The future of Australia's super: a new framework for a better system

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About ASFA
ASFA is a non-profit, non-politically aligned national organisation that is the peak policy and research body for the superannuation sector. Our mandate is to develop and advocate for policy in the best long-term interest of fund members. Our members – which include corporate, public sector, industry and retail superannuation funds, plus self-managed superannuation funds and small APRA funds through its service provider members – represent more than 90 per cent of the 12 million Australians with superannuation.

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1. Executive summary

Twenty years after the introduction of the Superannuation Guarantee (SG), the environment in which Australia's retirement income system operates has changed dramatically. In particular, the large demographic shift that is occurring due to an ageing population is revealing weaknesses in the way the system caters to those entering retirement. The time is ripe to review superannuation policy settings to ensure they deliver the best retirement outcomes for all Australians.

This report details a set of principles that should guide superannuation policy decisions, then outlines a policy framework to help the system deliver on its objectives.

The framework comprises a series of recommendations in regards to three key areas:

1. Retirement income streams

The superannuation system needs to be designed in order to deliver income streams in retirement. This means creating a regulatory environment that facilitates the development of a flexible range of arrangements for retirees, better managing the transition-to-retirement phase, providing incentives for people to access income streams and implementing tools that help move cultural attitudes away from a lump-sum mentality.

Specific recommendations include:

- trustees should be able to offer 'MyPension' arrangements
- trustees should be able to 'default' members into a MyPension arrangement on an 'opt-out' basis
- contributions, other than mandated contributions, should cease five years after the Age Pension eligibility age
- all member statements should contain a projection of the member's likely income stream in retirement based on their current balance and contribution rate.

2. Defining the system's purpose

In order for governments, the industry and the community to ascertain whether or not the superannuation system is delivering on its purpose, there needs to be a clear understanding of what 'success' looks like. Once this has been defined, clear goals and objectives can be articulated against which its success can be measured. In this respect, equity, coverage and adequacy are clear issues that need to be addressed.

ASFA believes the goals for the superannuation and retirement system for 2050 should be:

- Age Pension expenditure and tax expenditure on super (properly measured) of less than six per cent of GDP
- less than 20 per cent of retired Australians over Age Pension qualifying age relying solely or almost exclusively on the Age Pension
- Australians retiring with an income replacement rate in retirement – in terms of household disposable income – in excess of 65 per cent (on average)
- at least 50 per cent of Australians able to cover their expenditure in retirement and at least have a 'comfortable' lifestyle in retirement, as described in the ASFA Retirement Standard.

2050 goals

Age Pension expenditure and tax expenditure on super of **less than 6% of GDP**

Less than 20% of retired Australians over Age Pension qualifying age relying solely or almost exclusively on the Age Pension

Australians retiring with an income replacement rate in retirement **in excess of 65%**

At least 50% of Australians able to cover their expenditure in retirement and have a **'comfortable' lifestyle** in retirement

3. Improving the system to better align with the principles and goals that underpin it

In addition to the provision of income streams, there are various areas of the system where policies are misaligned with the principles that should underpin the system's design. These areas include the gender disparity in terms of the super balances of women, self-employed people, Indigenous Australians and casual workers. Policies therefore need to be adjusted to ensure the system delivers for these groups of Australians.

Specific recommendations include:

- removing the $450-a-month threshold for the SG
- allowing trustees to offer insurance to a class of MySuper members on an 'opt-in' basis
- applying the SG to all substantive income replacement payments
- allowing employers to contribute more to the superannuation accounts of women without breaching anti-discrimination legislation
- increasing the rate of SG from 9.5 per cent to 12 per cent as soon as possible
- building a review mechanism into the Inter-Generational Report (IGR) with respect to the SG rate
- if the IGR indicates the SG rate may be insufficient, the matter should be referred to the Productivity Commission for review
- introducing a default, opt-out, increase in contributions of 3 per cent over and above SG.
- retaining the Low Income Super Contribution (LISC) scheme permanently
- setting the superannuation preservation age 5 years younger than Age Pension age, up to a maximum of age 62
- allowing access to a limited income stream from age 60 for those who have been unemployed for a specified period
- amending the definition of 'permanent incapacity' to focus on a member's capacity to work
- creating a new condition of release to enable trustees to pay an income stream and/or a part lump-sum benefit to a member who satisfies the new definition of 'permanent incapacity'
- introduce a limitation period with respect to bringing a claim for permanent incapacity
- creating an insurance product dashboard to allow members to compare different insurance offerings
- creating a tax incentive to encourage beneficiaries to rollover a death benefit into their super fund.

While there is no doubt the tax concessions that apply to superannuation will need to be examined in detail, they will be addressed by ASFA in its response to the upcoming tax review, and therefore do not form part of this report.

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1. Introduction

The environment in which the retirement income system operates (superannuation and the Age Pension combined) has changed dramatically over the 20 years since the introduction of the SG.

At the time, there was a large working population relative to the number of older Australians and average life expectancies were around 74 for men and 80 for women, years lower than they are today.[1] Now the first round of baby boomers are beginning to retire, and they are also living longer in retirement than ever before. Over the next ten years, the majority of this generation will have reached their post-work years, dramatically increasing the old aged dependency ratio (the ratio of people aged 65 years and over relative to the working age population). In 2007, there were five working-age people for every person over 65. By 2056, this is set to almost halve, with less than three working-age people for every older person.[2]

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This demographic shift will pose challenges for governments as they strive to set policies that support people to build the savings they need to live with comfort and dignity in retirement. It also represents a watershed moment for the superannuation industry. The days of thinking about taking superannuation in a lump sum are numbered, and the era of income streams is about to commence. As average superannuation balances continue to grow, the demand for products that deliver an income stream to retirees will also increase.

At this critical point, it's time for the superannuation industry to step up to the plate and take the lead on developing a range of products that deliver income streams to retirees, and offer protection against the risks associated with increased longevity. The delivery of such products will help bring about the cultural shift required to encourage people to draw on their superannuation savings across a longer period of their retirement.

In May 2013, ASFA released a white paper for consultation. It dealt with a proposal for the transition between accumulation and retirement. This paper builds on that work and sets up a framework for the transformation that needs to occur in superannuation over the coming years to accommodate the challenges posed by an ageing population. It outlines a number of ideas to improve the system, including with respect to the provision and take-up of income streams.

Constant, incremental change, especially if it is perceived to be adverse, has the effect of diminishing confidence in the stability of the superannuation system. Perceptions of the risk of regulatory change can affect people's discretionary behaviour, such as deciding whether to make voluntary contributions or acquire an income stream. This effect is only exacerbated by the long-term nature of superannuation. Accordingly, it is critical that an entire package of changes is announced at the one time, and that suitable transitional arrangements are built into the design of the system.

A key challenge in encouraging cultural acceptance is ensuring that income streams are sufficient to deliver a comfortable retirement. This necessitates growth in the superannuation pool. The design of the regulatory framework with respect to income streams will be crucial in ensuring their effectiveness and acceptance by members. In particular, trustees need to consider offering default 'income stream' products and member statements need to provide projections of income streams, to change people's views on income replacement in retirement.

Twenty years on, it is also time to start looking at other areas where policy can be adjusted to help deliver better retirement outcomes to a larger portion of the community. The system is not delivering as well as it

[1] WHO 1996. World health statistics annual, 1995. Geneva: World Health Organization.
[2] Australian Bureau of Statistic, *Population projection, 4102.0 - Australian Social Trends*, March 2009. The old aged dependency ratio is expected to approximately double from 20% in 2007 to between 38% and 42% in 2056.

could for women, the self-employed, casual workers and Indigenous Australians. It is critical policymakers consider making changes to enhance the superannuation experiences of people in these groups and boost their retirement savings.

The retirement income system needs to change. It is our responsibility to ensure that superannuation is as effective as possible in delivering income streams in retirement to the majority of Australia’s retirees.

2. Policy principles

Over the past decade or more, the superannuation system has been subject to incremental changes and a significant degree of policy inconsistency. This has been the source of considerable confusion in the community, and has reduced people's confidence in the stability and reliability of the system. Given that superannuation is a long-term investment, subject to preservation, ensuring consumer confidence is critically important.

In order to create an environment for improved consistency in policy decision making, it is critical to define the underlying policy principles on which the system should be based. The overarching objective should be to design a system that delivers the best outcomes for fund members, within the fiscal constraints of the government.

ASFA believes the following principles should underpin retirement incomes policy decisions.

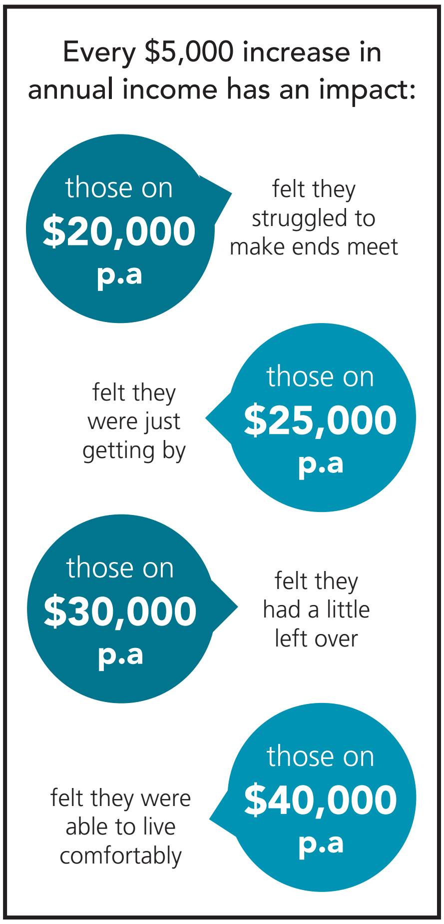
> **Principle 1: Adequacy**
> Retirement income policy should be designed to ensure as many people as reasonably possible have an adequate income in retirement.

The purpose of having a retirement income policy should be to ensure as many people as reasonably possible have an adequate income in retirement. The goal is to minimise the number of retirees living in poverty or relative poverty, and maximise the number living with comfort and dignity.

Numerous research studies have shown that even a modest increase in income in retirement can result in significant improvements in retiree satisfaction. Analysis of the results of an investment trends survey found that, in retirement, every $5,000 increase in annual income has the following impact on people's quality of life:

- those on $20,000 per annum felt they struggled to make ends meet
- those on $25,000 per annum felt they were just getting by
- those on $30,000 per annum felt they had a little left over
- those on $40,000 per annum felt were able to live comfortably.[3]

A superannuation-sourced income stream of only $5,000 per annum can boost a retiree's income by 25 per cent compared to the Age Pension alone. This can have a significant positive impact on their standard of living.



> **Principle 2: Universality**
> The retirement income system must be comprehensive in its coverage.

The retirement income system must be comprehensive, covering people in different types of employment structures, for example, employees, contractors and self-employed people. It must also cater for members at every stage in the employment lifecycle and at all levels of income.

[3] Investment Trends, *Retirement Income Report*, November 2013, for MLC/NAB, reproduced with permission.

Principle 3: Equity
The retirement income system must be equitable in its outcomes. Equity has two aspects: intra-generational equity and inter-generational equity. For superannuation, this means its taxation should reflect the principles of a progressive tax system.

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Achieving intra-generational equity requires individuals of the same generation to be treated fairly, after taking into account different levels of income and net worth. All other things being equal, in a progressive taxation system it is generally considered equitable if those on higher incomes or net worth contribute proportionally more in tax revenue than those on lower incomes or with lower net worth.

