

Super system evolution: Achieving consensus through a shared vision

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1.1 Three pillars

Australia has a three pillar retirement system, namely:

- A mandatory contribution (made by employers) which is currently nine per cent of wages, increasing to 9.25 per cent from July 2013 and then gradually to 12% from July 2019.
- Voluntary contributions, many of which include tax concessions.
- A government means-tested Age Pension commencing at age 65 for males and (currently) 64 for females but increasing to age 67 over the next decade. Veterans (pensioners who have been in the armed services) receive identical benefits but receive them five years earlier than civilians.

All elements are subject to constant changes for fiscal reasons.

- The employer contributions (Superannuation Guarantee, SG) commenced at three per cent in 1992 and will reach 12 per cent in 2019. Some commentators believe this should rise to 15 per cent eventually.
- The voluntary contributions include:
 - o Employers (usually large companies and governments) which pay a higher rate than the SG.
 - o Members paying pre-tax contributions from their salary package. The limit of concessional contributions has fallen significantly in recent years.
 - o Members paying after-tax contributions.
 - o The government co-contribution which matches after-tax contributions up to \$1,000 a year for low-income earners.
- The means testing of the Age Pension changes frequently.

Despite the regular changes which the governments makes for fiscal or equity reasons, the broad structure is robust and is supported by politicians and industry.

The critical element of Australia's retirement system is that members carry all the risks themselves. While there are some defined benefit arrangements, most of these are closed to new members. In the long-term, all members will hold accumulation (defined contribution) accounts.

1.2 The shift of assets towards the retirement phase

Rice Warner has estimated that retirement assets will increase to \$1,404 billion in current dollars (or \$2,187 billion in nominal dollars) at 30 June 2026. This results in the retirement market share of total superannuation fund assets increasing from 30 per cent at 30 June 2011 to 42 per cent at 30 June 2026.

Half of the assets currently held in the pension (retirement) phase are owned by members of self-managed superannuation funds (SMSFs). These members have high average account balances and have taken an active choice to use an income stream.

Table 1 – Total post-retirement market (2011 dollars)

Market segment	Today		In 5 years		In 15 years	
	30/6/2011		30/6/2016		30/6/2026	
	(\$M)	(%)	(\$M)	(%)	(\$M)	(%)
Not-for-profit funds	67,032	(16.5)	135,184	(22.1)	397,423	(28.3)
Commercial (retail segment)	133,238	(32.8)	180,382	(29.5)	383,631	(27.3)
SMSFs	206,094	(50.7)	295,264	(48.3)	622,556	(44.4)
Retirement market	406,364		610,830		1,403,610	

Note the not-for-profit funds would be larger if the PSS, CSS and military funds retained their pension accounts within these funds. However, pensions for these funds are paid out of consolidated revenue and are not regulated (or counted) by APRA.

The increased flow of funds into the retirement phase over the next 15 years reflects the baby boomers attaining their retirement ages during the projection period and also the maturing of the compulsory superannuation system.

1.3 The role of the Age Pension

1.3.1 Principles

The Age Pension is an integral component of the retirement benefit of most Australians. It has its own principles as set out in the Pension Review Background Paper of the Harmer Review. This states the five key principles underpinning a successful social security system to be:

1. Support should be at a basic acceptable standard of living.
2. Payments should be equitable between people in similar circumstances.
3. Payments are targeted to those not able to fully support themselves.
4. It promotes workforce participation and self-provision.
5. It is sustainable

The Age Pension broadly supports these principles. However, it is arguable whether it helps promote workforce participation and self-provision.

1.3.2. Acceptable standard of living

The first purpose of the Age Pension is to establish a suitable standard for a retiree without any other resources which should be supported by taxpayers. As a bare minimum, it must meet a minimum subsistence level to ward off poverty.

After the latest indexation from September 2012, the full Age Pension is \$712.00 a fortnight for a single person and \$1,073.40 a fortnight for a married couple. There is also a pension supplement for singles of \$60.60 a fortnight (\$91.40 for couples).

Table 2 shows the most recent budget standards for a modest and comfortable lifestyle as indicated by the ASFA Retirement Standard. These are based on a typical retiree at age 65.

While these values do not reflect the situation of every retiree, they allow us to gauge the average needs for different lifestyle expectations given costs of living in Australia. These are compared with the maximum annual rate of Age Pension¹ as at July 2012.

Table 2 – ASFA Retirement Standard

	Modest lifestyle – single	Modest lifestyle – couple	Comfortable lifestyle – single	Comfortable lifestyle – couple
Yearly total	\$22,641	\$32,603	\$41,169	\$56,317
Age Pension	\$21,076	\$31,775	\$21,076	\$31,775
Difference from Age Pension	\$1,565	\$828	\$20,093	\$24,552

It is clear that the Age Pension is close to meeting the modest lifestyle needs of retirees. As the benefit is linked to wages and the modest lifestyle is linked to prices, the Age Pension will gradually close in on the modest lifestyle for at least a period of some years. The ASFA Retirement Standard is adjusted for changes in prices every quarter but every four or five years is adjusted more substantively for changes in the pattern of expenditure by retirees and for increases in the general living standard of the community.

For a comfortable lifestyle, retirees need to build their own superannuation as the Age Pension by itself will be inadequate.

¹ Including pension supplements

1.4 Age Pension dependency

Currently 75 per cent of Australians over the age of 65 rely on a full or part-Age Pension for financial support.

Table 3 – Number of pensioners over age 65 in 2011

Age pensioners		Number of	Payments ² \$m
Full	Individual	622,846	\$12,126
Full	Couple	671,010	\$9,841
Part	Couple	556,669	\$6,534
Total		2,158,987	\$33,305
DVA pensioners over age 65		228,510	\$41112
Still working		166,029	
Self-funded		629,901	
Population over age 65		3,183,427	
Retirees aged 55 to 64		1,361,689	
Disability support pensioner		800,000+	\$13,800

Figure 1 illustrates that over the last 10 years, the proportion of the Australian population receiving the full Age Pension has decreased. This is most markedly between age 65 and 70 as this cohort has benefited from the Superannuation Guarantee for a longer period of their working lives than those who retired ten years earlier. Further, the cohort is wealthier than the one for the previous decade and some members may have deferred retirement which delays eligibility for the Age Pension.

