# Objective of Superannuation

Submission to Treasury

8 April 2016

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*This report has been prepared in response to the Government's discussion paper entitled 'Objective of Superannuation' issued on 9 March 2016.3*

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**SYDNEY**
Level 1
2 Martin Place
Sydney NSW 2000
P +61 2 9293 3700
F +61 2 9233 5847

**MELBOURNE**
Level 20
303 Collins Street
Melbourne VIC 3000
P +61 3 8621 4100
F +61 3 8621 4111

**ABN 35 003 186 883**
**AFSL 239 191**

**www.ricewarner.com**

# 1. Executive summary

## 1.1 This submission

This submission has been prepared by Rice Warner as a response to the Discussion Paper, Objective of Superannuation, issued by Treasury on 9 March 2016.

The Financial System Inquiry (FSI) recommended, that the primary objective of superannuation be:

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

The Government has accepted this recommendation. However, it now wants to canvass industry opinion on this purpose as well as determining whether to accept or modify the subsidiary objectives of the FSI.

## 1.2 About Rice Warner

Rice Warner was established in 1987 to support superannuation funds and businesses operating in the financial services industry. It is an Australian business, owned and controlled by its key executives.

Over the last three decades, it has built a strong reputation for insightful commentary. Its independence means clients can be sure the firm always acts in their best interest and provides unbiased advice. Clients include most large superannuation funds and life companies as well as many other participants in the industry (service suppliers, regulators and industry bodies).

Through its research and public policy activities, Rice Warner has built an unrivalled reputation for delivering a unique perspective across the superannuation, wealth management.

## 1.3 Conclusions

We are supportive of the approach taken by the FSI of having primary and subsidiary objectives. The primary objective provides the overarching objective while the subsidiary objectives ensure key elements of the primary objective. A single, simple statement is unlikely to provide sufficient focus and would probably become just a slogan.

### *Primary objective*

We are broadly supportive of the FSI's primary objective. We believe that the primary objective should also emphasise the need for a comfortable income in retirement. We would therefore propose a modest amendment so that the primary objective is:

*To supplement or substitute the Age Pension in or to provide an adequate income in retirement.*

### *Subsidiary objectives*

We are also broadly supportive of the subsidiary objectives, but offer the following suggestions:

| | |
|---|---|
| Smoothing of consumption | This is problematic given varying incomes needs over retirement with likely spikes due to unforeseen circumstances. We do not believe that this is a viable objective. An objective to allow retirees to meet income needs as they occur would be more practical. See Section 4.1 |

| | |
|---|---|
| Managing risks | We agree that supporting risk management is an appropriate objective. The opportunities to pool and manage longevity risk are, however, limited at the moment. (Section 4.2) |
| Pre-funding | We support this objective as it provides more security and has served Australians well. (Section 4.3) |
| Best Interests of Members | This is a sensible objective. |
| Alleviate fiscal pressures | We accept that there needs to be limits as to the impost of the system of the retirement incomes system. We broadly support the proposal from ASFA that there be a targeted cap for the cost to Government of direct outlays and tax concessions. The issue will be determining what the cap target should be. (Section 4.5) |
| Simple and efficient | We agree that this is a worthy objective, but are sceptical as to whether it is achievable given the long experience of grandfathering complex arrangements. |
| Life insurance | There is no objective for life insurance and we believe that this is a significant omission. Many superannuation members will be prevented by death or disablement from working through to retirement age. They will not be able to provide for themselves before and after retirement without the supplement of an insurance benefit. A subsidiary objective should be added to provide for life insurance to ensure comfortable retirement incomes even if the member cannot work to retirement. (Section 4.7) |

### *Commentary*

Superannuation is currently used for a range of purposes not specifically covered by the primary objective. We suggest that consideration be given to whether the other current usages (set out in Section 3) should be limited in any way.

We also need to ensure that superannuation and the Age Pension operate in concert to produce the best outcomes. We consider the Government should have the following objectives (Section 5.1):

- The Age Pension should be set at a level sufficient to keep all pensioners out of poverty
- Superannuation should aim to get as many Australians as possible to a comfortable living in retirement.