Inter-generational equity describes the burden or benefit one generation has compared with another. When it comes to making superannuation policy decisions, consideration must be given to the impact on inter-generational equity. The Age Pension and other forms of social security and welfare (such as Medicare, the provision of health care and other services, and the maintenance of infrastructure) are funded by taxpayers, and a large proportion of this tax revenue comes from those in paid employment. Therefore, it is critical that the concessional tax treatment of superannuation does not impose too great a burden on future generations of taxpayers.

Furthermore, the retirement income system (including both tax concessions and Age Pension payments) must also be perceived to be equitable, when assessed across all facets of the system, including the pre- and post-retirement phases. The community is sensitive to changes, so care should be taken to make sure changes do not undermine either intra-generational or inter-generational confidence in the system.

Principle 4: Simplicity
The retirement income system should be as simple as possible. Taking into consideration matters of equity and flexibility, there should be genuine simplicity in terms of design, making the system easier to understand and to implement.

The superannuation system should be simple enough for people to understand, while ensuring it remains equitable and flexible. Undue and unnecessary complexity should be avoided.

The retirement income system should also be flexible enough to take into account the varying patterns of work and lifetime income that exist. Phased retirement should be encouraged as a means of assisting people to remain in the workforce longer.

Principle 5: Sustainability
The retirement income system must be sustainable. This means ensuring it delivers on its intended objectives within the fiscal constraints of the government and taking into account declining taxpayer-to-aged-person ratios, the impact of future aged pension payments, the cost of the tax concessions and the tax burden faced by future taxpayers. Tax concessions should be limited appropriately.

The level of financial assistance for retirement provided by governments, and therefore by taxpayers, must be sustainable over the long term. This means taking into account demographic factors that contribute to fiscal outcomes, including the declining taxpayer-to-aged-person ratios, declining fertility rates and increasing longevity.

By the time the majority of baby boomers have retired, the rate of employed taxpayer-to-aged people will have halved from around five at present, to less than three. While minimising reliance on the Age Pension is the underlying reason for the emphasis on self-funding for retirement, it is critical to ensure that future employed taxpayers do not bear an undue proportion of the general tax burden and that an equitable contribution to tax revenue is made by retirees.

When it comes to tax concessions, the benefit of providing these to individuals must be assessed against the cost to taxpayers and reasonable limits applied. Currently, these are in the form of annual caps on concessional and non-concessional contributions. In future, to ensure that the sustainability of the system is maintained, it is imperative that a cost/benefit analysis is performed with respect to all proposed changes to policy.

In particular, concessional tax or social security treatment that favours one group unfairly over another, drives sub-optimal behaviour, or results in undue complexity or administrative burdens, should be avoided or reconsidered.

Principle 6: Three-pillar policy
The three pillars of the retirement income system – the safety net of the Age Pension; mandatory SG contributions and voluntary savings, both inside and outside superannuation – should remain in place.

The three-pillar policy: the safety net of the Age Pension; mandatory SG contributions and the provision of tax incentives, such as the concessional tax treatment of superannuation, to encourage voluntary savings, should remain in place.

The safety net of the Age Pension must remain so that those individuals or family units who earn below average wages or who spend time out of the workforce (for example, to raise a family or care for dependants, or because they are or disabled or unable to find employment), receive support from the government to achieve a basic income in retirement.

The second pillar, mandatory SG contributions, is critically important as it creates the pool of private savings required to help Australians fund all or part of their own retirement. In this respect, the third pillar, being the tax concessions applied to superannuation and other savings, also plays an important role in supporting members to contribute over and above the SG to their retirement savings.

The SG is also what sets apart the Australian superannuation system from most other pension systems in the world. It has been critical to the success of the superannuation system – which has grown to be $1.85 trillion as at the end of the June 2014 quarter.[4] This is the fourth largest pool of managed funds globally,[5] roughly equivalent to the size of Australia's annual GDP, and makes a significant contribution to Australia's economic growth and stability.

Principle 7: The system is about replacement income in retirement
The focus should be on providing income in retirement. Opportunities for accumulating excessive superannuation balances in a concessionally-taxed environment, for example with a view to generational transfer, should be minimised.

The underlying policy rationale to the concessional tax treatment of superannuation is to ensure that individuals have a reasonable income in retirement. Therefore, a cohesive retirement system should include measures to minimise opportunities to accumulate excessive (concessionally taxed) superannuation balances with a view to generational transfer. Using the superannuation system as a tool to accumulate wealth at concessionally-taxed rates perverts the intended purpose of the system and comes at a high cost to taxpayers.

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[4] APRA, *Statistics, Quarterly Superannuation Performance (interim edition)*, June 2014.
[5] *The Australian*, 5 February, 2013, www.theaustralian.com.au/business/wealth/nations-15-trillion-in-super-assets-the-fourth-largest/story-e6frgac6-1226570336509.

Principle 8: Prudentially regulated
Given the mandatory nature of superannuation, systemic risks within the superannuation industry, as well as individual entities that manage other peoples' money, must be supervised by a prudential regulator.

Prudential supervision, coupled with conduct regulation, is an integral part of any well-functioning financial system.

ASFA, in its response to the Financial System Inquiry Interim Report, recommended that in managing risks, there would be significant benefit in monitoring the risks of the superannuation system holistically. Given the dollar value of the holdings that the superannuation system will have in individual banks across default funds, choice superannuation and self-managed super funds (SMSFs), significant exposures may emerge that need to be assessed in the context of financial system stability.[6]

With respect to superannuation funds, other than SMSFs, which are managing money on behalf of other people, each institution/product provider/fund should be prudentially supervised by APRA.

[6] ASFA's response to the Financial System Inquiry Interim Report, August 2014, Page 34, www.superannuation.asn.au/policy/submissions

3. The retirement income system should be about income streams

3.1 Definition of 'income stream'

Currently, the incomes streams provided, as permitted under the provisions in the *Superannuation Industry (Supervision) Regulations 1994* (SIS Regulations), reflect the two 'extremes' of income stream products:

- a life pension or annuity (with no or extremely limited commutation and generally no death benefit unless reversionary)
- an account-based pension or annuity (which can be commuted to a lump sum without restriction, with no maximum withdrawal and a death benefit).

What is required is the flexibility to be able to create and offer an income stream that represents the 'middle ground'. That is, products that offer some protection against longevity risk and are also flexible enough to allow controlled access to commutations and limited lump-sum death benefits.

Generally, an income stream is defined by common law as being one or more periodic payments. In ASFA's view, the definition of income stream should necessitate, as a minimum, one payment per annum.

The one exception to this would be deferred income streams which, while not meeting the 'one payment per annum' requirement during the period of deferral, would meet this rule once the income stream commenced. This should not preclude the deferred income stream from being considered to be, and treated as, an income stream during the period of deferral.

It is imperative that the SIS regulations are re-drafted to reflect the various types of income streams and their characteristics, but only to the extent necessary to make the distinction between the different types. The legislation should stop short of prescribing highly specific attributes that an income stream must meet in order to be complying, but instead should simply provide for:

- the basis upon which the amount of each income payment is determined
- the extent to which the income stream is commutable
- whether there is any residual capital value and how that is determined.

While restricting commutations should be encouraged, retirees may still need to have the flexibility to convert income streams back into lump sums. Where restrictions on commutations are imposed, it may be necessary to create one or more income stream-specific conditions of release as an exception. For example, as a retiree ages, they may need to pay a bond to enter an aged care facility – this circumstance could form the basis of a specific condition of release. Consideration should also be given to allowing income streams to be reversionary.

Once the SIS regulations are re-drafted in such a manner, it would be relatively straightforward for both tax and social security legislation to cross-refer to the various types of income streams, in order to determine the tax and social security treatment of any particular income stream.

Types of income streams could be classified as below:

3.2 Need to balance longevity protection and flexibility

Account-based income streams (tier two) have proven popular with members because the member retains control over their capital, they are portable, easy to understand and to manage.

Research from Rice Warner found that 155,000 members were drawing down on their super via income streams, as opposed to 182,000 who took a lump sum.[7] However, as you can see from the table below, the assets in phased drawdown rollovers far exceed those taken as lump sums.

	Assets $A billion (2012/13)	Number of members
Lump sums	8	182,000
Phased drawdown rollovers	45	155,000
Total	53	337,000

This is important, as it reflects that people who have higher average balances are more likely to take an income stream. As the superannuation system matures and the average account balance grows, the demand for income streams will continue to increase.

Rice Warner analysis states that, over the next 15 years, we will see more Australians leaving or winding down from the workforce than entering it. It forecasts that, by 2029, Australia's ageing nation will comprise 2 million men and 2.3 million women in retirement drawing an income stream from their superannuation savings. This represents a shift to around 40 per cent (or $1.3 trillion in 2014 dollars) of Australia's retirement savings assets being converted to some form of retirement income stream. Currently, that number sits at 30 per cent (or $492 billion of total superannuation assets) in today's dollars.[8]

While tier two account-based income streams do meet the definition of an income stream, given they can be commuted and there is no maximum payment amount, they do not provide optimum protection against longevity risk.

Under the current rules, with the capacity to take lump sums and tier two account-based income streams, there is the risk that the member may:

- incur significant debts prior to retirement in the knowledge that a lump sum is available
- use their superannuation benefit too quickly, which will see them rely on the Age Pension
- use their superannuation benefit too slowly and, consequently, will have a poorer lifestyle in retirement, while leaving a residual benefit to others or to the estate. While on occasions this may be as a result of conscious estate planning, other instances may be caused by over cautiousness as a result of the member not knowing or being able reasonably to predict:
  - how long they or their partner will live
  - what expenses they will incur in future, especially with respect to the provision of residential aged care or medical treatment
  - what future net returns are likely to be
  - what may happen with the consumer price index (CPI)
- experience sequencing risk, where as a result of market corrections, there is a significant reduction in the account balance and, accordingly, income payments.

Accordingly, there is a need for the SIS Regulations to provide sufficient flexibility to enable providers to create and offer income streams that fall between tier two account-based income streams and tier six guaranteed indexed lifetime income streams. This will facilitate the development of a range of income streams, which afford varying degrees of protection against longevity, market and inflation risk, while also allowing flexibility for members to be able to select a product or combination of products which best suit their individual needs.

[7] Rice Warner research commissioned by ASFA, 2014.
[8] Rice Warner, *Australia's retirement income 'bulge'*, *Op Cit*.

In particular, there needs to be the flexibility to be able to provide:

- tier three type income streams – an account-based income stream which:
  - imposes a maximum payment amount as well as a minimum
  - limits commutations to prescribed circumstances, such as to provide a bond to enter into an aged care facility
- a broader range of tier four type income streams – such as variable income streams.

Facilitating the development of such income streams would produce products that provide members with increased protection against longevity risk.