While the proportion on the partial Age Pension has risen only marginally, the proportion of self-funded retirees has increased to a greater extent. Despite this encouraging trend, the proportion on the Age Pension remains high, reaching over 80 per cent of the population by age 75.

Figure 1 – Proportion of the population receiving the Age Pension and self-funded retirees, 2000 and 2011



² Rice Warner estimates

While the number of persons of eligible age for the Age Pension will increase markedly in the future due to our ageing demographics, the Superannuation Guarantee will limit the outlays. This is supported by Treasury projections to 2049-50, which show that those on the part pension will increase significantly with a commensurate fall in those entitled to the full pension. However, despite growing superannuation balances, Treasury projects that the proportion of the population not receiving any Age Pension will only rise slightly to no more than about 25 per cent of retirees.³

³ *Treasury 2010 Intergenerational Report*

Retirement can be a state of mind rather than something that can be objectively determined. However, a definition used by the Australian Bureau of Statistics (ABS) in measuring the number of retirees is the number of persons aged 45 and over who were not working or looking for full-time or part-time work.

Alternative definitions, such as including departures from prime-age employers or individuals who changed working arrangements to have shorter working hours, would inevitably result in different estimates of the average retirement age and the number of retired persons.

The ABS indicates that in 2010-11, of the 8.5 million people aged 45 years and over who had, at some time, worked for two weeks or more, 4.9 million (57 per cent) were in the labour force, 3.2 million (36 per cent) had retired from the labour force, and the remaining 340,300 (four per cent) were not currently in the labour force but had not retired.

The likelihood of being retired increased with age. For those aged 45-49 years, just five per cent were retired, compared to 16 per cent of 55-59 year olds, 68 per cent of 65-69 year olds and 87 per cent of those aged 70 years and over.

Of the 3.2 million people aged 45 years and over who reported that they were retired from the labour force there were 1.4 million men and 1.8 million women. Just under half of all retired people were aged 70 years and over (50 per cent of retired men and 41 per cent of retired women were aged 70 years and over).

2.1 Average age of retirement

In Australia, the average age at retirement for recent retirees (those who have retired in the last five years) was 61.4 years in 2010-11. Within this group, the difference between the retirement age of men and women was relatively small, with women retiring a little younger than men (the average retirement ages for this group were 62.5 years for men and 60.3 years for women).

While there may have been a shift to early retirement in other countries, in Australia the average age of retirement has been increasing. In 2004 the average age at retirement for recent retirees (those who retired in the last five years) was 60 years, which was 1.4 years lower than the average in 2010-11. Of this group, the difference between the retirement age of men and women was also larger, with women retiring approximately three years younger than men (the average retirement age for men was 61.5 years for men and 58.3 years for women). The labour force participation rate for older women in particular has been increasing.

As indicated in Figure 2 below, in Australia both the average effective age for retirement and the eligibility age for a government financed retirement benefit are currently slightly above the OECD averages. When the increase to age 67 comes into effect for the Age Pension in Australia, we will be towards the top end of the range in terms of international practice. However, it should be noted that a number of other countries are also increasing the eligibility age for their equivalent of the Age Pension.

It is interesting that there is little evidence in Figure 2 to indicate that the eligibility age for a government retirement benefit has any impact on the average retirement age. There appear to be other factors at work which are more important.

Figure 2 – Average effective age of retirement versus the official age, 2006-2011^{a,b}



Source: OECD estimates derived from the European and national labour force surveys.

a) The average effective age of retirement is defined as the average age of exit from the labour force during a five-year period. Labour force (net) exits are estimated by taking the difference in the participation rate for each 5-year age group (40 and over) at the beginning of the period and the rate for the corresponding age group aged 5-years older at the end of the period. The official age corresponds to the age at which a pension can be received irrespective of whether a worker has a long insurance record of years of contributions.

b) Official retirement age is shown for 2010.

c) For Belgium and France, workers can retire at age 60 with 40 years of contributions; for Greece, at age 58 with 35 years of contributions; and for Italy, at 57 (56 for manual workers) with 35 years of contributions.

2.2 The number of people aged 65 and over

The 2010 Intergenerational report prepared by the Commonwealth Treasury indicates that in 2009-10 there were around 3 million Australians aged 65 and over, with around 0.4 million aged 85 and over. By 2020 these figures are projected to grow to 4.2 million and 0.5 million respectively. By 2050 the impact of ageing on the population structure is more striking, with 8.1 million aged 65 and over, and 1.8 million aged 85 and over.

The number of people turning 65 each year is rapidly increasing as the first of those born after the cessation of World War II turn 65. In 2006 around 168,000 persons a year turned 65 but by 2012 this figure had jumped to around 252,000. The year 1947 was a peak year for births. However, the “baby boom” continued for a considerable period of time with around 300,000 persons a year projected to turn 65 during the period 2025 to 2030. Post-war immigration also will have an impact on the population age distribution.

2.3 Member risks and uncertainty

Australians in accumulation funds don't know what they are going to receive at retirement – and they are even less certain about how much they need and how they should spend their benefit in the retirement years. Superannuation is complex enough but the interaction with taxation and social security adds another dimension of uncertainty.