The adequacy of retirement incomes is a critical component of retirement incomes system. We believe that the ASFA Comfortable Standard is a reasonable target for adequacy, but that this single measure should be expanded to include standards for specific groups. For example:

- Renters
- Different geographic locations.

Fiscal sustainability will require an equitable balance between direct Government outlays and tax concessions. If more is to be done alleviating poverty in retirement, concessions need to be better targeted.

Boosting national savings via inflation protected investments in superannuation will be beneficial in its own right and by improving living standards in retirement

This report was prepared and peer reviewed for Treasury by the following consultants.


Prepared by

Michael Rice
CEO
Telephone: (02) 9293 3704
Michael.rice@ricewarner.com

Prepared by

Nathan Bonarius
Consultant – Market Insights
Telephone: (02) 9293 3722
Nathan.bonarius@ricewarner.com

Prepared by

Alun Stevens
Senior Consultant
Telephone: (03) 8621 4105
Alun.stevens@ricewarner.com


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# 2. Key Objective of Superannuation

## 2.1 Do we need an objective?

In our submission to the Tax White Paper Task Force[1], we stated that the main reason for having a superannuation system is to encourage people to become self-sufficient in retirement.

The system has many well-known issues which we listed:

- The Age Pension is neither a safety net nor a universal benefit since Australia has a unique system of means-testing its State benefit. This makes it difficult for workers to plan for retirement, given the majority will receive a full or part Age Pension during their retirement.
- The means tests for the Age Pension exclude the value of the family home. This favours home owners over renters. It also creates anomalies between different home owners. A couple with a home worth $500,000 and $1.25 million of financial assets would receive no Age Pension. In contrast, a couple with a $3 million home and minimal financial assets would receive a full Age Pension, at the expense of taxpayers in much less fortunate situations. Further, as Australia has limited death duties, the family home is passed tax-free on death in retirement. This could occur even if a married couple receives a full Age Pension throughout retirement – and this benefit is worth more than $800,000.
- Taxation has a complex basis. Superannuation funds are taxed on contributions and earnings and this reduces the end benefits members will receive. In contrast, most earnings and benefits received after age 60 are tax-free.
- Tax concessions are generally agreed to be inequitable even though they are changed by government frequently.
- Default investment strategies in the working years are world-class. However, there are no defaults in the retirement phase and the interaction between superannuation, taxation and the Age Pension is complex.

When we look at these issues, we note that the system has not grown as part of any considered plan, but as a consequence of:

- Award superannuation, which was originally a trade-off for a wage claim, and which transformed into the Superannuation Guarantee system
- past (ever-changing) tax and social security settings

Consequently, an overarching objective of the system is needed, which would allow all future proposed changes to be considered against it before they are made. This will provide focus and certainty for all participants.

We therefore support the move to define the objective of superannuation. We also support the approach of having a primary objective and subsidiary objectives. The primary objective provides the overarching objective while the subsidiary objectives ensure key elements of the primary objective. A single, simple statement is unlikely to provide sufficient focus and would probably become just a slogan.

[1] https://ricewarner.com/wp-content/uploads/2015/07/Tax-White-Paper.pdf

## 2.2 FSI Recommendation

The FSI stated that superannuation should have the primary objective of providing *income in retirement to substitute or supplement the Age Pension.* Implicitly, this statement looks at the three tiers of our retirement system and attempts to link them.

The first tier is the Age Pension, which is both a safety net for poorer retirees and a supplement (a part-Age Pension) for those with limited income. Most superannuation is built from the second tier of mandatory employer ('superannuation guarantee') contributions which are linked to the wages of employed workers. The third tier, which is used largely by those who are well-off, is supplementary voluntary contributions.

The key words in this objective are:

- Income – which implies a regular drawdown of pension payments, though not necessarily a fixed income stream such as an annuity

- Retirement – which implies the time period following cessation of work, noting that this need not coincide with the eligibility period for the Age Pension

- Substitute or supplement – one of the key complexities of the retirement system is the means testing of the Government Age Pension.