ASFA has identified eight impediments to the provision of income streams or to their take-up, including the need to reform:

1. the SIS regulations
2. the APRA prudential standard on minimum surrender values of longevity products
3. the means test treatment for longevity products
4. the approval processes for longevity products
5. the provision of advice on post-retirement products
6. the taxation of deferred annuities and other longevity products
7. capacity for SMSFs to purchase deferred annuities and like products
8. allowing MySuper products to pay benefits as pensions.[9]

ASFA identified how to overcome some of these impediments in their response to the Treasury discussion paper on retirement income streams.[10]

A further impediment is the requirement to hold what may be considered unduly conservative levels of capital. The submission made by Challenger Life Company Limited to the Financial System Inquiry addressed the capital standards with respect to annuities as follows:

> *"In order to assess the difference in capital approach to meeting long term guarantees, Ernst & Young has compared the capital requirements of a lifetime annuity – as a percentage of premium – between a life company operating in Australia and a life company subject to Solvency II, which is due to apply in the EU from 1 January 2016.*
>
> *The table below compares capital requirements for Australian life companies and European life companies assuming that they hold three different asset mixes:*
>
> - *advanced bank asset mix;*
> - *100% corporate bonds, duration matched to that of liabilities; and*
> - *asset mix weighted towards growth assets (i.e. including an allocation to equities and property).*

Lifetime annuity – as percentage of premium

Asset mix	***Australian life company***	***Euro life company***
Advanced bank	*32%*	*40%*
100% corporate bonds	*32%*	*23%*
Growth rating	*38%*	*44%*

> *The above table demonstrate that the capital requirements of life companies in Australia are comparable with those proposed under Solvency II. Note that Solvency II requirements presented correspond to the Solvency Capital Requirement as distinct from the (lower) minimum capital requirement. On the other hand, Australian life companies are explicitly required by APRA to hold a target surplus of capital above the amounts presented here"[11].*

[9] ASFA, *Changes to regulatory settings for financial products dealing with longevity*, Oct 2013.
[10] ASFA, Submission to Treasury re *Discussion Paper – Review of retirement income streams regulation*, Sept 2014.
[11] Challenger Life Company Limited, Submission to the Financial System Inquiry, 26 August 2014, Page 49.

Recommendation 1	The regulatory framework should enable the retirement income system to offer a full range of income streams in a competitive market, to enable consumers to select whatever product, or combination of products, will best suit their retirement needs.

3.3 Transition from accumulation phase to income stream – cessation of contributions

Ideally, the retirement income system should retain some flexibility for those who wish to maintain a blend of working part-time and retirement. The concept of a fixed, or single retirement age is now an anachronism.

Defined benefit funds need to have the concept of a single 'retirement age', as this is integral to the benefit design of the fund. With defined contribution funds and the changing demographics of the population, the concept of a strict retirement age is less relevant and is really only linked with preservation age and transition-to-retirement pensions.

As the Age Pension eligibility and preservation ages increase, there is also an increasing tendency to move between full-time work, part-time work and not working. Therefore, there is a greater need to examine how this transition to retirement phase should work. This includes options and rules for accessing superannuation as well as making contributions.

Given the purpose of superannuation is to provide income in retirement, there is an argument that there should be a 'line in the sand' whereby contributions to superannuation should cease.

With respect to accepting contributions, SIS regulation 7.04 creates an operating standard where, generally, the only contributions that can be accepted by the trustee (other than mandatory) are when the member:

- is not under 65, but is under 70 and employed at least 10 hours per week during the financial year in which the contributions are made
- is not under 70, but is under 75 and has been gainfully employed on at least a part-time basis during the financial year in which the contributions are made – contributions received on or before the day that is 28 days after the end of the month in which the member turns 75.

For simplicity, accepting contributions should be aged based and not a function of hours worked. The underlying policy rationale for imposing a condition with respect to hours worked is to mitigate the risk of estate planning, however, there are some issues with respect to this:

- estate planning is a function of age – the older the member the more likely it is that they may be estate planning
- whether or not a member is still working is arguably irrelevant as to whether they are estate planning
- work tests are unduly intrusive on members and are cumbersome and expensive to administer.

Accordingly, contributions should simply cease at a particular age, irrespective of whether the member is working. ASFA suggests that the most appropriate age for this to occur is Age Pension age plus five years.

The one exception to this should be with respect to mandated contributions, such as SG, which should continue to be accepted.

Recommendation 2	Contributions, other than mandated contributions, should cease five years after the Age Pension eligibility age.

3.4 Incentives to take an income stream

In order for the system to achieve its key objectives, superannuation should be used for retirement income and not for the provision of a bequest or the repayment of significant levels of debt. Providing incentives for people to take up an income stream can help achieve this objective.

Incentives may include giving beneficial social security treatment for all or at least some income streams. For example, income streams that meet certain prescribed criteria could be treated differently for social security asset or income tests. This could include where they support increased longevity protection through such measures as limiting access to lump sums; having no death benefit or confining the amount to the return of a reduced purchase price and having maximum payment amounts (tiers three to six). This recognises that the member has 'locked up' capital, may be subject to counter-party risk and has a reduced, or even nil, residual capital value which can be left as a death benefit.

Importantly, allowing members to acquire a range of income streams to suit the differing needs that retirees have over the span of their retirement would enable them to better plan for their retirement.

For example, allowing a member to acquire a deferred tier four to six income stream to fund their later retirement years would enable them to plan with more certainty how to use a tier two or tier three account-based income stream during the first 15-20 years of their retirement, say until age 80. The commencement of a deferred income stream at age 80 would minimise the need for a substantive balance to be left in the original account based income stream after 15 to 20 years, as the payments from the deferred income stream could supplement, or even form the bulk of, the member's income for the remainder of their retirement.

The need to provide protection against longevity risk is real and growing. Most Australians will live at least 15 years after age 65 (that is, 66 per cent of males and 78 per cent of females live past age 80, with these percentages growing every year). There is a 15 per cent chance that one person in a couple will live past age 95.[12]

Recently released Mercer analysis has highlighted the importance of an appropriate legislative structure in relation to the post-retirement stage. It analysed the mortality rates of public sector pensioners and revealed (allowing for continued improvements in mortality) that most retiring white-collar workers are likely to live much longer than the current average life expectancy of 84.1 for men and 87 for women.[13]

Proportion of white collar 65 year olds expected to live to at least the age shown in column 2 or 3	Males	Females
50%	88	91
35%	91	93
20%	94	96
5%	99	100+

Consideration could be given to restoring, at least partially, concessions for some superannuation income streams (tiers four, five and six as a minimum) with respect to the eligibility tests for social security income support payments, such as the Age Pension. The taking of a lump sum could also affect eligibility for the Age Pension, disability pension or healthcare card for a period of time after the lump sum is taken. The take up rate of tier four to six income streams could be monitored over time and, if considered excessive, consideration could be given to imposing some kind of limit.

Recommendation 3

The social security system should provide limited incentives for income streams offering longevity protection.

[12] Australian Bureau of Statistics, Life tables.

[13] Mercer, Second round submission to the Financial System Inquiry, August 2014, http://fsi.gov.au/files/2014/09/Mercer.pdf.

3.5 Need for a MyPension income stream

Tier five and six life pensions and annuities are effective products to protect retirees against longevity and investment risk in retirement, while tier six provides inflation protection as well. This means the amount of the payment is guaranteed for life and the counter-party bears both market and longevity risk. With tier four products, the amount of the payment may vary depending on the experience of the pool or the amount of the payment may be fixed or indexed but only payable for a specified period. This will offer a higher level of longevity protection than tier two and three account-based pensions.

For a number of reasons, however, members have not been inclined to purchase tier four, five or six income streams. These reasons are varied and complex and include that:

- there is not a prevailing culture of pensions/annuities in Australia (as there is in places such as the United Kingdom (UK) and Europe, which still have significant defined benefit schemes) but instead a 'lump sum' culture where control over the capital is retained. This is exacerbated by the prevalence of defined contribution funds where a lump sum benefit is accrued during the 'accumulation' phase, which only serves to reinforce a lump sum mentality
- there can be a genuine need for access to capital during retirement, especially with respect to housing – be it house maintenance (given the relatively high proportion of home ownership) or eventual access to residential aged care
- often there is a desire to leave a bequest
- acquiring a life pension/annuity can be an irrevocable decision if unable to commute;
- pricing:
  - can be complicated
  - is a function of the prevailing interest/annuity rates at the time of purchase, for what can be quite a long term (decades) proposition
  - currently, in Australia, can appear to be relatively expensive, as the benefits and protection provided by such products can be difficult for members to value
- there can be legitimate concerns about counter-party risk over such an extended period.

Accordingly, there is a need to 'nudge' consumers to consider acquiring tier three, four, five and six incomes streams with at least some of their superannuation benefits. This could include purchasing a deferred income stream through the payment of premiums over a period of time.

Acquiring longevity protection via a tier four, five or six income stream comes at a price – there is a cost in transferring the market and longevity risk to a third party that reduces the amount of income stream payment which would otherwise be received. As such, there is a need to develop a range of products which, individually or in combination with others, provide different options suitable for a variety of members with diverse needs.

Importantly, there is a need to reframe the retirement income system to encourage people to take an income stream, as opposed to a lump sum, which has the ability to provide at least some protection with respect to longevity, inflation and market risk. This will encourage members to think about replacing income in retirement and raise awareness of the need to manage the different risks.

Accordingly, ASFA submits that the *Superannuation Industry (Supervision) Act 1993* and SIS Regulations and the *Corporations Act 2001* and regulations (Corporations legislation) should be amended to:

- enable the development of 'MyPension' arrangements for retirement incomes, loosely equivalent to 'MySuper' arrangements
- allow the MyPension arrangements to be designed by the trustee having regard to the demographics and profile of their fund membership
- require the trustee to take into consideration the various risks faced by their members, including the extent to which longevity protection should be provided
- ensure that the ability to offer one or more MyPension arrangements would be approved by APRA
- permit trustees to 'default' members into a MyPension arrangement at some time after the member has attained preservation age
- allow the trustee to determine the pre-conditions a member must meet prior to the trustee converting the member into one of their MyPension arrangements. This may mean that some members, for example

those with a low account balance, are not placed into a MyPension arrangement
- ensure that members who have been defaulted into a MyPension arrangement would be able to opt-out' of the arrangement within a specified period.

Trustees would need to be mindful of their fiduciary duties in determining whether to provide a MyPension and in designing any MyPension arrangements offered. A trustee would be able to offer a MyPension arrangement but would not be required to do so.

Trustees would also need to ensure that adequate and appropriate disclosure is provided to members about the financial, tax and social security consequences of them being defaulted into a MyPension arrangement, their options with respect to 'opting out' and any choices they may have within the MyPension arrangement, such as the amount and frequency of income stream payments.

There will be a need to amend the disclosure requirements in the *Corporations Act* and regulations, in particular with respect to product disclosure statements.

There also should be a MyPension 'product dashboard'. The dashboard could disclose key features which would be provided through the MyPension arrangement and could utilise scenarios to illustrate the effect of differing economic/financial and other circumstances on the range of incomes which would be likely to be delivered and the expected longevity of tier two, three and four income streams. The content and the format of the dashboard would be prescribed, as would any assumptions as to such factors as the range of likely long term market returns and changes in the CPI. A member should be able to compare one offer of an income stream against the other and answer the questions: which arrangement is likely to provide with the highest amount of income for the longest time? How much risk will I bear? What will it cost me on an annual basis?

Furthermore, periodic statements could incorporate disclosure as to the extent to which an income stream is being funded by returns or by drawdown of capital.

Recommendation 4	Trustees should be able to offer a MyPension arrangement/s.

Trustees should be able to default a member into a MyPension arrangement.

Importantly, the creation of MyPension allows trustees and members to start thinking about investing through retirement. At the moment, members may claim their benefit as a lump sum at any time after preservation age. This can result in a heavier weighting towards relatively liquid assets and can see the fund incur transaction costs in realising assets in order to be able to pay benefits.

The availability of MyPension arrangements, whereby members would be defaulted into an income stream post-preservation age, would enable trustees to invest over a significantly longer period (through retirement), with a heavier weighting towards less liquid assets, including infrastructure.