In fact, members are subject to a number of risks prior to and in retirement, namely:

- **Investment risk** – Members don't know what their final retirement benefit will be – it will be subject to the vagaries of volatile asset prices over the period when they are accumulating their benefit and through the retirement years.
- **Management & agency risk** – Members don't know whether their fund will perform well relative to its peers and investment objectives.
- **Longevity risk** – Members don't know how long they will live so they cannot budget a prudent amount to withdraw each year during retirement.
- **Budgeting risk** – Expenditure patterns vary considerably during the active, passive and frail periods of retirement. Movement through these phases differs by individual so it is difficult to budget for expenditure needed in retirement time periods.
- **Inflation risk** – Expenditure in retirement is subject to inflation so fixed incomes can be diluted in real terms (Australia has had a prolonged period of real interest returns on term deposits which are widely held by retirees so this risk tends to be downplayed).
- **Liquidity risk** – Once they start drawing their retirement benefit, members will be subject to liquidity risk – they don't want to have to realise assets to produce income when market values are low. The risk of retiring at a time of low asset values is deemed to be **Sequencing risk**.

As most members are not engaged with their superannuation, it is critical to have sound default structures. These need to take into account all the above risks as well as the likely requirements of the typical member.

2.4 Longevity

The key risk with longevity is that members will spend all their financial wealth including superannuation before they die. Members often underestimate how long they will live and are largely oblivious to the impact of future improvements in longevity.

The table (using ABS projections) shows the rapid extension of life expectancy in recent years with predicted further improvement in future years.

When considering the retirement needs of younger people, it is important to note that most will survive to retirement and most will then have a longer life in retirement.

Table 4 – Life expectancy at age 65

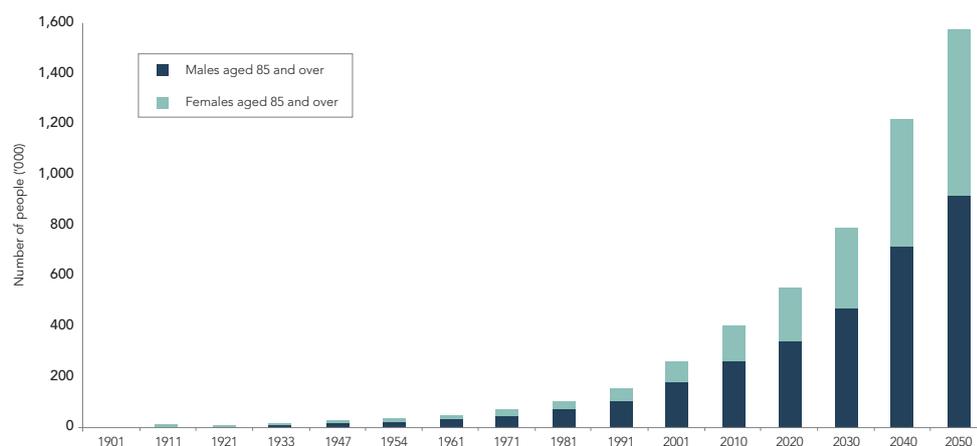
Year	Male	Female
1901-10	11.3	12.9
1920-22	12.0	13.6
1946-48	12.3	14.4
1960-62	12.5	15.7
1980-82	13.8	18.0
2000-02	17.4	20.8
2011	21	24
2031	24	26
2051	26	28

Table 5 – Percentage of 20-year-olds who reach 65

Year	Male (%)	Female (%)
1901	57.6	65.1
2012	89.6	93.7

One of the consequences of improving mortality is that the number of very old retirees, who are predominantly frail, is growing considerably. This cohort has special needs, particularly around aged care.

Figure 3 – The over 85s



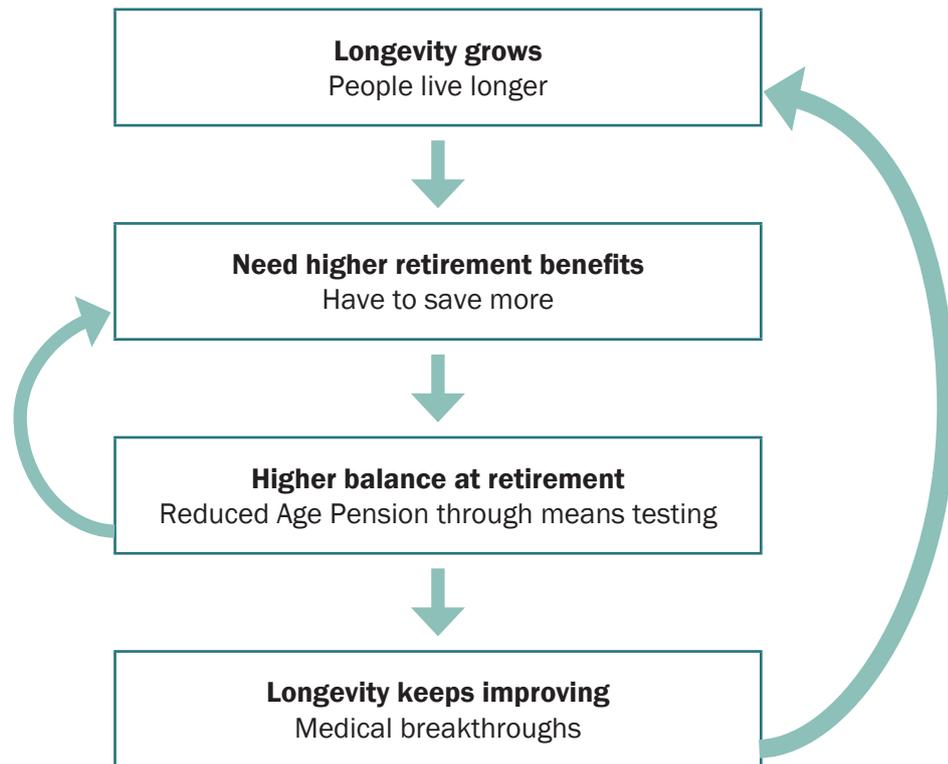
The table below shows the longevity for males, females and couples. It shows that there is a 50 per cent chance that one member of a couple (usually the female) will live to age 95. Most Australians would not plan for this!