A key advantage of having a specified objective is that it will prevent superannuation benefits being diverted to other purposes. This is necessary to avoid superannuation being diluted and not achieving its purpose. As many people will not achieve a comfortable lifestyle in retirement, it would be imprudent to further reduce their chance of doing so.

Such requests have included:

- Using super to pay for health costs
- Using it to pay for home deposits
- Diverting the SG to supplement the income of young people or low-income earners.

Note that retirees can have other financial assets, the most common of which are funds held in bank deposits. The family home is also an asset which could be used for retirement income. Neither of these is mentioned in the primary or secondary objectives of the FSI.

## 2.3 Broader objective

Superannuation is but one element, albeit a significant one, in the accumulation of wealth to support lifestyles in retirement. The purpose of superannuation therefore needs to be considered in the context of the broader objectives of retirement incomes.

The purpose for superannuation as proposed by the FSI deals only with two of the elements of the retirement incomes system.

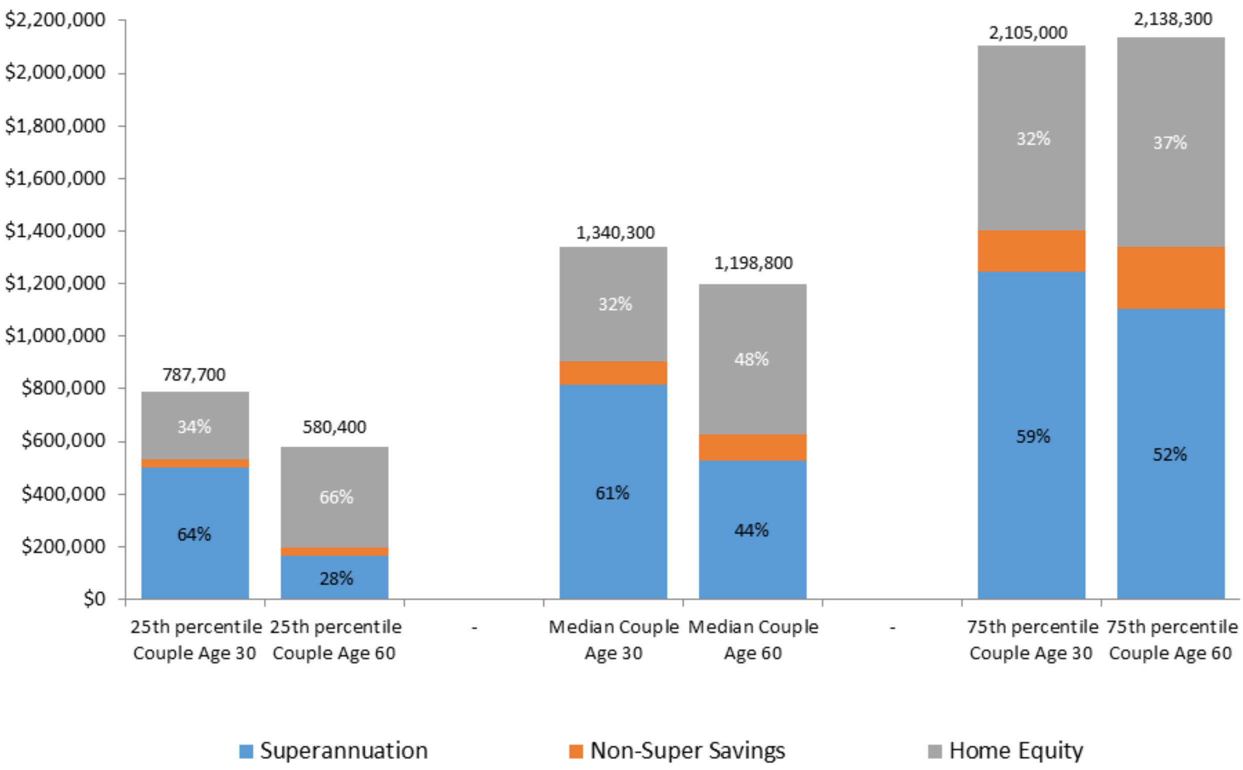
Australians have four types of assets in retirement:

- The family home is the largest asset for most retirees
- The Age Pension is the largest asset for retirees who rent and a bigger asset than superannuation for the majority of current retirees.
- Superannuation

- Other assets, including investment properties and equities.