Having a default MyPension sends a clear message to the community that superannuation is about replacing income in retirement, not about lump sum payments. MyPension means that consumers can rely on the superannuation system to provide an income stream that will be supported by appropriate:
- regulation – allowing for flexibility as one size does not fit all, especially in retirement
- regulatory oversight and approval of MyPension arrangements
- ongoing disclosure.

By way of example of how default arrangements could work, a trustee could determine that a member who has reached preservation age and who has not received a contribution for three months would be defaulted into a MyPension arrangement on the following basis:
- a member who has an account balance below $25,000 would not be defaulted
- a member who has an account balance between $25,000 and $500,000 would be defaulted into a tier two account-based income stream, with premiums paid for a deferred tier five income stream

commencing at age 80
- a member who has an account balance between $500,000 and $1,000,000 would be defaulted into a tier three account based income stream, with premiums paid for a deferred tier six income stream commencing at age 85
- a member who has an account balance in excess of $1,000,000 would not be defaulted.

By definition a 'default' arrangement is one which is developed by the trustee, in consideration of its fiduciary duty, which is given effect to in the absence of any explicit direction/instruction from a member.

There will be practical impediments when it comes to 'defaulting' a member into an income stream, not the least of which is the likelihood that the trustee may not have up-to-date bank account and/or address details for the member. The trustee may also need to meet the 'know your client' requirement for the purposes of the *Anti-Money Laundering and Counter Terrorism Financing Act 2006*. Disclosure to members – on joining, in the lead up to retirement and at the time of conversion from accumulation to income stream – will be critical. In particular, it will be important, prior to defaulting a member into a MyPension, that the trustee advise the member that they should seek financial advice.

If the default income stream incorporates a tier four, five or six longevity component, the trustee should be able to design the product so that the member commences paying for the longevity product at an age prior to preservation age, say from age 50 (a deferred income stream). This will have the effect of reducing the cost of the longevity product compared to the cost if acquired at a later stage.

In addition, there is a regulatory prohibition on contributions being made into a pension or annuity. Under the SIS Regulations, the provider needs to commute the original pension and set-up a new pension. This adds unnecessary costs and complexity for members and represents a considerable administrative burden on superannuation funds and therefore should be reviewed.

Need for financial literacy and advice

Income streams are not well understood by the community. Therefore, it is imperative that these changes work in combination with efforts to increase financial literacy and mechanisms to provide effective financial advice to members approaching retirement.

Advice services and self-help advice tools have a significant role to play in inducing behavioural change and in facilitating acceptance of the need to think in terms of replacing income in retirement and mitigating longevity, inflation, market and liquidity risk. It is important that the full range of advice services and tools are accessible to the community, particularly those in or near retirement.

Recent research with respect to individual capability and effort in retirement benefit choice found that:

> *"Retirement benefit products often have complex and irreversible features, and pre-retirees may not know about them or understand how they work. We conducted a preliminary survey showing that only one third of 920 respondents (aged 50-74 years) had heard of a life annuity, only 20% knew that it lasted until death, and only 8% knew that it guaranteed an income. Respondents were also ignorant about other retirement income products such as phased withdrawals. In fact, objective measures of retirement income product knowledge among middle-aged people are much worse than objective measures of financial literacy (Agnew et al. 2013). Poor knowledge of pension products is common and can lead to unwitting mistakes (Mitchell 1987; Gustman et al. 2009).)"*[14].

Accordingly, it is imperative that the use of advice services and tools is enabled and encouraged as a key facilitator in effecting a cultural change within Australia from a mentality of lump sums to income streams. Members will need assistance in assessing various options available to them and in making

[14] Bateman, Hazel and Eckert, Christine and Iskhakov, Fedor and Louviere, Jordan J. and Satchell, Stephen E. and Thorp, Susan, Individual Capability and Effort in Retirement Benefit Choice (July 24, 2014). UNSW Australia Business School Research Paper No. 2014ACTL07. Available at SSRN: http://ssrn.com/abstract=2494036 or http://dx.doi.org/10.2139/ssrn.2494036, Page 2

choices that are appropriate to their circumstances. Decision-making in a digital environment – including the decision to accept a default – is different and regard should be had to this when determining how to make information and advice available to members.

Recommendation 5	Trustees should be able to 'default' members into a MyPension arrangement on an 'opt-out' basis

There are a number of regulatory considerations with respect to the creation of MyPension arrangements and a default regime which will need to be addressed. These have been identified in the appendix.

3.6 Projections of income streams on member statements

Given the increasing importance of reframing superannuation as an income stream, there is an urgent need to finalise the details regarding how projections of income streams (in today's dollars) can be disclosed on member statements. This includes the prescription of the assumptions and the required form of disclosure.

Ideally, each year, superannuation funds should provide members with projected benefits showing the income stream they would receive in retirement, based on their account balance in the statement. In this way, a culture of income streams can begin to be created and members will be able to see what gap exists between their desired level of income in retirement and what has been projected.

The provision of these projections should be phased in, initially on a voluntary basis before becoming mandatory. The actuarial assumptions should be set by the Australian Government Actuary and the format and content should be specified in the Corporations legislation.

There is evidence that members welcome, and respond to, projections of income streams in their periodic statements. By way of example, Cbus achieved a 97 per cent approval rate from members for statements that presented them with an estimate of their income in retirement in today's dollar value. The building industry fund conducted the exercise with 20,000 members to raise awareness that taking the lump sum was not the only option on retiring.

Since the statements were sent in June 2013, Cbus has registered a jump in engagement from the control group; 12 per cent have raised contributions, 10 per cent have changed investment options and 14 per cent have contacted the Cbus advice team.[15]

Recommendation 6	All member statements should contain a projection of the member's likely income stream in retirement based on their current balance.

[15] http://investmentmagazine.com.au/2014/03/cbus-members-happy-to-be-confronted-with-income-projections

4. Purpose of the system

4.1 What the system needs to deliver

The retirement income system is comprised of three components:

- a means-tested Age Pension as a safety net
- mandatory SG contributions made by employers for 'employees'
- incentives for voluntary savings – both inside and outside superannuation.

The primary objective of superannuation should be to provide a reasonable level of replacement income for as long as possible during retirement, or, ideally, for the whole of retirement. Historically, we have seen a cultural preference in Australia towards taking a lump sum benefit, as opposed to an income stream, in retirement. There are many factors that contribute to this including the desire to control capital, the potential to leave a bequest, a mistrust of providers and an unduly restrictive regulatory environment that has limited the range and flexibility of income-stream products.

Income streams help retirees spread their savings across their retirement, and therefore the retirement income system needs to encourage and provide a range of income stream products that help manage a range of risks, including longevity risk.

Designing and providing an income-oriented system with at least some longevity risk protection requires a strategy that has a long-term focus.

When the SG legislation was introduced into Parliament, Treasurer Dawkins, in the second reading speech, stated as follows:

> *"The superannuation guarantee levy represents another major step forward in the development of retirement incomes policy. It will lay the foundation for income security and higher standards of living in retirement for future generations of retirees. The superannuation guarantee levy provides:*
>
> - *major extension of superannuation coverage;*
> - *an efficient method of encouraging employers to comply with their award obligations; and*
> - *an orderly mechanism by which employer superannuation support can be increased over time, consistent with the' economy's capacity to pay.*
>
> *The levy will consolidate the reforms implemented since 1983, and will provide a coherent and equitable framework in which retirement incomes objectives can be progressed. It will ensure that, by the beginning of the next century, virtually all employees will be accumulating substantial superannuation savings to help fund their retirement income.*
>
> *The increased self-provision for retirement will permit a higher standard of living in retirement than if we continued to rely on the age pension alone. The increased self provision will also enable future Commonwealth governments to improve the retirement conditions for those Australians who were unable to fund adequately their own retirement incomes.*
>
> *Lastly, self-provision will increase the flexibility in the Commonwealth's Budget in future years, especially as our population ages, and will increase our national savings overall, thus reducing our reliance on the savings of foreigners to fund our development".*[16]

In August 2011, the Allen Consulting Group provided a report to ASFA with respect to the contribution of superannuation to the Australian economy. In the executive summary, the Allen Consulting Group concluded as follows:

> *"Australia's mature superannuation industry continues to benefit all Australians in three ways.*

[16] http://parlinfo.aph.gov.au/parlInfo/download/chamber/hansardr/1992-04-02/toc_pdf/H%201992-04-02.pdf;fileType=application%2Fpdf#search=%22chamber/hansardr/1992-04-02/0154%22, Page 1763

First, Australia's superannuation sector assisted the country in avoiding the worst consequences of the Global Financial Crisis. When overseas markets dried up, Australia's large superannuation funds through their direct and indirect investments were able to help Australian companies raise equity and so reduce their reliance on overseas debt markets.

Second, the federal government's announced reform of raising the Superannuation Guarantee from nine per cent to twelve per cent is both good for workers and affordable for employers. Workers benefit from the increase in their post-retirement standard of living that comes from the increase in the Superannuation Guarantee. It is affordable for employers because the economic incidence of the rise in the Superannuation Guarantee does not fall on them once the reform has bedded down...

Third, Australia's superannuation sector plays an increasingly important role in helping to fund Australia's substantial investment needs now and into the future. This occurs through investments made by investment managers and increasingly direct by superannuation funds. Australian superannuation funds support private sector investment via investments made on the stock exchange... Australian superannuation is an increasingly important player in funding much-needed public and private infrastructure... An aging population will also be seeking the type of long-lived, low risk, moderate reward investments which large-scale public infrastructure projects provide".[17]

4.2 What does success look like? How should it be defined?

In its submission to the Financial System Inquiry Interim Report, ASFA recommended:

- setting clear and measurable objectives for the system in both the accumulation and retirement phases
- identifying what success should look like and measuring the performance of the system against this
- ensuring that regulation is consistent with policy objectives and holding regulators to account by assessing their performance against appropriate indicators
- monitoring emerging gaps and risks in both system design and regulatory architecture and reach.

ASFA believes the overarching objective of superannuation must be described as both:

A FISCAL IMPERATIVE	**A SOCIAL IMPERATIVE**
reducing the call on the public purse of retirement income for older Australians for future generations	to ensure that all Australians are given the opportunity to have a dignified retirement.

To enable accountability against these objectives, ASFA believes the system must have clearly defined measures of success and long-term goals it should aspire to.

ASFA's goals for the super and retirement system in 2050:

- Age Pension expenditure and tax expenditure on super (properly measured) of less than six per cent of GDP
- less than 20 per cent of retired Australians over Age Pension qualifying age relying solely or almost exclusively on the Age Pension
- Australians retiring with an income replacement rate in excess of 65 per cent (on average) in retirement (in terms of household disposable income)
- at least 50 per cent of Australians able to cover their expenditure in retirement and at least have a 'comfortable' lifestyle in retirement, as described in the ASFA Retirement Standard.

Detail on the approach ASFA has taken in coming up with these objectives and their interaction with one another, provided in our submission to the Financial System Inquiry, is extracted below.

[17] The Allen Consulting Group, *Enhancing Financial Stability and Economic Growth, The Contribution of Superannuation*, August 2011, Report to the Association of Superannuation Funds of Australia (ASFA), Page iv.