Age of survival for 65-year-olds⁴

% surviving	Females	Males	Joint-Life*
90	76.1	72.9	85.9
80	81.7	78.1	88.4
70	85.2	81.7	90.2
60	87.9	84.6	92.4
50	90.1	87.1	94.8
40	92.1	89.4	95.2
30	94.2	91.7	97.5
20	96.4	94.2	99.5
10	99.5	97.7	102.7

⁴ Australian Life tables 2005-07 – 25-year mortality improvement factors

Longevity provides a key problem for young savers. Effectively, they have the dilemma set out below.



2.5 Health adjusted life expectancy

With the increase in life expectancy across the developed world (including Australia) being driven mainly by people living longer into old age, an important question is raised: are people spending these extra years of life in poor health? The issue of 'healthy life expectancy' stresses that increases in life expectancy alone are not important. What is important is that people live longer lives in better health. This is also crucial to expectations and requirements in regard to the involvement of older workers in the paid labour force. An increase in life expectancy is not in itself a justification for an increase in the eligibility age for the Age Pension.

A common measure used to summarise developments in the average number of years in good health is 'health adjusted life expectancy' (HALE). This is an estimate of the number of healthy years (free from disability or disease) that a person born in a particular year can expect to live based on current trends in deaths and disease patterns. The average number of years spent in unhealthy states is subtracted from the overall life expectancy, taking into account the relative severity of such states.

According to the Australian Institute of Health and Welfare (AIHW), the estimated HALE for Australia in 2003 was 70.6 years for males and 75.2 years for females. This means that males born in 2003 could expect to lose an average of 7.7 years of their life to disability, while females could expect to lose 8.0 years. In many cases these years of disability are towards the end of life.

In 1996, the average years of healthy life lost due to disability was 6.9 years for males and 7.7 years for females (AIHW 2007). Thus, although life expectancy increased between 1996 and 2003 by 3.6 per cent for males and 2.3 per cent for females, the average years of life spent in an unhealthy state also increased by 11.6 per cent for males and 3.9 per cent for females. If these trends continue, it may be the case that increases in life expectancy will be largely offset by an increasing burden of disease and disability.

2.6 Differences in health status and life expectancy by income level

The gains in life expectancy are not distributed equitably. For instance, in NSW, males born in the highest socio-economic status (SES) groups in 2007 are expected to live 4.3 years longer than those born in the lowest SES group, and an average of about 3.7 years longer than those born into the middle three SES groups. In females, the difference in life expectancy between the highest and lowest SES groups was 2.6 years in NSW in 2007.

In the 12 years between 1995 and 2007, life expectancy increased for all SES groups for both males and females. The increase was greater for males than for females across SES groups. In absolute terms, the 'gap' in life expectancy between the lowest and highest SES groups increased over this period. The difference in life expectancy increased from 3.1 to 4.3 years for males, and from 1.6 to 2.6 years for females in NSW.

Rates of disability also are related to socio-economic status.

These findings are very relevant to proposals to further increase the preservation age for superannuation and the eligibility age for the Age Pension. Individuals who take up the Age Pension at the minimum eligibility age are much more likely to be in the lower socio-economic groups than those on a part Age Pension or who are self-funded in retirement.

What is the ASFA Retirement Standard?

The ASFA Retirement Standard benchmarks the annual budget needed by Australians to fund either a comfortable or modest standard of living in the post-work years. It is updated quarterly to reflect inflation, and provides detailed budgets of what singles and couples would need to spend to support their chosen lifestyle.

Few people know exactly how much money they will need to spend each year to fund a comfortable lifestyle in retirement. The ASFA Retirement Standard has been developed to help with this problem by objectively outlining the annual budget needed by Australians to fund a comfortable standard of living in the post-work years.

The Standard was first introduced in 2004 and has since been revamped to give Australians a more comprehensive picture of how much they need to spend to support their retirement lifestyle. The revised Standard reflects changes in living standards, new expectations of retirees and their evolving spending patterns. In particular, the budgets for Communications, Health, Energy, Clothing, Household goods and services, Recreation and Transport have been updated. Australians can now get a more comprehensive picture of how much they need to spend to support their retirement lifestyle. The revised Standard now incorporates expenditure on:

Communications –	reflecting the increased number of retirees who want a mobile phone and broadband internet connection to keep in touch with friends and relatives. Changes have been made in both the comfortable and modest budgets.
Private health insurance –	the cost of this is now included in the ‘Health’ budget for both lifestyles, reflecting that a majority of retirees hold private health insurance.
Energy –	the allocation for this is now more in-line with contemporary levels of cost in this area.
Clothing –	this budget is now based on more diverse shopping patterns for both modest and comfortable lifestyles.
Household goods and services –	now includes the costs of computer equipment upgrades as well as services such as hairdressing and personal care items. The ‘comfortable’ standard budget includes air conditioning, home alarm system, and regular pest inspections.
Recreation –	this budget has been substantially amended and now amongst other things includes the costs of membership of social and sporting clubs. There is also allowance for the costs of eating out and other excursions. A ‘comfortable’ budget allows for the purchase of sporting items such as golf clubs or fishing gear.
Transport –	now reflects the increased costs for a retiree to own, maintain and run a car.

These changes to the ASFA Retirement Standard will ensure that it remains relevant to the needs of both retirees and those planning for retirement. The enhancements made will also make it easier for retirees to adjust for major spending changes such as rapidly increasing energy prices. Focus groups, comprising of retirees, were engaged in developing the revised Standard to ensure that it reflects the real needs of real people.