The wealth components vary significantly by size of wealth as shown in the Graph 1:

**Graph 1. Projected retirement wealth Couples Aged 30 and 60 by wealth percentile Current Dollars.**




Superannuation is a significant contributor to the wealth of retirees and will be even more significant for younger generations who will have had the benefit of superannuation for longer, but it is not the only contributor. For some sections of the population, it is not the main source of retirement wealth.

An issue for Government to consider is whether the primary objective needs to be extended to take account of the other sources of wealth as well as superannuation.

# 3. Current usage of superannuation benefits

Superannuation has many usages, namely:

- Providing an income stream in retirement – this is the primary use of most account-based pensions, which is the dominant retirement product
- Lump sums at retirement – the major use of those with small retirement balances (say, below $100,000)
- Lump sums during retirement – generally used for emergencies
- Transition to Retirement pensions – benefits taken while still working
- Savings outside superannuation – those pension payments not required for consumption
- Funds for estates (bequests)
- Insurance benefits

Apart from the first, these uses all fall outside the primary objective. This suggests the primary objective needs to be modified or the subsidiary objectives need to be strengthened.

## 3.1 Lump sums

Most superannuation benefits are rolled over into pensions. However, members with smaller balances tend to take lump sums.

**Table 1. Use of Retirement Benefits**

| | Assets | | Accounts | |
|---|---|---|---|---|
| | ($b) | (%) | ('000) | (%) |
| Lump Sum | 9.23 | 16.7 | 224 | 58.9 |
| Pension | 46.14 | 83.3 | 156 | 41.1 |
| **Total** | **55.36** | **100.0** | **381** | **100.0** |

Source: Retirement Income: Myths and Realities[2]

The majority of retirees buying a pension use an account-based pension (still called an allocated pension by many within the industry). Retirees within an SMSF simply shift assets from accumulation to pension phase whereas those in an APRA-regulated fund effectively cash out their retirement benefit and then use it to purchase a product from the same or another fund.

A small number of retirees purchase lifetime annuities. These are used entirely to provide an income stream. The majority of retirees appear not to want annuities. It is likely that they see them as poor value in these low interest times but even in earlier years they were not popular. It is likely that the Age Pension is perceived to be a lifetime annuity – and this is indexed to wages and guaranteed by the Government.