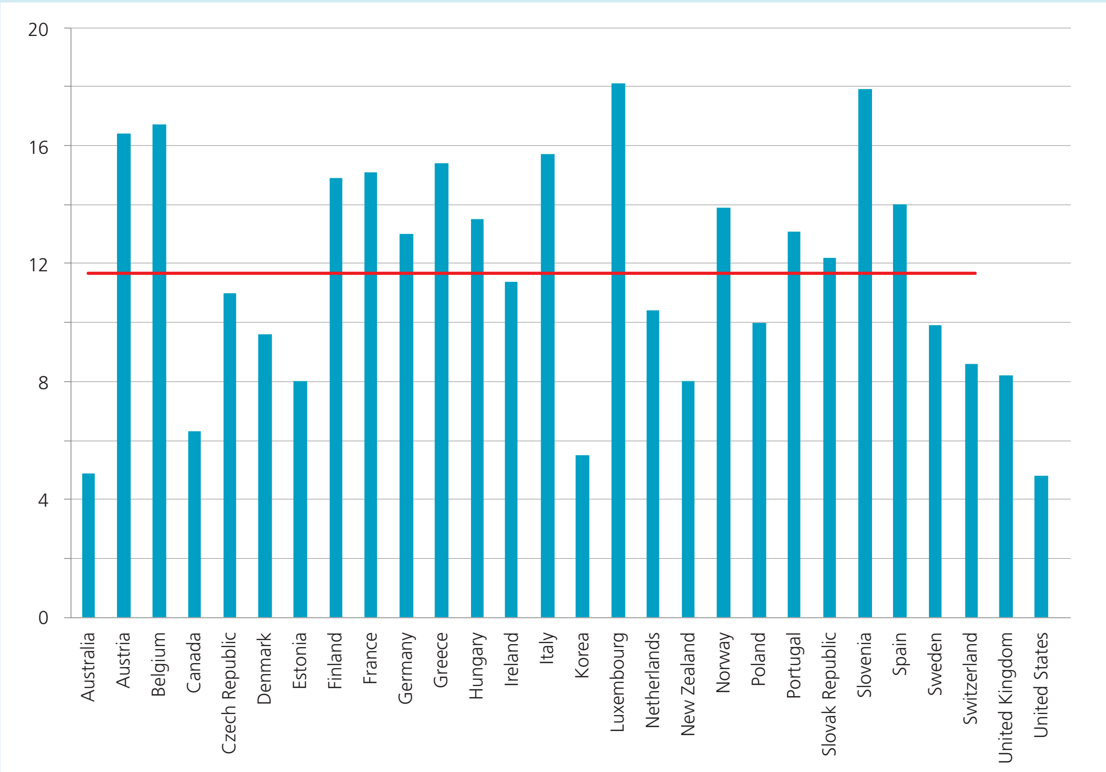
2050 goals

Limit Age Pension expenditure

ASFA proposes limiting total direct and indirect public expenditure to no more than six per cent of GDP. This is around half the average projected level for OECD countries for public pensions alone. If achieved, it would be lower than just about any other developed country.

Current expenditure on the Age Pension is around 2.7 per cent of GDP and is projected to grow to around 3.9 per cent of GDP by 2050, if current policy settings are not changed. A goal of total direct and tax expenditure of less than 6 per cent of GDP is proposed, but on the basis that tax expenditure are properly measured. Taking into account savings on the Age Pension bill and behavioural and other changes if tax concessions for super were removed, current tax expenditure on superannuation is just over 1 per cent of GDP. This tax expenditure is projected by ASFA to grow to no more than 2 per cent of GDP by 2050. This assumes the basic structure of current tax policy settings for contributions, fund earnings and benefits are kept in place, but with some refinements made to ensure that tax expenditure is appropriately directed.

Projected public expenditure on pensions (2050, percentage of GDP)



Halve the number of Australians reliant on the Age Pension

Currently, 40 per cent of Australians old enough to qualify for the Age Pension receive a full Age Pension. This 40 per cent of the population have very little other income. Halving this percentage would be a major achievement given that there is a substantial proportion of the population that has little, if any, paid employment during their life. Achieving this would make a substantial contribution to containing future public expenditure on the Age Pension.

Increase average living standards in retirement

Currently, the average replacement rate of household income in retirement is less than 40 per cent of household disposable income during people's prime working years. The proposed target of 65 per cent is a significant increase in average living standards in retirement by the year 2050.

Ensure more Australians have a dignified retirement

Currently, less than 20 per cent of single people aged over 65 are able to support a standard of living at or above the ASFA Retirement Standard 'comfortable' level and only around 30 per cent of all couples able to support that level. Additional personal contributions and/or enhancements to government assistance will be needed to meet the proposed goal set by ASFA of at least 50 per cent of retirees achieving at least the comfortable standard. ASFA projections indicate that, on the basis of current policy settings and contributions, only around 20 per cent of singles and just under 50 per cent of all couples will be able to support the comfortable standard in retirement in 2050.[18]

As long ago as 1993, in *National Savings – A report to the Treasurer*, Dr Vince Fitzgerald identified the extent to which private saving can contribute to national saving goals:

> *"As it stands, the Superannuation Guarantee is projected to raise national saving … by one per cent within 20 years. This effect on national saving is not simply a 'by-product', but is crucial to its effectiveness as retirement incomes policy".*[19]

Fitzgerald went on to observe that:

> *"Fixing a schedule to bring in employee co-contributions, and the questions of coverage of the self employed and access to those out of the workforce … could raise the Superannuation Guarantee's impact on national saving to well over 1 per cent of GDP in 10 years and well over 2 per cent of GDP ultimately"*[20]*.*

In ASFA's response to the Financial System Inquiry Interim Report, ASFA observed, the contribution superannuation has made with respect to liquidity and the availability of capital within Australia:

> *"As outlined in ASFA's initial submission to the Inquiry, superannuation funds are already heavily invested in the banking sector; firstly, as deposit holders in Australian Deposit-taking Institutions (ADIs) such as banks and building societies, and secondly, as holders of bank equity. As of December 2013, superannuation funds had invested about $217 billion in deposits accepted by banks. A further $22 billion was invested in the bonds of financial corporations (bank and non-bank), and $159 billion invested in the equity of financial corporations (bank and non-bank). This means a total of around $398 billion of superannuation funds are invested in Australia's banking sector, representing 22 per cent of total superannuation (ABS). This is an important source of liquidity for Australian banks and it reduces the need for them to source wholesale funding from overseas (Levine)".*[21]

The contribution of superannuation to a national pool of savings has been echoed by others, including the Charter Group appointed on 9 May 2013 in its report on the Charter of Superannuation Adequacy and Sustainability and Council of Superannuation Custodians[22] and other commentators, such as the Commonwealth Bank of Australia's submission to the Financial System Inquiry.[23]

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[18] ASFA, *Submission to the Financial System Inquiry Interim Report*, 26 August 2014, Page 6 – www.superannuation.asn.au/policy/submissions.
[19] Fitzgerald, *National Savings – A report to the Treasurer*, June 1993, Page 49.
[20] Fitzgerald, *Op cit*, Page 50.
[21] ASFA, Sub to FSI on Interim Report; *Op Cit*, Page 32.
[22] Charter Group, *Report to the Treasurer and Minister Assisting for Financial Services and Superannuation*, July 2013, www.treasury.gov.au/Policy-Topics/SuperannuationAndRetirement/supercharter/~/media/Treasury/Policy%20Topics/Superannuation/supercharter/Downloads/PDF/super_charter_report.ashx.
[23] For example, the Commonwealth Bank of Australia, *Wellbeing, Resilience and Prosperity for Australia, Financial System Inquiry final submission*, August 2014, Page 13 – http://fsi.gov.au/files/2014/08/Commonwealth_Bank.pdf.

5. Improvements to the design of the system

5.1 Coverage

As the system has matured, it has exposed gaps in its coverage that negatively impact on its equity and universality. Therefore, the extent of coverage, particularly when it comes to the SG, needs to be reviewed.

5.1.1 SG $450-a-month threshold

Given the increasing number of people working casual hours and the trend towards more people working part time, the existence of the $450-per-month threshold for the payment of SG penalises low-income earners, those who are permanent part-time workers and those with multiple jobs, who receive little or nothing in the way of SG contributions.

ASFA estimates that **around 250,000** individuals, the majority of them women, would benefit from the removal of the threshold by receiving higher retirement savings

ASFA estimates that around 250,000 individuals, the majority of them women, would benefit from the removal of the threshold by receiving higher retirement savings. The cost to employers and the Commonwealth Budget would be modest.[24] On the assumption that the 250,000 people missing out on superannuation contributions because of the $450-per-month threshold have average relevant wages of $3,000 a year, the total wages bill for them would be $750 million per annum. Superannuation payments at the rate of 9.5 per cent would amount to approximately $70 million a year. This compares to a total wages bill for the economy of around $600 billion a year.

Recommendation 7	Remove the $450-a-month threshold for the SG.

5.1.2 Impact of insurance on low balances

Consideration also needs to be given to the effect of fees and insurance premiums on relatively small account balances.

Until 1 July 2013, the SIS Regulations provided that superannuation benefits under $1,000 had to be protected from erosion by fees. With member benefit protection, where the member had a withdrawal benefits of less than $1,000, the amount charged by a fund as an administration fee could not exceed the amount credited as investment returns.

The removal of member benefit protection has resulted in a significant number of complaints about the erosion of superannuation accounts through the application of administration fees. Similarly, the deduction of insurance premiums also has the potential to erode account balances.

Erosion of benefits has the potential to diminish consumer confidence in superannuation significantly, especially with respect to low-paid, part-time or casual employees.

Most people’s first experience of the workforce and paid employment generally occurs with a part-time job as a school or university student, or in an entry-level role. This will also represent that person’s introduction to superannuation.

Given the amount of remuneration with respect to these jobs is usually fairly low, contributions to superannuation and the amount of superannuation benefits, for the first few years at least, are similarly low and susceptible to erosion by administration fees and insurance premiums. This does not represent a great introduction to superannuation for the average person.

A trustee which has a MySuper product must provide, on an ’opt-out’ basis, a level of insurance cover with

[24] ASFA, *Equity and superannuation – the real issues*, Sept 2012, Page 3 – www.superannuation.asn.au/policy/reports.

respect to death and permanent incapacity. This has the potential to erode the benefits of members with low account balances.

The statutory obligation should be ameliorated such that the trustee has the ability, after having taken into consideration such factors as the age, account balance and employment status, to offer insurance to a class of MySuper members on an 'opt-in', as opposed to 'opt-out', basis.

Recommendation 8	Give trustees the ability, after having taken into consideration such factors as the age, account balance and employment status, to offer insurance to a class of MySuper members on an 'opt-in', as opposed to an 'opt-out', basis.

5.1.3 Income replacement payments: paid parental leave/salary continuance/ worker's compensation

When people spend periods out of work, either to care for their family or due to injury or illness, they often stop contributing to their superannuation. This can have a dramatic impact on their final superannuation balance, particularly for women who take time out of the workforce to have children.

Therefore, in situations where income is replaced as a result of a workplace entitlement to receive a salary or wage, such as paid parental leave, salary continuance payments or worker's compensation, it would be consistent, and appropriate, if the SG were to apply to such payments.

Given the financial impact this may have on various parties, there may be a need for transitional arrangements with respect to this.

Recommendation 9	That the SG applies with respect to all substantive income replacement payments.

5.1.4 Women

The average super balance of women is significantly lower than that of men. The reasons for this include:

- time out of the paid workforce for the purposes of care-giving – be it children or other family members
- lower average incomes
- increased prevalence of women in casual or part-time employment.