Budgets for various households and living standards (March quarter 2013)

	Modest lifestyle – single	Modest lifestyle – couple	Comfortable lifestyle – single	Comfortable lifestyle – couple
Housing – ongoing only	\$61.53	\$59.06	\$71.31	\$82.67
Energy	\$41.42	\$55.01	\$42.03	\$57.01
Food	\$74.23	\$153.76	\$106.04	\$190.88
Clothing	\$17.49	\$28.39	\$37.86	\$59.06
Household goods and services	\$25.95	\$35.18	\$72.99	\$85.51
Health	\$38.06	\$73.45	\$73.34	\$133.27
Transport	\$94.48	\$97.15	\$140.79	\$143.47
Leisure	\$71.61	\$106.69	\$217.02	\$297.40
Communications	\$9.45	\$16.54	\$25.97	\$33.06
Total per week	\$434.22	\$625.26	\$789.53	\$1,080.04
Total per year	\$22,641	\$32,603	\$41,169	\$56,317

The figures in each case assume that the retiree(s) own their own home and relate to expenditure by the household. This can be greater than household income after income tax where there is a drawdown on capital over the period of retirement. Single calculations are based on female figures.

What is considered a modest and comfortable retirement lifestyle?

A modest retirement lifestyle is considered better than the Age Pension, but still only able to afford fairly basic activities.

A comfortable retirement lifestyle enables an older, healthy retiree to be involved in a broad range of leisure and recreational activities and to have a good standard of living through the purchase of such things as; household goods, private health insurance, a reasonable car, good clothes, a range of electronic equipment, and domestic and occasionally international holiday travel.

Both budgets assume that the retirees own their own home outright and are relatively healthy.

The difference between the two budgets mainly relates to the extra items included in the comfortable budget. These include items such as being able to update the kitchen or bathroom at some stage, some wine, eating out from time to time, being able to entertain family or friends at home, private health insurance at the top rate, purchasing magazines and CDs, an economy overseas holiday and being able to afford additional alcohol, purchase tobacco or make gifts.

Retirement savings needed to support either a comfortable or modest retirement standard

Lump sum retirement benefits after 30 years in a taxed fund

Tax treatment and contribution level	Wage of \$30,000	Wage of \$50,000	Wage of \$100,000
9% contributions and investment earnings taxed at current rates.	\$110,000	\$183,000	\$366,000
Lump sum if contributions made at the rate of 12% of salary.	\$146,000	\$244,000	\$487,000
Lump sum needed to support comfortable lifestyle for a couple (assumes receipt of part Age Pension).	\$510,000	\$510,000	\$510,000
Lump sum needed to support comfortable lifestyle for a single person (assumes receipt of part Age Pension).	\$430,000	\$430,000	\$430,000

All figures in today's dollars (using 3.75% AWE as a deflator), investment earning rate of 7% assumed. Annual expenditures needed for a comfortable lifestyle are as at March 2013 \$41,169 for a single, \$56,317 for a couple.

The lump sums needed for a modest lifestyle are relatively modest, being \$50,000 for a single and \$35,000 for a couple as the required expenditures of \$22,641 for a single and \$32,603 are mostly met by the Age pension as at March 2013 of \$21,076 for a single and \$31,775 for a couple (including the pension supplement payment).

Super Guru website

Information on the ASFA Retirement Standard can be found on ASFA's dedicated consumer website, Super Guru (www.superguru.com.au).

Super Guru, which has been developed with the support of the Victorian Government provides calculators, interactive modules, information and fact sheets on choice of fund, managing super, planning for retirement and the Age Pension.

Super Guru aims to break down the complexity of superannuation and provide information in a simple and easy to understand format.

Expenditure patterns vary significantly during the retirement years.

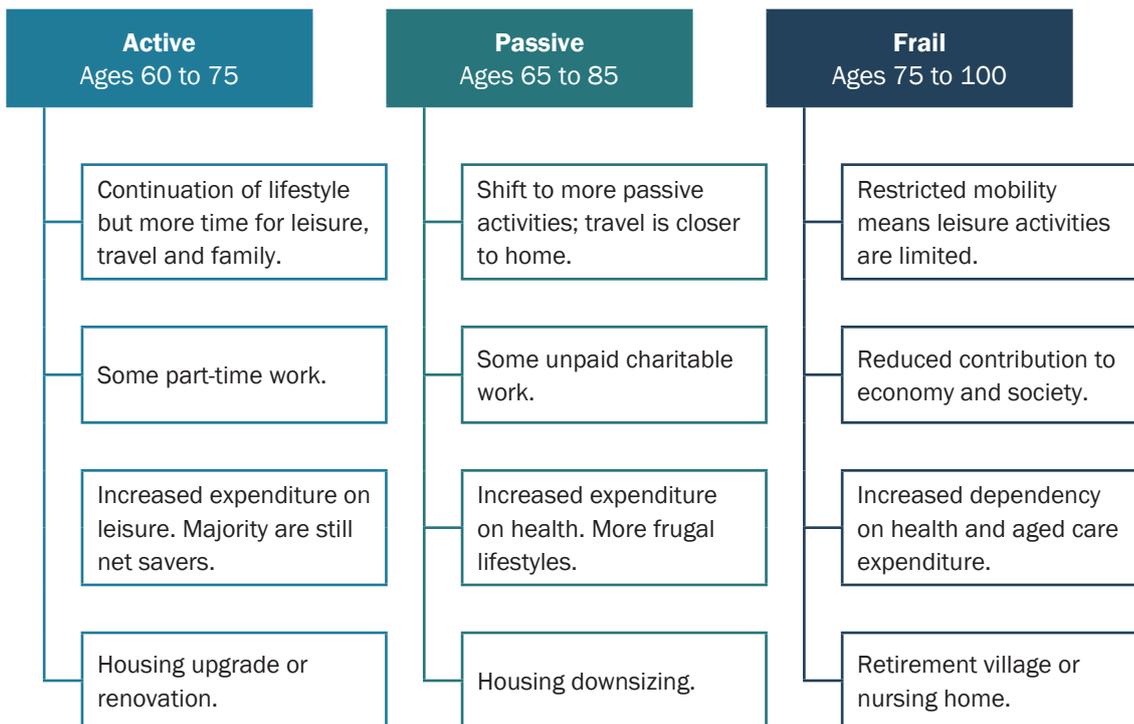
There are three distinct periods:

- 1. Active** – the early years of retirement are similar to the last years of work. There is a small fall in consumption but activities do not change much.
- 2. Passive** – as health declines, activities become more passive and expenditure reduces.
- 3. Frail** – health deteriorates and consumption changes. Aged care costs can be significant.