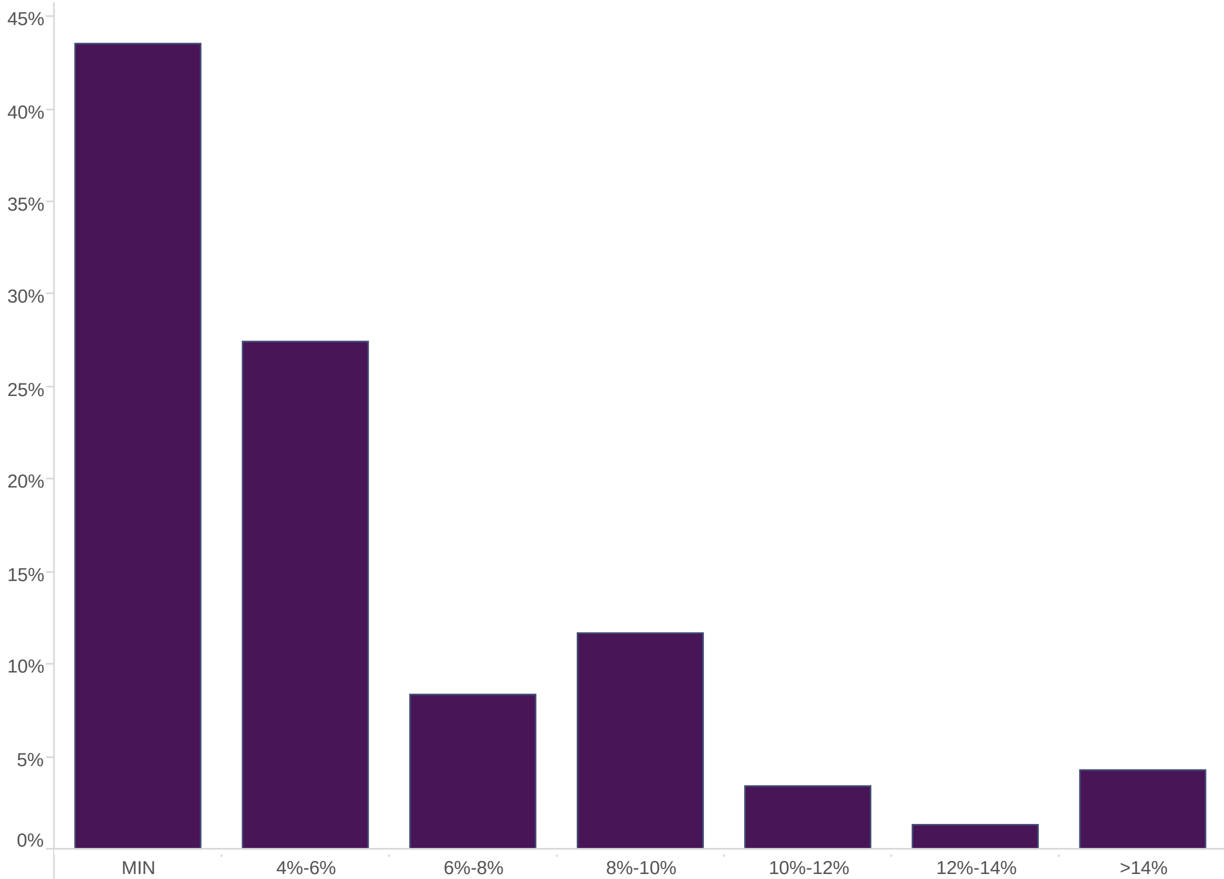
[2]http://www3.colonialfirststate.com.au/content/dam/wm/advisers/common/docs/Retirement_Myths%20_RealitiesFINAL.pdf

A number of retirees buy term certain annuities – and then roll them over like bank Term Deposits. Once again, these people are risk averse and want capital preservation.

## 3.2 Retiree drawdown behaviour

A significant number of retirees draw the minimum withdrawal amount required by legislation. For retirees up to age 75, this is usually close to the fund earning rate, so they are effectively living off their earnings and not consuming their capital.

**Graph 2. Distribution of Drawdown Rates**




Source: Rice Warner's Superannuation Insights Study

## 3.3 Lump sums at retirement

We have analysed the use of lump sum benefits. Most of the funds are used to pay down debt or are used to purchase investments. This is just a different form of retirement saving and both lead to higher levels of retirement income.

**Table 2. Use of lump sums in retirement**

| Use of lump sums | Age at Retirement from the labour force | | | | | |
|---|---|---|---|---|---|---|
| | 55 and under | 55-59 | 60-64 | 65-69 | 70 and over | Total |

| | % | | | | | |
|---|---|---|---|---|---|---|
| Rolled it over/invested it in an approved deposit fund/deferred annuity or other superannuation scheme | 8.5 | 15.8 | 13.5 | 14.2 | 12.3 | **12.8** |
| Purchased an immediate annuity | 0.7 | 1.2 | 0.7 | 1.9 | 0.0 | **1.0** |
| Invested the money elsewhere/personal savings/bank | 11.9 | 14.9 | 24.6 | 16.0 | 24.1 | **17.6** |
| Paid off home/paid for home improvements/bought new home | 30.1 | 23.7 | 21.2 | 25.3 | 27.4 | **25.1** |
| Bought or paid off car/vehicle | 10.8 | 6.9 | 11.5 | 10.1 | 12.0 | **10.0** |
| Cleared other outstanding debts | 16.4 | 10.8 | 7.8 | 9.4 | 3.9 | **10.9** |
| Paid for a holiday | 2.9 | 8.5 | 8.9 | 8.2 | 8.2 | **7.1** |
| Assisted family members | 2.8 | 3.7 | 1.8 | 4.3 | 4.3 | **3.0** |
| Undecided/Did not know | 16.0 | 13.9 | 8.6 | 10.1 | 7.3 | **12.0** |
| Lump sum details not stated | 0.0 | 0.5 | 1.4 | 0.4 | 0.5 | **0.6** |
| **Total** | **100.0** | **100.0** | **100.0** | **100.0** | **100.0** | **100.0** |