Removing the $450-per-month threshold for SG and paying SG on parental leave payments would help reduce this difference in entitlements. The effects of compound interest also would be very favourable in regard to superannuation contributions made on behalf of women, mostly in their 20s and 30s, who take parental leave. ASFA estimates that the cost to the Commonwealth Budget would be just over $20 million a year.[25]

Furthermore, women have a longer life expectancy and therefore need a higher superannuation balance at retirement than do men, as on average they will live some three to four years longer in retirement.

Given the above, there should be scope for employers who wish to contribute more superannuation with respect to female employees to be able to be free to do so without breaching anti-discrimination legislation. By way of example, Rice Warner, as part of a wide-ranging package of measures approved by the Human Rights Commissioner, contribute an extra two per cent of salary in superannuation contributions for their female employees over and above what they contribute for their male employees.[26]

[25] ASFA, *Equity and superannuation, Op cit*, Page 3.
[26] http://ricewarner.com/research/superannuation/valuing-females-in-retirement.

Recommendation 10	Employers should be able to contribute more to super for women without being considered to have breached anti-discrimination legislation.

5.1.5 Indigenous Australians

Indigenous Australians have lower coverage and lower average super balances than the general population. This is largely related to differences in paid labour force experience.

Superannuation coverage for Indigenous Australians is approximately 70 per cent for men and 60 per cent for women, compared to 85 per cent for men and 80 per cent for women for the general population. Average (mean) balances are also lower than for the Australian population as a whole.

In addition, current superannuation regulations do not always work well with the circumstances of Indigenous Australians, particularly those in remote areas who may have difficulty in liaising with their superannuation fund and in claiming benefits or identifying lost accounts.[27]

In order to ensure this group is treated equitably, it is important the different cultural circumstances and needs of Indigenous Australians are recognised. By way of example, lower life expectancies for Indigenous people may warrant consideration of the merits of allowing earlier access to superannuation. The experience of Indigenous people could be improved materially through education programs that enhance financial literacy.

Recommendation 11	The particular circumstances and needs of Indigenous Australians should be recognised and their experience of superannuation improved, through education and enhanced financial literacy.

5.1.6 Self employed

There is a case to extend the compulsory superannuation regime to include the self-employed. Nearly ten per cent of the labour force is self-employed. While tax concessions have led to some self-employed saving for retirement through superannuation, average balances and coverage have remained relatively low. Around 29 per cent of self-employed people have no superannuation, with no superannuation being more common for males than females.[28]

Around 50%
of the self-employed do not have significant business or other financial assets

While many self-employed people and small business owners consider that their business is their super, a considerable proportion of self-employed people do not own a business with any material goodwill or value, other than their labour. Around 50 per cent of the self-employed do not have significant business or other financial assets. According to research from the Productivity Commission, over 25 per cent of the self-employed are dependent contractors, in that they have working arrangements similar to employees and are not conducting a business as such.[29] Other self-employed people run businesses with little or no value other than the value of their labour, such as a plumbing or carpentry business, which means that upon the retirement of the person, the business has little in the way of sale value.

Furthermore, even where there is an on-going business of some value, there is still a risk to individuals where their business fails, or the value of the business at retirement is diminished. This can leave them with inadequate savings to fund their retirement.

In addition, the fact that the SG is not payable with respect to the self-employed is a distinction within the SG

[27] ASFA, *Equity and superannuation, Op cit*, Page 3.
[28] ASFA, *Equity and superannuation, Op cit*, Page 2.
[29] P Waite, M. and Will, L. 2001, *Self-employed contractors in Australia: incidence and characteristics*, Productivity Commission Staff Research Paper, AusInfo, Canberra; http://www.pc.gov.au/__data/assets/pdf_file/0017/8315/secia.pdf.

regime that, at best, is a source of confusion and, at worst, is exploited by the artificial creation of arrangements whereby individuals are considered to be self-employed to avoid the need to pay SG. Recent research commissioned by Cbus, AustralianSuper and REST and performed by Tria Partners reveals systemic issues with respect to employer compliance with their SG obligations. In particular, the research indicated that over 50,000 persons were involved in sham contracting arrangements.[30]

Accordingly, the self-employed should be subject to compulsory superannuation. While this may pose some design challenges with respect to the concept of 'income' against which compulsory superannuation is to be applied, and the person\entity who is responsible for making the superannuation contributions, this should not preclude work being done in this area.

Consideration could be given to introducing a scheme similar to the Medicare surcharge, whereby a surcharge amount is payable unless a minimum amount of taxable income is contributed to superannuation. Utilising a concept of taxable income would ameliorate concerns with respect to potential adverse effects on the cash flow of start-up enterprises.

There will need to be transitional arrangements, like those that were applied when the SG was first introduced in 1992. This could take the form of an annually increasing percentage of taxable income to be contributed to superannuation until the percentage reaches 12 per cent. Consideration could also be given to whether there may be a need to create an exemption for high-net-worth individuals who have net assets over a certain value.

Recommendation 12	Compulsory superannuation should be extended to the self-employed.

5.1.7 Employer compliance with SG obligations

As outlined above, the recent research performed by Tria Partners revealed systemic issues with respect to employer compliance with their SG obligations.

Non-payment of super by employers affects **around 650,000** Australian workers, leaving them collectively out of pocket almost **$2.5 billion** annually

The research found that the non-payment of super by employers affects around 650,000 Australian workers, leaving them collectively out of pocket almost $2.5 billion annually. It found that the average person affected loses around $3,750 per annum in superannuation, or around nine months' worth of super for someone on average weekly earnings.

The loss of super impacts more heavily on younger and lower-income Australians. For a 25 year old, a one-off loss of this magnitude could equate to a loss of $13,500 at retirement in today's dollars. Those in more vulnerable circumstances, industries or modes of employment may endure multiple losses throughout their working life.[31]

At present, it can often take months or years for non-payment to be addressed. This has a significant impact on the retirement savings of thousands of Australians.

Recommendation 13	The ATO should have adequate systems, processes and people to ensure employers comply with their SG obligations with respect to their employees.

[30] Tria Investment Partners, *Superannuation Guarantee non-compliance, Final Report for CBus, AustralianSuper & REST, with contributions from ASFA*, 15 September 2014 and ASFA Media Release: 6 October 2014, *Super failure: Every year, $2.5 billion worth of missing superannuation owed to workers*, www.superannuation.asn.au/media-release-6-october-2014.
[31] Tria, *SG Non-compliance, Op cit.*

5.2 Adequacy

5.2.1 SG

In order to enable Australians to accrue sufficient superannuation to provide them with financial security in retirement, it is imperative that the rate of SG be increased from 9.5 per cent to 12 per cent as soon as possible.

Increasing the SG by half a per cent every year is an affordable increment to employers.

The Allen Consulting Group analysed the effects of the original proposed increase of the SG from its current level of nine per cent to 12 per cent. The Allen Consulting Group observed that the reform would be beneficial for future retirees and for all current Australian workers.

> *"Increasing the SG from nine to twelve per cent will ensure that future retirees will have a higher standard of living in retirement... recent polling shows that half of those currently in the workforce want more than $40,000 a year in retirement, while a third want more than $50,000 or more a year. Even after reviews and possible increases, the Age Pension will not be enough to match Australians' lifestyle expectations for their future retirement. Currently, fewer than 10 per cent of those aged over 65 receive over $40,000 per year.*
>
> *ASFA 2008 and ANOP polling[32]."*

The Allen Consulting Group went on to conclude that the Age Pension alone is not enough.

> *"Using the ASFA Retirement Standard, a single person needs around $407 per week, and a couple needs to spend around $589 per week to fund a modest lifestyle. This is higher than the Age Pension, which currently pays $335.45 per week for a single person and $505.70 per week for a couple".[33]*

They also observed that a nine per cent SG is not enough.

> *"Australia's current policy setting for retirement income policy will generate low incomes by international standards. OECD modelling shows that Australia's current policy settings will provide a 'replacement rate' for an average Australian income earner entering the labour market in 2006, of just 41.6 per cent. This compares to an OECD average of 59 per cent.*
>
> *It also should be noted that since compulsory superannuation was first introduced there has been a significant increase in life expectancy. In 1983, a Australian female reaching the age of 65 could expect to live on average for another 18 years, while an Australian male could expect to live for a further 14 years. By 2002, these figures had risen to 21 years for females and 18 years for males. Even if nine per cent contributions were sufficient when the SG was announced, then the increase in life expectancy of between about 20 per cent (for females) and 30 per cent (for males) at age 65 implies that a substantial increase in the rate of the SG is required".[34]*

The Allen Consulting Group concluded that the increase in the SG to 12 per cent would be acceptable to workers.

> *"The purpose of saving is to reduce current consumption in order to be able to increase consumption in the future (during retirement). It follows that it cannot be an automatic criticism of a policy to increase compulsory savings that it might make workers slightly worse off compared to what they would otherwise be able to spend prior to retirement.*
>
> *... Most people are myopic when it comes to managing their finances and if left to their own devices are*

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[32] Allens Consulting Group, *Op Cit*, Page 18.
[33] Allens Consulting Group, *Op Cit*, Page 19.
[34] Allens Consulting Group, *Op Cit*, Page 21.

likely to put off saving for retirement until later in life. In particular, most young people would be unlikely to save any money for retirement unless they were required to do so. However, various survey findings indicate that people support measures which compel them to save.[35]

… As noted above, the popularity of the policy to increase the SG indicates that people recognise their own myopia and need for 'pre-commitment' devices in savings technology.

They also concluded that the increase in SG to 12 per cent would be affordable for employers.

"In the long run there will be no effect on employers, because employers will pass on the burden of increase either in the form of price rises on the goods and services they sell, or in the form of lowered wages (or wage growth) for their employees, or both. All employers will face the same superannuation obligation so no employer will suffer any specific disadvantage flowing from it.

Increasing the Superannuation Guarantee is like imposing a (pure) payroll tax, and it is well-known in the economic literature that such taxes are among the most efficient taxes available to government – in the long run they are known to impart minimal distortions (deadweight loss) on an economy, leading to no change in employment, profits, international competitiveness, or in the allocation of capital and labour in firm production".[36]

The Allens Consulting Group went on to observe that:

"[T]he fact that the increase in the SG will be phased in over six years provides assistance to employers in planning to adapt to its introduction. The impact on wages costs in any one year will be small.... Additionally, the already sizeable proportion (25 per cent) of employees who already have superannuation contributions greater than nine per cent will ameliorate the effect.

In the long run, markets and factors of production adjust so that employers are no better or worse off than they were before the introduction of the rise of the SG".[37]

They concluded that the increase in the SG to 12 per cent is affordable for the taxpayer.

"Recent research published by the Australian Treasury (Gruen and Soding, 2011) explores the impact of compulsory superannuation on both national savings and on the Commonwealth Budget.

... The Federal government's fiscal strategy commits it to achieve budget surpluses on average over the medium term. It follows that any budget shortfall arising from the tax-preferred status of compulsory superannuation will be offset elsewhere in the budget, on average over the medium term.

The boost to private saving therefore translates (on average over time) to the same boost to national saving because the public sector makes good any shortfall in tax revenues elsewhere in the budget. The current estimated boost to private (national) saving is about 1.5 per cent of GDP, rising significantly over the next decade, as the Superannuation Guarantee rises gradually from 9 to 12 per cent.

... The public sector's contribution is estimated to be about 0.4 per cent of GDP currently, rising gradually to nearly 0.7 per cent of GDP by the end of the decade, and then staying around that level to the middle of the century"[38].