The variation in expenditure patterns suggests that there should be flexibility in the payment of any income streams. For example, a mandatory lifetime annuity would not allow complete integration between retirement income and its consumption.

Health costs increase significantly with age. However, the costs are largely borne by private health insurers and government although there can be significant co-payments for some procedures and drugs not covered by the public health system.

Pensioners are largely immunised against the cost increases. Conversely, pensioners can face significant costs associated with aged care late in life.



4.1 Budget standards for the frail

Analysis undertaken by the ASFA Research Centre in 2011 indicates that budget standards for those aged 90 differ substantially in a number of ways from budget standards prepared in regard to the expenditure needs of retirees aged 70.

However, there are significant commonalities between the budget standards for the different ages given that many basic needs (housing, food, household services and communication) remain much the same for each group.

The main differences arise in regard to transport and leisure. Those aged 90 have relatively low participation rates in motor vehicle use and overseas holidays and that reduces expenditures in these expense categories.

The main areas where those aged 90 have additional expenses are household services and health.

There has been a gradual reduction in some health risk factors through increased public education (healthy lifestyles and diets) and advances in disease management (including diagnostic, pharmaceutical, surgical and other technological innovations). For example, the prevalence of cardiovascular diseases, cancers and injuries among people aged 85 years and over has fallen.

However, as survival rates increase, there is an increased risk of the elderly developing other non-fatal, but disabling, conditions including renal failure and vision loss. With improved lifestyle choices and medical interventions, the number of older people who are surviving major diseases that have been previously associated with high mortality is increasing, but many are left to manage chronic conditions.

This has implications for health expenditures by older households. While many procedures are available through the public system at minimal cost to the patient, such services can in effect be rationed. Many retiree households maintain private health insurance so that they have more options in regard to medical procedures.

However, there can be considerable gap payments involved in regard to surgical operations such as those for cataract removal or hip or other joint replacement. One approach for putting together a budget standard (eg ASFA Retirement Standard) might be to treat such expenditures as a capital item and in effect amortise them over a number of years. For a major medical incident or procedure involving gap payments totalling \$10,000, it might be appropriate to have a \$2,000-a-year payment in the retirement budgets for those aged in their late 80s or early 90s.

Because health insurance premiums do not increase with age it is not appropriate to increase the health insurance premium amount for a 90-year-old. However, given the increased incidence of health conditions with age there is a case for increasing the amounts in the retirement budgets for out-of-pocket expenditure on chemist and like supplies and on co-payments to medical practitioners.

Some out-of-pocket expenses might be for relatively low tech items such as incontinence aids, while others might be for the latest drug treatments not yet available from the Pharmaceutical Benefits Scheme.

The net impact of these various factors is that Retirement Standard figures for those aged 90 are slightly lower overall at the 'modest' standard. At the 'comfortable' standard expenditures are about 10 per cent lower in aggregate largely due to the elimination of relatively costly leisure activities for those in that age group and standard of living.

4.2 The role of each pillar in meeting expenditure needs

It is not easy for a member to plan for their retirement years. In addition to the difficulty in planning for a variable expenditure pattern, there are other difficulties in integration arising through:

- Variable retirement ages – members can retire between the Preservation Age (55 shifting to 60) and 75; the Age Pension eligibility age is 65 increasing to 67; the median retirement age is 61.
- Two-thirds of new retirees are partnered so the financial circumstances of the spouse (including a de facto spouse) need to be considered.
- An individual or family can have assets outside superannuation.
- The Age Pension is means-tested – with different thresholds for individuals and couples.

- Many retirees now retire with debt so some of their account balance will be used as a lump sum to pay this off – rather than being used for retirement income.
- There is a trend for more Australians to work part-time when they have retired.

Further, the majority of retired Australians own their own home and it will become important to unlock this wealth efficiently to support their financial needs in retirement. In later life, these needs extend to health costs and aged care costs – but these are separate and currently not integrated with superannuation.

While many factors will impact on the long-term sustainability of the Age Pension, the most significant are:

- the ageing of the population and associated dependency ratios;
- Age Pension design; and
- growth in private savings and private pensions.

Each of these can be influenced to a greater or lesser extent by changing policy settings.

5.1 The ageing of the population

The projected increases in the proportion of the population aged 65 years or older, and life expectancy, will increase the number of individuals potentially eligible for the Age Pension and the period they might be eligible to receive it.

Australia also has an ageing population structure which is not particularly rapid, by the standards of many developed countries. Fertility rates have increased in recent years and immigration policies are designed in such a way that they favour immigrants who are younger on average than the general population. Changes to immigration policy settings and measures designed to influence fertility rates can impact the rate at which the population structure ages but generally the impact of any feasible changes is relatively low.

While the total Australian population is projected to continue to grow, annual rates of population growth are projected to slow gradually, from 2.1 per cent in 2008–09 to 0.9 per cent in 2049–50. Australia's population is projected to grow from around 22 million people currently to 35.9 million people in 2050.

As well, average Australian mortality rates have fallen significantly, with life expectancies rising for both men and women. These changes have added to population growth and the proportion of older people in the Australian population. As a result, the number of Australians aged 65 and over is projected to grow from around 3 million in 2010 to 8.1 million by 2050, from 13.5 per cent of the population to 22.7 per cent. Accordingly, the number of people of eligible age for the Age Pension is projected to increase by around 150 per cent by 2049–50.

Another consequence will be that the number of those aged 65 and over relative to the working age population will continue to increase. The increasing dependency ratio could potentially increase the tax burden on the working age population to support existing government programs, including the Age Pension. However, this will be influenced in part by the growth in the real income of Australians and its distribution between working age and older Australians. For instance, if the distribution remains constant, the incomes of those in the labour force would be expected to increase.