Source: ABS Survey data (Cat 6238.0)

## 3.4 Lump sums during retirement

Most retirees appear to be frugal and they spend their capital sparingly. However, there will be times when they need money for emergencies. Examples include supporting their family, paying for out of pocket health expenses and aged care.

Given the drawdown patterns of retirees, there does not appear to be any misuse of lump sum withdrawals. Of course, there will always be cases where people misuse their own money through excessive gambling or other wastage. Perhaps elderly demented retirees will be more vulnerable to this (or fraud).

## 3.5 Transition to Retirement pensions

Technically, these are not used for retirement income in the early years as the benefits are drawn before retirement commences.

We believe the main purpose of a Transition to Retirement (TTR) Pension, introduced in 2005, was to assist employees to continue to work part time while supplementing their income from a pension.

In fact, many full time workers use these vehicles to ‘catch up’ if they have inadequate retirement savings. By moving their superannuation benefit into a pension, the fund earnings become tax-free (which increases the benefit). Another benefit is that a minimum withdrawal is made each year. This amount supplements the individual’s disposable income and they can then make further concessional contributions to supplement their ultimate retirement benefit.

## 3.6 Savings outside superannuation

Many Australians hold financial assets outside superannuation. These are also a source of retirement income.

Those pension payments not required for immediate consumption are usually deposited in bank accounts and used as a different form of saving. Many retirees accumulate wealth during their retirement years.

## 3.7 Funds for estates (bequests)

Pension benefits left to non-dependants are considered to be a bequest. These are not used for any form of retirement income or to support living standards in retirement.

As retirees have no means of knowing how long they will live, they cannot absorb their benefit smoothly during their lifetime. They may well, therefore, provide an involuntary bequest via the transfer of unused capital at the time of death.

Supporting planned bequests through superannuation would undoubtedly detract from the primary purpose of providing retirement incomes. If the Government wanted to reduce bequests, it could tax them at higher rates or require retirees at advanced ages to buy annuities. Nonetheless, this is likely to be ineffective for so long as retirees can draw pension benefits of any size at any time.

# 4. Subsidiary Objectives

## 4.1 Smoothing of consumption

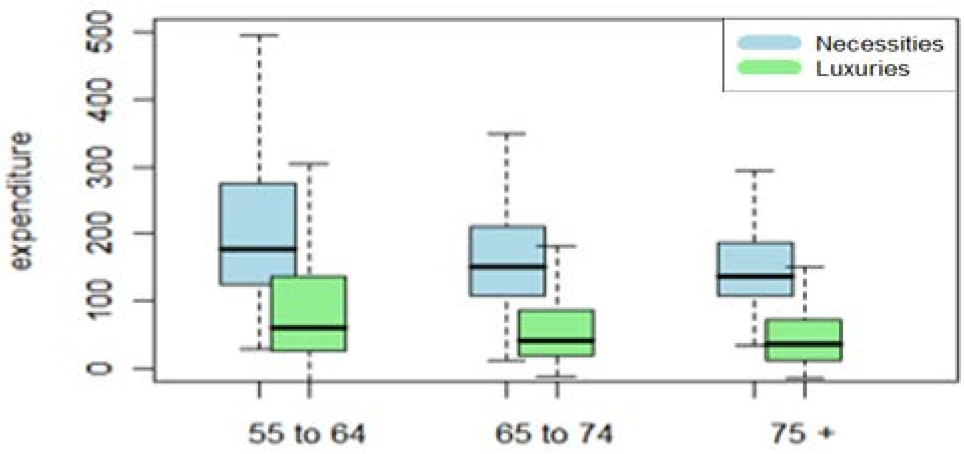
The FSI has a subsidiary objective to ***facilitate consumption smoothing over the course of an individual's life.***

This could be better worded as it implies that retirees should have a regular consumption pattern throughout their life. In reality, some expenditure is regular and increases with inflation while some is random.

