the need to consider longevity protection[2].

[2] We have made further comments on the issue of management of longevity risk in Section 2 below.

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Therefore Mercer proposes that the objective of our total retirement system should be:

> *to provide the vast majority of Australians with an income throughout their retirement that enables their pre-retirement living standards to be maintained.*

The exception (from 'the vast majority') would be for those Australians with considerable wealth and/or income for whom it is unreasonable to provide taxpayer support through superannuation at a level that allows them to maintain their pre-retirement living standards from their superannuation income. That is, it is reasonable to impose a limit on the extent to which the Government supports the provision of retirement income.

Mercer's suggested approach

The primary purpose of the age pension should be to alleviate poverty amongst older Australians. That is, it should be focused on those with limited means. As an individual's means increase, whether through income or wealth or a combination thereof, it is reasonable that the provision of the age pension reduces.[3]

This approach is broadly consistent with the FSI's recommendation that the purpose of superannuation is to:

> *To provide income in retirement to substitute or supplement the Age Pension*

However the FSI objective represents a very high level objective and does not help clarify at what point the age pension should be reduced as superannuation income increases. In other words, at what point does the supplementation become substitution? Similarly, the FSI did not discuss the rate of substitution.

We suggest that the following principles would help determine appropriate outcomes:

1. the primary purpose of the age pension is to alleviate poverty amongst the aged

2. where the age pension is means tested:

    - the age pension should not be reduced until a single person's income exceeds 40% of the average wage[4]
    - the rate of substitution should be such that there is a clear increase in an individual's future retirement income (allowing for the age pension, superannuation and tax) from additional superannuation contributions

[3] There would be some advantages in a universal, non-means tested pension (particularly much greater simplicity, lower administrative costs and reduction of disincentives to savings as well as earning other income). However given the current circumstances we have assumed continuation of a means-tested age pension for the purpose of this submission.
[4] A higher percentage would be used for a couple.

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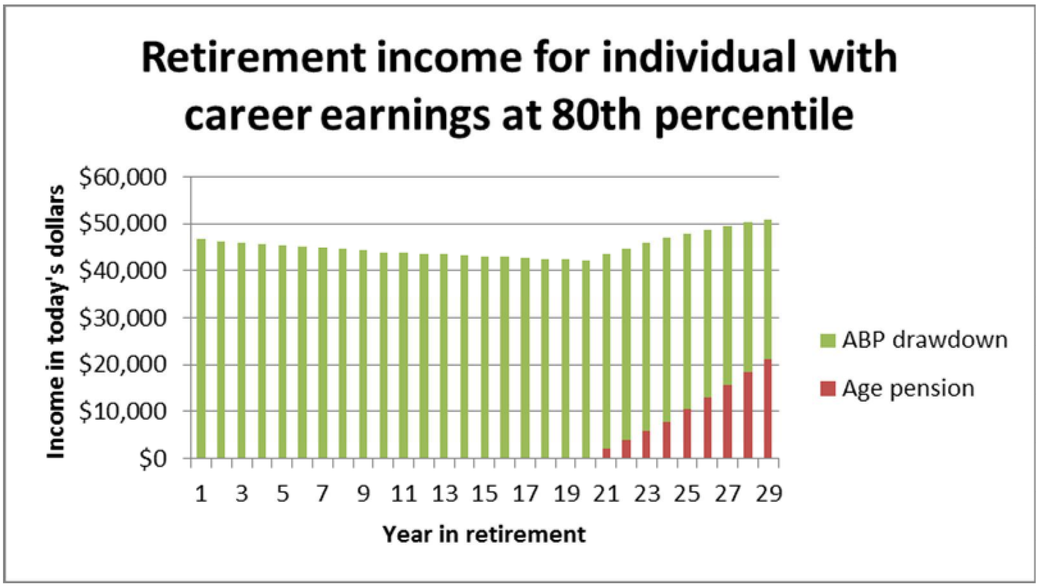
3. subject to other considerations (in particular simplicity and equity), it is appropriate that superannuation tax concessions not be directed at enabling the maintenance of lavish or extreme pre-retirement living standards from superannuation income alone.

To provide some perspective in respect of the possible application of this last point, we expect that it will apply to only a very small percentage of people.

As an example of the complementary roles of superannuation and the age pension, let us consider an individual who earns income at the 80th income percentile[5] throughout their working career from age 20 to age 67 (the future pension eligibility age). The following graph shows their level of retirement income (in today's dollars) assuming they withdraw from their account based pension at the minimum rate[6] each year.



The graph indicates that this retiree will not receive any age pension from the Government until age 88, or their 21st year in retirement. Life expectancy at age 67 for someone entering the workforce at age 20 today is likely to be about 24 years. Therefore it is reasonable to expect that some of these individuals will be receiving a part pension in the future.