The rate of growth in GDP in Australia has been relatively strong by the standards of developed countries. This has partly been the product of good economic management. However, population growth has assisted in achieving this economic growth, as has growth in national savings and investment driven by the boost to household savings from mandatory contributions to private pensions.

5.2 Age Pension design

The fiscal sustainability of the Age Pension system is also aided by a number of its basic design features, particularly the maximum rate of payment being set at a modest level in absolute terms rather than being related to earnings of individuals while they were in the paid labour force. Another key design feature is that no entitlement, discounted or otherwise, is possible prior to the entitlement age.

The means test, through its asset and income testing elements, aims to provide the greatest benefits to those most in need while restricting the access of those with higher levels of income and wealth. At the same time, the means test

has thresholds and taper rates for withdrawal of benefits that are designed to provide incentives for the accumulation of private retirement savings and self-provision of retirement income.

There also are differences between the means test applied to homeowners and to those who are not homeowners, reflecting the fact that the family home is not assessed as an asset in the means test. Wage income is treated differently to income from financial investments. As well, income is deemed at a set rate relative to assets for some financial investments and there are special arrangements applying to pension income streams received in retirement.

A joint means test is applied to couples, which includes de facto spouses and same sex partners.

5.3 Projected Age Pension expenditure

The future financial impact of programs such as the Age Pension is required to be assessed on a regular basis in what is known as the *Intergenerational Report* (IGR). The IGR came to life as a key requirement of the *1998 Charter of Budget Honesty Act*. The Charter requires an intergenerational report to assess the long-term sustainability of policies over the 40 years following the release of the report, including the impacts of demographic change. The IGR has played a major role in raising community awareness of long-term fiscal challenges and, in so doing, placed greater focus on Government decisions with long-term consequences.

Not surprisingly, the various IGR reports indicate that aging of the population will contribute to pressure on government spending and fiscal sustainability. The Australian Treasury projects total government spending to increase to 27.1 per cent of GDP in 2049-50, around 4¾ percentage points higher than its projected low point in 2015-16. In today's terms, that is the equivalent of adding around \$A60 billion a year to government spending.

Around two-thirds of the projected increase in spending over the next 40 years is related to health expenditure across all age groups; reflecting pressures from aging, increasing community expectations and the funding of new technologies.

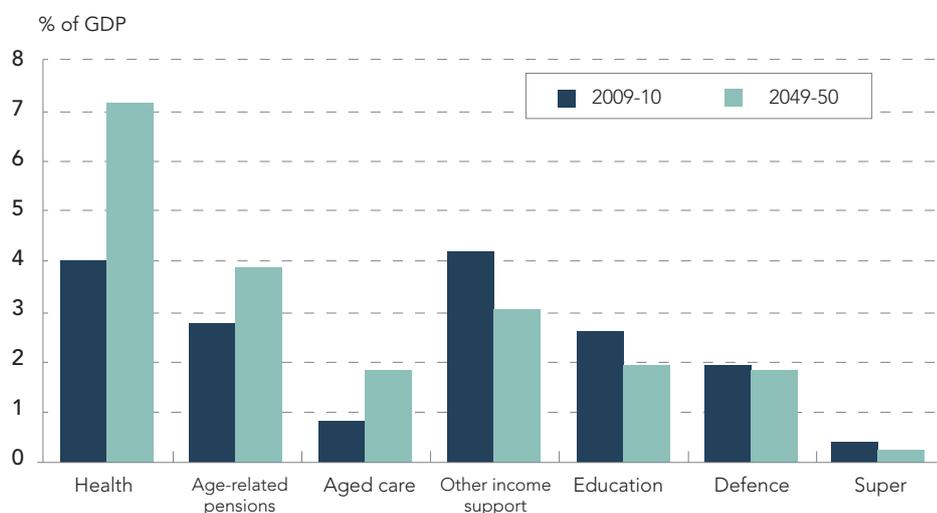
Growth in spending on age-related pensions and aged care is also significant, both as a proportion of GDP and in real spending per person. Currently, about a quarter of Australian Government spending is directed to health, age-related pensions and aged care. The Intergenerational Report projects that Australian Government spending on these functions will increase significantly over the next 40 years, pushing their share of spending to almost one-half.

As a proportion of GDP, spending on health is projected to rise from 4.0 per cent to 7.1 per cent. Age care expenditures are projected to rise from 0.8 per cent of GDP to 1.8 per cent in 2049-50.

Expenditure on age-related pensions are projected to rise from 2.7 per cent to 3.9 per cent of GDP.

Figure 4 provides further details.

Figure 4 – Projected expenditure by major category



Factors affecting the projections of age-related pension spending include:

- A decline in the proportion of pensioners receiving a full Age Pension, because of the increased value of individuals' mandatory pension and other private assets and income;
- The proportion of people with a partial Age Pension is projected to increase significantly while the proportion of the eligible age group not receiving any Age Pension is projected to rise slightly; and
- Changes to policy settings which reduce expenditures, such as raising the eligibility age for the Age Pension from 65 to 67 and increasing the withdrawal rate in the income test for the Age Pension from 40 cents in the dollar of private income to 50 cents.

When the next Intergenerational Report is prepared in 2015, it can be expected to take into account the increase in compulsory pension contributions from 9 per cent to 12 per cent. This will further moderate the increase in age-related pension spending, particularly towards the end of the projection period.

There has been considerable recent public debate in Australia about the sustainability and equity of government assistance for the aged in Australia. However, much of this debate has been based on assertion rather than analysis. For instance, the fact that Australia has an ageing population structure is not sufficient to come to the conclusion that current tax concessions for superannuation are unsustainable.

The projected increase in direct government expenditure on retirement income is not negligible but it is relatively modest by the standards of many countries. The level to which expenditures, as a percentage of GDP, will increase in forty years' time will be less than the starting point for just about all OECD countries in 2010. Those countries which do have a sustainability problem, for instance, Greece, Italy and France already have public pension bills in excess of 10% and are heading to reach 20% or more of GDP in some cases.