There is evidence that expenditure is highest in the early years of retirement as people maintain their lifestyle in their active years. At some stage, retirees become more sedentary and their consumption falls. Later in life, when frail, some costs such as Aged Care, increase.

Research by Tim Higgins at ANU of expenditure patterns of retirees illustrates these trends as shown in Graph 3.

**Graph 3. Expenditure in retirement by age**




Given the variability of expenditure and the possibility that there will be one-off expenses periodically, should smoothing of consumption be an objective?

## 4.2 Managing financial risks

It is true that products with risk pooling would help retirees to manage longevity risk efficiently. However, the only product that achieves this is a lifetime annuity. Unfortunately, the value trade-off in these low interest times is too high.

Even though it is not possible to do this efficiently, we agree that mortality pooling is desirable. Many funds are looking at pooling without the need for a hard guarantee such as provided on annuities.

## 4.3 Funding

As superannuation is owned by individuals, there is more security in a funded system. It also benefits the nation as it adds to the pool of savings. Note, Australian superannuation funds have earned more than 4% p.a. above CPI over the last 20 years. Therefore, pre-funding has also increased the value of the retirement pool in real terms.

## 4.4 Best interest of members

This is a sensible objective.

## 4.5 Alleviate Government's fiscal pressure

ASFA has suggested that the cost to Government through Age Pension outlays and tax concessions on superannuation be capped at 6% of GDP.

It is difficult to have a firm cost as the Age Pension outlays are in respect of the current generation of pensioners whereas tax concessions are for future generations of retirees. However, a target such as that proposed by ASFA would be a good guide for Government. Any target should also provide for a balance between direct outlays and reductions of income via tax concessions to ensure equity across income bands.

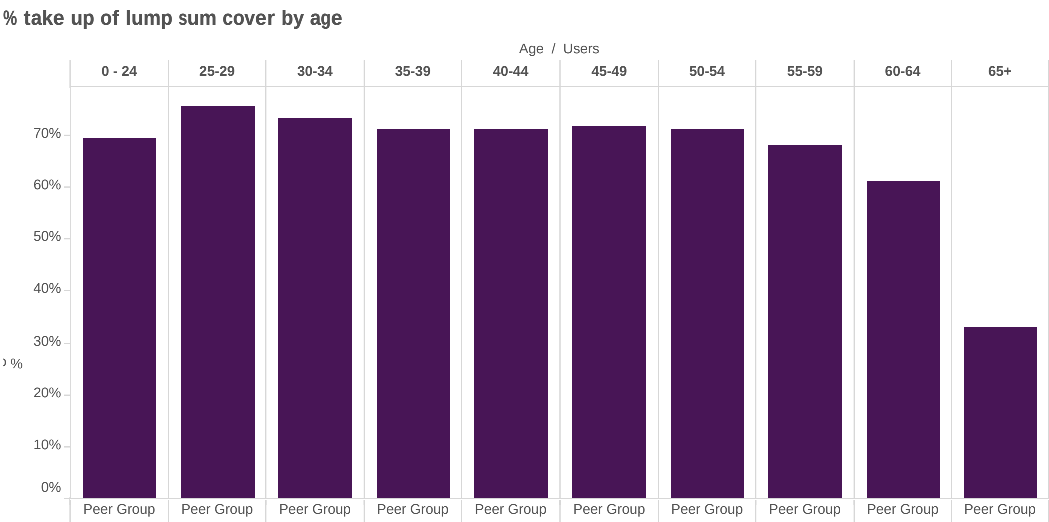
## 4.6 Principles

We agree it is desirable to have a simple and efficient system. Unfortunately, superannuation has become far too complex. There are a number of areas where the system could be made much simpler. However, the political obsession with grandfathering benefits means it will always remain unnecessarily complicated.