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[35] Allens Consulting Group, *Op Cit*, Page 21.
[36] Allens Consulting Group, *Op Cit*, Page 23.
[37] Allens Consulting Group, *Op Cit*, Page 24.
[38] Allens Consulting Group, *Op Cit*, Page 26.

Recommendation 14	The rate of SG should be increased from 9.5 percent to 12 per cent as soon as possible.

Concerns have been raised that 12 per cent may not be sufficient for the majority of middle-income earners. If economic conditions, investment markets or other financial circumstances were to deteriorate, this shortfall could be exacerbated and, if income replacement goals are to be reached, the rate of SG may need to increase. This is why the impact of SG needs to be modelled carefully on a periodic basis.

Recommendation 15	A review mechanism should be built into the inter-generational report so that the current rate of SG contributions is modelled to determine whether it will be sufficient.

Recommendation 16	If the inter-generational report indicates the rate of SG may be insufficient, then this should be referred to the Productivity Commission for review.

For a significant proportion of individuals, contributions of 12 per cent of earnings may not be sufficient to deliver appropriate outcomes in retirement.

This was identified by Dr Vince Fitzgerald back in 1993, where he observed:

> *"Our ultimate goal for the maintenance of pre-retirement income, through superannuation, is a national choice needing more discussion, but a 12 per cent total contribution appears only an interim goal; 18 per cent looks ultimately a more appropriate goal as it would over the decades make most Australians independent of the age pension".*[39]

Rice Warner has observed that, at a personal level, many retirees will not have adequate savings for their retirement. Their latest Retirement Savings Gap research measured (at 30 June, 2013) a $727 billion savings gap. This is $67,000 per person less than the amount required for an 'adequate' retirement, which would pay retirees up to their life expectancy (more than 20 years).[40]

Compounding this issue is longevity risk: half of Australia's retirees will live well beyond their life expectancy age.

As shown by the table below, while an increase in the SG to 12 per cent will deliver substantially improved outcomes for individuals and households, it falls short of achieving either the ASFA Retirement Standard's 'modest' or 'comfortable' level for those on the median wage of approximately $50,000 per annum.

Lump-sum retirement benefits after 30 years in a taxed fund

	Wage of $30,000	Wage of $50,000	Wage of $100,000
Lump sum if contributions made at the rate of 9.5% of salary	$116,000	**$193,500**	$387,000
Lump sum if contributions made at the rate of 12% of salary	$146,000	**$244,000**	$487,000
Lump sum if contributions made at the rate of 15% of salary	$183,000	**$305,000**	$610,000

Source: ASFA.[41]

[39] Fitzgerald Report, *Op Cit*, Page 49.
[40] Rice Warner, *Australia's retirement income 'bulge' requires urgent, comprehensive fix*, August 2014, http://ricewarner.com/newsroom/2014/august/27/australias-retirement-income-bluge-requires-urgent,-comprehensive-fix/
Compounding this issue is longevity risk: half of Australia's retirees will live well beyond their life expectancy age.
[41] ASFA, The impact of delay or not getting at all to a 12% Superannuation Guarantee contribution rate, September 2014, Page 5.

The lump sum needed to support comfortable lifestyle for a couple is $510,000, while that needed to support comfortable lifestyle for a single person is $430,000, representing an income of approximately $42,000 per annum. These figures assume receipt of a part age pension and do not take into account the Low Income Superannuation Contribution (LISC). Outcomes for low-income individuals would be further enhanced if the LISC were to be maintained.

For the middle 60 per cent or so of members with income on either side of the median income (which is approximately $50,000), SG at the rate of 12 per cent will not be sufficient to achieve a comfortable lifestyle in retirement.

Given that 12 per cent may not be sufficient for a number of consumers, especially those with broken working patterns, it would be worth considering introducing a 'default', 'opt-out' scheme with respect to an additional 3 per cent of contributions. Members would be able to opt out of some or all of the additional 3 per cent contribution. Ideally, contributions could be made from pre-tax income, however, consideration could be given to a regime whereby they are made from post-tax income.

Recommendation 17	There should be a default, opt-out, increase in contributions of three per cent over and above SG.

5.2.2 LISC

Prior to the introduction of the LISC, for members earning up to $37,000 per annum, superannuation was not concessionally taxed – it was in fact taxed punitively.

Without this measure, individual members would pay the following tax on their income (ignoring the Medicare levy) in the 2013/14 year:

- for a member who earned up to the tax-free threshold ($18,200) – income paid as income is tax free, whereas SG contributions would be taxed at the (nominal/headline) rate of 15 per cent
- even for a member who earned the maximum $37,000 per annum, the average rate of income tax they would pay on their income taken as income is 9.65 per cent (as opposed to 15 per cent on SG).

In considering tax concessions for superannuation, two issues must be weighed up:

1. the importance of encouraging private provision so that retirees can substantively achieve a reasonable income in retirement and contribute to the country's future economic prosperity
2. recognition that in a country which supports a progressive income tax system, appropriate levels of support should be provided for individuals across the income range.

The LISC assists in meeting both these goals.

There is an issue of the fairness of tax treatment for those on incomes of less than $37,000 given that a flat rate of tax applies to superannuation contributions. At the very least, individuals on a zero marginal tax rate on their income should not be required to pay tax at a higher rate on their concessional superannuation contributions.

Every single dollar of concessional contributions is taxed at 15 per cent in the fund from the first dollar, as opposed to zero tax payable on incomes up to $18,200 and then 19 per cent on only that income which is in excess of $18,200 up to $37,000 (which is where the LISC cuts out).

The LISC currently benefits 3.6 million Australians on low and modest incomes, including 2.1 million women. It benefits around 30 per cent of workers, who in 2009/10 only received around 1.2 per cent of total superannuation concessions. The introduction of the LISC nearly doubled the amount of tax assistance for persons earning less than $37,000 a year.

For a person earning just $37,000 a year, aged 30 and retiring aged 65, if the LISC applied over their working life it would boost their superannuation balance, in today's dollars, by around 20 per cent, from $200,000 to $240,000.

According to the recent Australian Bureau of Statistics (ABS) figures for 2011/12, the average person on $30,000 a year has only around $138,000 in superannuation at the age band of 60 to 64. For those aged 40 to 44 on $30,000 a year the average superannuation balance is only $36,000.

In the 40–44 age group	
The average **WOMAN**	The average **MAN**
on $30,000 a year has	
$33,000 in super	**$44,000** in super

Again, there are differences in the average balances for men and women, particularly for younger women in age groups where they may have recently spent time out of the paid labour force due to family responsibilities. Women are far more likely to have incomes around the $30,000 a year level than are men. The average woman on $30,000 a year has around $33,000 in superannuation in the age group 40 to 44. For men, the figure is higher, at $44,000.[42]

Given all of the above – there is an argument that LISC should be extended permanently.

This measure applies to people earning less than $37,000 per annum – generally the poorest in society, including part-time and casual workers, and students. It is simply not realistic to expect most of these people to be in a financial position to make voluntary contributions.

It is not fair to tax these people at what amounts to a penalty rate of tax with respect to their SG contributions, compared to the level of tax they would pay if it were taken as income. This is especially the case as this is the group of people for whom the additional take-home pay (were it not paid as an SG contribution) would make the biggest difference to their current standard of living.

Recommendation 18	The LISC scheme should be retained permanently.

5.3 Preservation age

Preservation age is an integral component of the retirement income system. At present, the large gap between Age Pension eligibility and preservation age gives rise to a risk that people will deplete their superannuation savings quickly, and then fall back on the Age Pension. This reduces the positive impact of superannuation on an individual's quality of life in retirement, and reduces the savings to the government.

Given the increase on the Age Pension age to age 67, and then 70, consideration should be given to whether the superannuation preservation age needs to increase.

When the preservation age initially was set at 55, Age Pension age was 60 for women and 65 for men. Since then, the Age Pension age for women has gradually increased to be equivalent to that of men, with the age for both increasing gradually to age 67 by 1 July 2023. It has since been announced that the government intends to increase the Age Pension age to 70 by between 1 July 2025 and 1 July 2035. Meanwhile, the superannuation preservation age has been legislated to increase from age 55 to age 60, with effect between 2015 and 2024.

Ideally, the preservation age should be linked to the Age Pension age and should be set to be a specified period less than the Age Pension age. If this were done, then the preservation age would increase automatically, and in synchronisation with, the Age Pension age.

If a period of 5 years were adopted, this would see the preservation age increase, in a phased manner, from age 60 to age 62, as the Age Pension age increases to age 67. This would minimise the risk of dissipation of superannuation monies prior to Age Pension age.

[42] ASFA, Submission to Treasury providing comment on the Draft Mineral Resource Rent Tax Repeal and Other Measures Bill 2013, October 2013 – www.superannuation.asn.au/policy/submissions-2013.

However, in making such changes, consideration also needs to be given to those older Australians who for a range of reasons, including restricted abilities due to health issues and a lack of employment opportunities, may find themselves unable to find employment, or sufficient employment. If they are unable to access their superannuation, or the Age Pension, this will lead to an increase in both disability and unemployment benefits. Therefore, there may need to be some sort of early access in order to protect this group, which is outlined below.

Also, if the preservation age were to increase to above age 60, the conditions of release in the SIS Regulations may need to be reviewed in light of this. In particular, the condition of release with respect to the cessation of employment with an employer who had contributed to the fund on or after age 60 could now occur prior to preservation age being reached.

Recommendation 19	The superannuation preservation age should be set 5 years younger than the Age Pension age, up to a maximum of age 62.

5.4 Early access

Despite some suggestions to the contrary, there is little evidence that the current provisions with respect to early release – either on compassionate grounds or on the grounds of financial hardship – are resulting in undue leakage from the system. Given that superannuation is for retirement, it will be critical to ensure that early access is not extended for such purposes as providing a deposit for a house, which not only reduces the amount a person has in superannuation but serves to add inflationary pressure to house prices.

There is evidence that up to 40 per cent of retirements are not voluntary but occur earlier than planned, generally as a function of ill-health or involuntary redundancy.[43]

Up to 40% of retirements are not voluntary but occur earlier than planned, generally as a function of ill-health or involuntary redundancy

If there were to be a phased increase in preservation age from age 60 to age 62, consideration may need to be given to amending the conditions of release to allow at least some access to superannuation for those in this age group who have been unemployed for a prescribed period, say 12 weeks.

This could take the form of access to a limited income stream, similar to the transition-to-retirement pension currently available once preservation age is reached.

This could mean that a person aged 60 to 62 could receive a portion of their benefit as a regulated, non-commutable, income stream. Limitations could be imposed, as they are currently with respect to a transition-to-retirement, such that, for example, a maximum of 10 per cent of the account balance could be paid as an income stream per annum.

Recommendation 20	Access to a limited income stream should be available from age 60 for those who have been unemployed for a specified period.

[43] ABS 6238.0 - Retirement and Retirement Intentions, Australia, July 2012 to June 2013.

5.5 Role of insurance

Insurance provides an incredibly valuable benefit to members of superannuation funds, generally providing them with default cover in the event of death and total and permanent disability (TPD), and often with respect to total but temporary disablement (TTD) as well. For a number of members, insurance within superannuation is frequently the only life insurance they have in place. In the case of death, it provides critical support to dependants, while in the event of permanent incapacity and the inability to earn income, it can provide a member with financial security.