This modelling allows for the legislated increase in the SG to 12% in 2025, some allowance for additional salary sacrifice contributions in line with current experience, as well as the new asset test rules introduced from January 2017.

In today's dollars, this individual has a projected final superannuation balance of $1.036 million (of which 10% is assumed to be taken as a lump sum) and concessional contributions in their final year of employment of $17,635.

[5] This is equivalent to an income of about $100,000 in today's dollars.
[6] Research indicates that this is the most common behaviour amongst retirees.

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The purpose of this example is to recognise that even at above average incomes for an entire full time career, a part age pension is likely to be paid in the later years of retirement. That is, income from superannuation provides substitution for the age pension well up the income scale and does not cease at median or average incomes.

Furthermore, we must recognise that superannuation accumulates over a lifetime and therefore, the taxation support should be expressed with this fact in mind. Such a lifetime approach, which could replace the current focus on annual contribution caps, would also provide greater flexibility and opportunity for those with career breaks.

Who is superannuation for?

In addition, the FSI recommendation does not provide any indication of the desired breadth of coverage of superannuation. For example, should superannuation policy be aiming to support retirement incomes for:

- all Australians of working age?
- all Australians of working age with a capacity to save?
- all Australians in paid employment?

We note that the current SG system covers most wage and salary earners but does not cover:

- contractors and other self-employed workers
- those on social security benefits or receiving paid parental leave payments (in most cases)
- those out of the workforce or doing small amounts of paid work (less than $450 amount from any employer) but who are not eligible for any social security benefits e.g. many non-working spouses caring for children

The legislating of superannuation's objective provides an opportune time to review whether the objective should embrace the ideal of providing superannuation for all Australians, which would then guide policy decisions on (for example) the breadth of SG coverage and level of incentives for those outside the workforce.

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Section 2 – Subsidiary objectives of the superannuation system

We agree it is preferable to express the objectives of the superannuation system in legislation via a reasonably brief primary objective plus a number of subsidiary objectives, as proposed by the FSI, rather than to try to include all the desirable elements in a single objective.

We have set out below our comments on the subsidiary objectives proposed by the FSI.

Subsidiary objective (FSI)	Why the objective is important (FSI)	Mercer comments
Facilitate consumption smoothing over the course of an individual's life	Superannuation is a vehicle for individuals to fund consumption in retirement largely from working life income. The system should facilitate consumption smoothing while providing choice and flexibility to meet individual needs and preferences.	We agree with this objective. This objective supports the SG system by which a minimum level of superannuation contributions is required for most employees throughout their working life. The current concessional contribution caps are consistent with this objective to the extent that they encourage consistent voluntary savings to make the most use of contribution tax concessions. However the current annual contribution caps arguably do not meet this objective from the viewpoint that they limit the ability of those who are out of the workforce for a period of time to "catch up" their superannuation contributions. This is particularly significant for many females who may spend some years out of paid employment often because of family responsibilities. It is also significant for those working part-time while caring for young children or older parents. Such part-time workers are likely to have a very limited capacity to save for retirement during those years. Potential policy response: Lifetime concessional tax limits to

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superannuation contributions, as opposed to annual limits, would create a fairer and far more equitable retirement savings system for all Australians.

If an individual doesn't use the current concessional cap of $30,000 in a given year, half of what's unused should be rolled over to the next year and so forth. However, a concessional contribution in any year should not exceed three times the standard annual concessional cap, currently making $90,000 the maximum cap in any single year.

Lifetime concessional contribution caps would provide many more Australians with a fairer opportunity to build their nest egg in a tax-effective manner when they've the financial capacity to do so. This does not need to be retrospective.

The reality is most Australians cannot afford additional super contributions of $30,000 for much of their working life and are therefore missing out if they leave the bulk of their super contributions to the latter part of their career, often when their disposable income is highest.

Retirement savings are a lifetime journey and all Australians should have the opportunity and flexibility to build a more secure retirement when they can afford it.

Lifetime limits would create a much fairer system; they would secure more adequate retirement incomes for more Australians; lessen the cost of the future age pension to taxpayers; and allow people – particularly women –

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		who have been in and out of the workforce to catch up in their retirement savings. This objective also supports the use of longevity products to smooth consumption over the course of an individual's life.
Help people manage financial risks in retirement	Risk management is important as retirees generally have limited opportunities to replenish losses. The retirement income system should help individuals manage longevity risk, investment risk and inflation risk. Products with risk pooling would help people to manage longevity risk efficiently.	This is an important aim. In particular, a range of longevity products needs to be encouraged. Longevity risk is one of the biggest risks facing retired Australians as the length of their retirement is unknown and therefore ensuring their savings last as long as they do is challenging. We agree with the emphasis on longevity protection via pooled approaches that support surviving retirees (e.g. lifetime annuities and mortality pools) rather than the use of conservative drawdown approaches that are likely to result in sub-optimal retirement living standards and sizable bequests. Retirees with longevity protection can draw down on their savings more confidently, consistent with the objective of super being to provide an income throughout retirement and not as an estate planning vehicle. Potential policy responses: (i) Remove impediments to innovation in income products (ii) Given the societal benefits associated with longevity risk sharing products, the social security and/or tax systems could provide incentives for income streams offering longer term longevity protection – for example, the first $X or a percentage of any assets invested in a longevity risk sharing product could be excluded from the assets test and/or deeming under the income test.