## 4.7 Life insurance

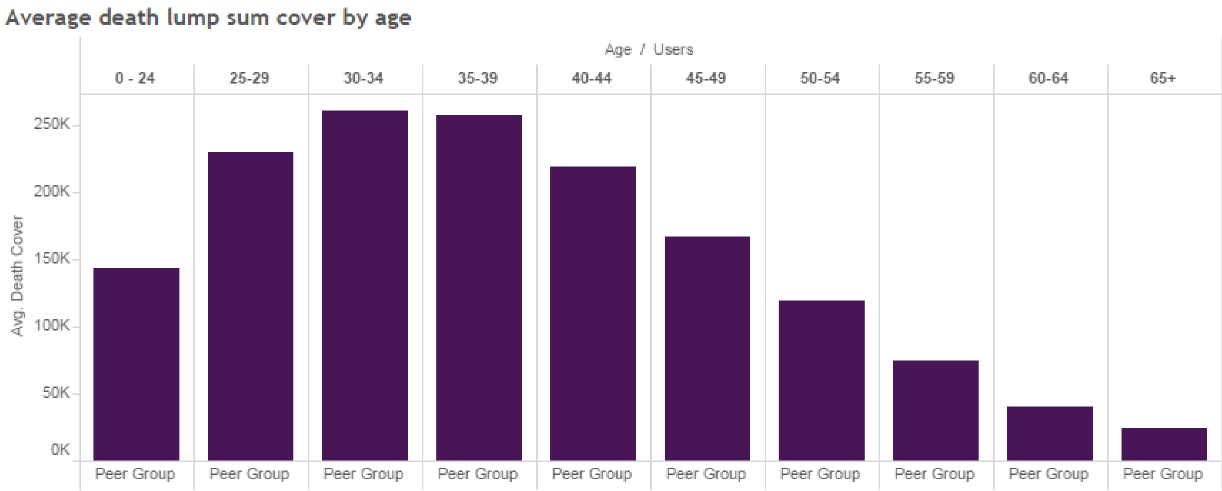
There is nothing in the objectives on life insurance even though this is a major part of the system. Life insurance provides security for those who are prevented from working through to retirement age, but need to support themselves and their families before and after retirement.

**Graph 4. % Coverage of superannuation members – lump sum cover**




Source: Rice Warner's Superannuation Insights Study

**Graph 5. Average superannuation death cover**




Source: Rice Warner's Superannuation Insights Study

# 5. Discussion Points

## 5.1 Retirement income or standard of living?

We consider the Government should have the following objectives:

- The Age Pension should be set at a level sufficient to keep all pensioners out of poverty
- Superannuation should aim to get as many Australians as possible to a comfortable living in retirement.

For the first objective, some targeting is necessary. For example, increasing rental assistance for those on a full Age Pension (or providing public housing) would be a well-targeted initiative.

Superannuation alone might not be enough to provide a comfortable living throughout all the retirement years. However, it would be sufficient for most Australians in conjunction with the release of equity in the family home.

## 5.2 Adequacy

The system is structured in a way that those who are prepared to sacrifice current income will be able to have an adequate retirement. The Government need only be concerned about whether the system allows people to generate benefits that are far in excess of adequacy – in which case, concessions are poorly targeted.

We believe the ASFA Comfortable Standard is a reasonable target for adequacy. It is simple and applies a uniform target for all. We should recognise variations need to be made for:

- Renters
- Location

## 5.3 Fiscal sustainability

Our submission to the Tax White Paper Tax Force discussed better targeting of concessions.

If the Government wants to spend more on alleviating poverty in retirement, it needs to target its concessions better.

There should be broad equity across income bands between direct outlays and outlays provided via tax concessions.

## 5.4 National savings

Superannuation funds collectively have earned about 4% above CPI over the last 20 years. This is close to the target set for the Future Fund so it is an excellent achievement.

If funds can maintain this record, it will lead to higher levels of national savings as well as providing members with better living standards in retirement.

Given the nation’s reliance on foreign capital, any increase in national savings is beneficial.