There is an old adage that 'life insurance is not bought, it is sold'. There tends to be an underinsurance problem within Australia. Without insurance in superannuation, it is arguable that the majority of Australians would have no, or insufficient, life insurance.

Recent research performed for ASFA by Rice Warner has revealed that:

- insurance provided to people through their superannuation reduces the annual government social security spending by about $403 million. These savings are a result of a decrease in costs related to government spending on income payments to families who have lost a breadwinner, or individuals who have become disabled
- insurance through super delivers a number of additional benefits to the community. In particular, it results in more people having life insurance cover than otherwise would, as a relatively low percentage of people in Australia purchase life insurance voluntarily. This means that, without the provision of insurance through superannuation, the underinsurance gap in Australia would be much bigger
- In terms of the total size of insurance cover across the community, group insurance within super represents:
  - 71 per cent of total death benefit sums insured
  - 88 per cent of overall TPD sums insured
  - 59 per cent of income protection monthly benefits.[44]

Most of these policies are group insurance policies, which have benefits and limitations.

Benefits frequently include the provision of 'automatic acceptance' up to a certain limit, subject to certain conditions, with negligible or no underwriting of individuals and cheaper premiums than individual life policies, in part due to tax treatment. On the other hand, group policies, as opposed to individual ones, can be limited in the extent to which they are able to exclude certain risks and/or load premiums. This can result in people seeking to increase their insurance who have, for example, a pre-existing medical condition being excluded from increasing their insured benefit altogether.

Notwithstanding the Rice Warner research, insurance premiums in recent times have increased significantly, due to a number of factors including:

- significant increases in automatic acceptance limits, amounts of sum insured and offers to match or transfer existing insurance
- increased selection against funds with automatic acceptance by members with adverse health conditions
- issues with respect to the quality of insurance data
- an increase in the number of long dated claims, with significant delays between ceasing employment and the TPD claim being notified
- issues with the definition of TPD and how it has to be applied in practice
- increased involvement of plaintiff law firms, including prior to the trustee's decision being made
- reduced capacity and competition in the market.

As part of the Stronger Superannuation reforms, the *SIS Act* was amended to insert a specific trustee director covenant with respect to not unduly eroding a member's benefit through the deduction of insurance premiums. During the same period, APRA introduced *Superannuation Prudential Standards SPS 250 – Insurance in Superannuation*, which states that it:

> *"establishes requirements for an RSE licensee with respect to making insured benefits available to beneficiaries.*

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[44] Rice Warner, *Insurance Administration Expenses*, ASFA, August 2014.

The Board of an RSE licensee is ultimately responsible for having an insurance management framework that reflects the risks associated with making available insured benefits that is appropriate to the size, business mix and complexity of the RSE licensee's business operations. The insurance management framework must include the insurance strategies for each registrable superannuation entity required in the Superannuation Industry (Supervision) Act 1993.

The key requirements of this Prudential Standard are that an RSE licensee must also:

- *ensure that insurance arrangements adequately address the minimum requirements set out in this Prudential Standard; and*
- *formulate and give effect to appropriate selection processes for, and due diligence of, insurers and monitor relationships with insurers on an ongoing basis"*[45].

The Prudential Standard, coupled with other prudential guidance, such as *CPG 235 – Managing Data Risk* – should see trustees manage their insurance framework appropriately.

There are, however, some improvements that could be made to the regulatory environment, which could materially improve insurance within superannuation.

5.5.1 Definition of 'permanent incapacity'

The current approach to the concept of 'permanent incapacity' has led to escalating total and permanent disablement (TPD) insurance costs. Without intervention, the costs of insurance will continue to rise, reducing retirement benefits for members. The insurance market will also continue to tighten, potentially reducing insurance cover for members.

Permanent incapacity was intended to permit the release of retirement benefits early in the event that, as a result of injury or illness, the member is unlikely to be gainfully employed in an occupation for which they are reasonably qualified. Decades of judicial and tribunal interpretation, however, have effectively lowered the claim threshold quite substantially. It is not uncommon for members now to claim TPD benefits even though they have a capacity to work. Lowering the claim threshold has resulted in more members claiming permanent incapacity, and TPD where externally insured, and higher claims have increase the cost of insurance.

To reverse this trend, the definition of permanent incapacity should be changed to focus less on the likelihood of engaging in future gainful employment, assessed at the point of claim, and focus instead on capacity to work from time to time, taking into account possible rehabilitation, retraining and treatment options.

Regulation 1.03C of the SIS Regulations defines permanent incapacity as follows:

"a member of a superannuation fund or an approved deposit fund is taken to be suffering permanent incapacity if a trustee of the fund is reasonably satisfied that the member's ill-health (whether physical or mental) makes it unlikely that the member will engage in gainful employment for which the member is reasonably qualified by education, training or experience."

Assessing the likelihood of a member engaging in future gainful employment requires the trustee, at a particular point in time, to be reasonably satisfied as to whether or not a member's ill health, at that point in time, makes it unlikely that the member will engage in gainful employment for which the member is reasonably qualified.

This point in time could be some decades before the member's likely retirement age and requires the trustee to form a view as to:

- the state of the member's health, based on what can be incredibly technical, and conflicting, medical evidence
- whether that state of health will cause the member – at any time in the future – to be unable to engage in gainfully employment for which they are reasonably qualified.

This necessitates an effective 'crystal ball gaze' as to:

[45] APRA, Superannuation Prudential Standard 250, Page 1.

- the continuing state of the member's health
- whether the member's health will mean they are unlikely to engage in future employment, which involves an assessment of likely employment opportunities, and the member's occupational fitness for those opportunities, over the period prior to when retirement was likely to have occurred.

The result of this process for trustees is a high bar to decline a claim. To achieve the policy intent of preserving retirement benefits, except where a member is forced into early retirement due to ill-health, the legislation should lead to a higher bar to accepting a claim for permanent incapacity. This can be effected by changing the definition of permanent incapacity to focus on a member's capacity to work, removing or tempering the more extreme crystal ball gazing aspects, and allowing trustees to take into account rehabilitation, retraining, and treatment prospects.

Advances in thinking in this area have focused on the physiological benefits of reframing capability in terms of 'ability', not 'disability', and the effect that this can have on the member's prospects for recovery. In fact, the current definition provides a material incentive for a member to be found 'incapable' and can be detrimental to their health and prospects of recovery.

Recommendation 21	The definition of 'permanent incapacity' should focus on a member's capacity to work that takes account of rehabilitation, allows attempts to return to work, a member's ability to work in a reduced capacity and the potential for any improvements in health.

To ameliorate the effect of amending the legislation, consideration could be given to the definition being amended to encourage and support returning to work in a reduced or alternative capacity. This may involve the creation of another 'limb' to the definition of permanent incapacity, which would allow the trustee to pay a reduced benefit where rehabilitation prospects or environmental factors are present.

In circumstances where the trustee is satisfied that the member satisfied this new limb, a new condition of release could be created to enable the trustee to pay an income stream, and/or a reduced lump sum benefit, to the member.

Recommendation 22	There should be a new condition of release that enables the trustee to pay an income stream and/or a part lump-sum benefit to a member who satisfies the new definition of 'permanent incapacity'.

5.5.2 Ability to limit claim periods

Another issue that has been the cause of concern and which has contributed to the increase in premiums, is the increasing number of claims where there is a significant delay between the advent of the member's ill health and the TPD claim being notified.

Not only does this create considerable practical difficulties for the trustee in assessing the claim, as access to relevant materials may be limited, it also serves to create a level of uncertainty with respect to the claims experience, which can lead the need for the insurer to have to build larger reserves, further increasing premiums.

Given that super funds are trusts, generally there is no applicable limitation period with respect to the bringing of a TPD claim. Consideration should be given to creating a statutory limitation period within the *SIS Act*.

Recommendation 23	The *SIS Act* should contain a limitation period, so that permanent incapacity claims can be bought up to seven years after the date the member is determined to have been unable to be gainfully employed due to ill-health.

5.5.3 Insurance 'dashboard'

Currently, there are no standards with respect to disclosing insurance to members in a consistent manner.

By way of example:

- disclosure can be on an 'age last' or 'age next' basis
- salary continuance benefits can be stated as a weekly, monthly, quarterly or annual amounts
- premiums for death, permanent incapacity and temporary incapacity benefits can be stated as a weekly, monthly, quarterly or annual amount.

This lack of consistency can make it difficult for members to compare different insurance offerings.

Recommendation 24	Fund members should have access to an insurance product dashboard to allow them to compare different insurance offerings.

5.6 Death benefits

Given the concerns with respect to adequacy, and in line with underlying policy rationale with respect to preservation, consideration could be given to providing an incentive to the beneficiaries of a death benefit to rollover some or all of it into their superannuation account, as opposed to taking it as a lump sum. This would encourage superannuation money to remain in the system, to be utilised for retirement.

Recommendation 25	There should be a tax incentive to roll-over a death benefit into the superannuation fund of the beneficiaries.

Appendix
Further information about issues discussed

Ongoing contributions: a superannuation fund may continue to receive contributions in respect of a member whose default pension is triggered because a condition of release is satisfied.[1] Unless the pension standards are amended to allow contributions to be added to an income stream, the member's accumulation account in the superannuation fund will need to remain open. This raises practical issues including the viability of maintaining the accumulation account, particularly if contributions are low, because of fees and costs and other charges, including any insurance premiums, which apply.

Insurance cover: at the time a default pension is triggered, the member may have insurance cover that will cease if their accumulation account is closed, and may not be able to be re-instated without full underwriting. Even if the accumulation account is not closed, a minimum amount, say $5,000, may need to be retained in the accumulation account to meet the cost of any insurance premiums. Alternatively, insurance cover could be 'transferred' to the pension account, however there may be other implications arising from such an approach, such as the tax deductibility of insurance premiums.

Consolidation of other accounts: When a person satisfies a condition of release, they might consolidate a number of accumulation accounts, and possibly any existing transition to retirement pension account into one or more pensions for taxation or other reasons. A default pension will not necessarily provide a member with an appropriate opportunity to consolidate their superannuation savings into one pension product.

Reversionary beneficiary nominations: a default pension will not necessarily provide a member with an appropriate opportunity to choose a reversionary pensioner. It might be possible for the nomination to be collected at the commencement of a member's accumulation phase in a fund, however a member's circumstances might change significantly after that time. A more timely collection point is immediately before the default pension commences. In any case, as there no application form required prior to the default pension product commencing, it is less likely that a fund will obtain a reversionary beneficiary nomination relevant to the member's circumstances at the time of satisfying a condition of release or commencement of the pension. This may have social security and/or taxation implications for the member and/or any dependants.

Payment of income stream payments: it will be important to ensure that there is an efficient, robust and secure payment system for pensions. This includes ensuring pensions are pay into the default member's bank account and that it is the member that actually receives the payment. This system should be part of the next conversation after SuperStream is implemented.

Many of the above issues may be addressed by clear and prominent disclosures[2] about how the default pension works; what the default pension's features are and what steps a member should consider or take to effectively manage their interest in a fund, including obtaining financial advice. These disclosures should be provided at the time a person acquires an accumulation product with a default pension (via a product disclosure statement [PDS]) and, more importantly, before a fund commences the default pension.

[1] The contributions may be personal contributions or employer contributions, subject to contribution standards under the *SIS Act*, including the 'work test' applicable to persons aged 65 or more. Ongoing employer contributions may have to be attributed to the member's MySuper interest in any case.
[2] At the time a person acquires an accumulation product with a default pension (via a PDS) and before a fund commences the default pension.