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

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		of the concessions. • Firstly, it ignores future age pension costs which will inevitably increase if super benefits were reduced due to higher tax on contributions, earnings or benefits. A recent report from the House of Representatives Standing Committee on Tax and Revenue[7] recommended that the interactions between superannuation and the age pension should be modelled on a regular basis. • Secondly, it ignores any redirection of contributions to other tax effective investments that would occur if the super rules became less favourable. • Appropriate long term policy can only be determined taking into account the total cost of the retirement system. It is worth noting that the projected cost of public spending on pensions in 2050 for Australia is less than 3% of GDP compared to an OECD average of about 10% of GDP.[8]
Be simple and efficient, and provide safeguards	The system should achieve its objectives at the minimum cost to individuals and taxpayers. Complexity is less appropriate for a compulsory system, as it tends to add to costs and to favour sophisticated and well-informed investors. Given the compulsory nature of SG contributions, the system needs prudential	Simplicity and efficiency are important elements, but better outcomes for members should not be sacrificed for simplicity. For instance, we believe the most appropriate investment outcomes for disengaged members can be achieved through a lifecycle investment approach in which the asset mix changes dependent on the member's age. Whilst this adds some complexity, we consider the more appropriate investment outcomes outweigh the additional complexity. It will only be possible to assess whether the system is achieving its

[7] House of Representatives (2015), Standing Committee on Tax and Revenue, The Tax Expenditures Statement, Recommendation 4
[8] OECD, Pensions at a Glance 2015 OECD and G20 Indicators, Table 9.5

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	oversight and should provide good outcomes in both the accumulation and retirement phases for disengaged fund members.	objectives at the minimum cost to individuals and taxpayers if the objective includes a desired level of overall income from superannuation and the age pension.

Need for restricted access and tax concessions

In our view it is important for the subsidiary objectives to also draw out the need for restrictions on access to superannuation, so that it is used for the intended purpose of providing income in retirement, but that these access restrictions need to be counterbalanced by tax concessions. Without such tax concessions, there would be no incentive for voluntary superannuation saving due to the restrictions on access. As noted in the 2010 Henry Report on Australia's Future Tax System:

> *"Superannuation is the main form of lifetime saving outside the family home. There is a bias in the current taxation system against long-term saving, particularly lifetime saving such as superannuation. There are at least two reasons for taxing superannuation more favourably than other saving (with the exception of housing) to reduce this bias.*
>
> *The first reason is that taxing superannuation earnings, like the earnings on most forms of savings, means that the effective rate of tax on the real value of saving increases the longer an asset is held…This effect is more pronounced in superannuation than other savings as superannuation saving is generally held for a longer time. This justifies a more favourable tax treatment.*
>
> *The second reason is that superannuation is a form of deferred income. People should be taxed on superannuation at the rate that would apply if their income had been spread over their entire life rather than merely over their working life. This is an income-smoothing argument. As a person's retirement income is generally lower than their income while they were working it should be taxed at a lower rate."*

Provision of insurance

Another issue which does not seem to be adequately catered for in the FSI's proposed objectives is the provision of death and disability insurance within superannuation. While the inclusion of insurance in superannuation does add a significant layer of complexity and cost, the rates negotiated by super funds are generally considerably lower than members could obtain individually and, for most people, the cover provides valuable protection and helps reduce Australia's chronic underinsurance problem.

In our view insurance within superannuation provides a valuable cost-effective service within the group arrangements and should be supported by the objectives adopted.

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Measuring success

We note a number of the proposed objectives will be difficult to measure. Nevertheless, if future Governments are required to justify future legislative changes against the enshrined objectives, this may reduce the chances of inappropriate and/or knee-jerk legislative change occurring in future. That is, Governments would need to justify why a particular change should be introduced if it was inconsistent with the previously agreed objectives.

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Section 3 – Where should the objectives be enshrined?

We have recommended above that the objectives relate to the overall retirement income system including both superannuation and the age pension.

With this in mind, we recommend that the objectives be enshrined in a standalone piece of legislation (e.g. The Retirement Income System Objectives Act 2016) rather than in existing legislation relating to either superannuation or the age pension.