5.4 Tax concessions for private pensions

Australia has a relatively large stock of private pension assets relative to GDP compared to most other countries in the world. As well, the ratio of concessionally taxed pension contributions to national income is amongst the highest in the world and this will further increase with the gradual increase in compulsory contributions to 12 per cent of wages.

Accordingly the amount of tax assistance provided to private pensions in Australia also needs to be taken into account when assessing the ongoing sustainability of government assistance for retirement incomes.

A starting point is assessing the cost to the government budget of the tax concessions is the annual Tax Expenditures Statement published by the Australian Treasury.

The headline figure in the Tax Expenditures Statement claims that the revenue that the government forgoes as a result of tax concessions for superannuation currently is around \$A31.8 billion, growing to \$A44.8 billion in 2015-16.

The major components of these claimed tax expenditures is revenue of \$A17.1 billion foregone on superannuation fund investment earnings in 2012-13 and revenue foregone on employer contributions of \$A13.2 billion. Whilst these figures are impressive in their size they are also excessive and do not actually reflect the overall effect of superannuation on taxation receipts.

The reason for this is that the Tax Expenditures estimates equal the revenue which would have been collected if all superannuation contributions and income currently contributed or earned had been taxed at the full marginal rate of every member, less the tax revenue actually collected. For instance, future balances and the associated tax base would be much smaller if higher taxation applied along the way.

Other problems with the Tax Expenditures Statement estimates for superannuation include:

- In the future private pensions will bring rewards for the government budget, including a decrease in Age Pension expenditures
- In the benchmark it is assumed that the behaviour of individuals in terms of savings and consumption decisions would not change if the tax arrangements were changed. In effect it is assumed that people would continue to place what they had been putting into private pensions into non-concessionally taxed investments such as bank accounts
- The Tax Expenditures benchmark assumes that capital gains would be taxed at full marginal personal income tax

rates, without the 50 per cent deduction that applies to all other capital gains received by individuals

- High returns associated with long term managed savings in the form of private pensions are seen as increasing the cost of the tax concessions rather than reducing future claims on the government for retirement income support through the Age Pension

However, while the headline revenue foregone figures get most of the attention in public debate, even the official Treasury document contains the admission that removing the tax concessions would not generate revenue gains as large as those numbers. In a not very prominent spot towards the back of the Tax Expenditures Statement issued in January 2013, at page 212, are estimates based on a revenue gain approach. These figures are considerably lower than the claimed revenue foregone figures. For instance, the projections for the concessional taxation of fund investment earnings are a revenue gain of \$A17.7 billion in 2015-16 compared to the notional revenue foregone figure for the same year of \$A25.1 billion. There is a similar divergence in the figures for the size of the tax concession for employer contributions.

One reason for the divergence in the figures for fund earnings is that imposing higher taxes would reduce the superannuation asset base and hence future fund earnings. As well there would be significant behavioural changes. Superannuation balances which are not subject to preservation would be moved out to more concessionally treated investments, such as negatively geared rental housing or shares, where interest payments are deductible but capital gains are only partially taxed. Further, fewer voluntary contributions would be made to super.

As noted above, the tax expenditures estimates also fail to take into account the savings on the Age Pension bill from individuals having superannuation assets and income in retirement.

While no official estimates of this impact have been prepared, ASFA has undertaken analysis which indicates in broad terms the budget savings achieved in this area. They are substantial:

- Around \$3 billion savings annually from around 160,000 people with super balances sufficient to take them completely outside the Age Pension system.
- Around \$3 billion savings from around 500,000 people receiving around \$5,000 a year from the Age Pension due to the income test on superannuation income streams.
- Over \$1 billion savings from around 150,000 people no longer receiving a part Age Pension because of either the asset test or income tes

The \$7 billion amounts to around 20 per cent of the current Age Pension bill.

Going forward the amount saved from the Age Pension bill will increase because:

- There will be more Age Pensioners as a result of the ageing of the population structure.
- Private pension balances are increasing.
- The Age Pension maximum payment is increasing in real terms.

Of course without private pensions at least some individuals would save for retirement, but the amount would be much less, especially after the deduction of tax at personal marginal tax rates.

Once this current \$A7 billion annual savings in Age Pension expenditures as a result of private pensions is taken into account, the cost of tax concessions for private pensions drops substantially. In calculating the ongoing cost to tax revenue it is also necessary to deduct the leakage of savings into other tax-advantaged areas such as negative gearing which would occur with any decrease in tax concessions. Removing tax concessions would also shrink the superannuation pool directly through the higher amount of taxation extracted. Taking these various factors into account, a more meaningful estimate of the aggregate tax concession for superannuation on an ongoing basis would be around \$A16 billion. This is roughly half the headline figure in the Tax Expenditure Statement and only just above one per cent of GDP.

The treatment of pension benefits as tax free when they are received after age 60 has also drawn public commentary on sustainability. At present, the tax revenue forgone by allowing retirees to withdraw a pension from their super tax-free is around \$A500-800 million per annum. It would not be possible to tax superannuation benefits at full marginal tax rates because contributions and fund earnings had already been subject to considerable taxation, albeit at concessional rates.

While the average balance in retirement is growing, it is only at a modest rate and there are still very few individuals with very large accounts. Accordingly it is unlikely that the cost of tax free benefits after 60 will grow significantly, even over coming decades. Reintroducing a tax on benefits for those aged over 60 would crush community confidence in super which would have a dramatic impact on the long-term sustainability of the system.

While the absolute amount of the tax concessions will grow with the growth in assets relative to GDP and the prospective growth in compulsory contributions, this will not be that large in relative terms. Taking into account system assets increasing by 50 per cent and contributions by less than a third [both relative to GDP] and a shift to more assets in pension phase, the ongoing cost of the tax concessions is likely to be around 1.5 per cent of GDP.

Announced but not yet legislated policy changes such as a higher tax on contributions made for individuals with an annual income of \$A300,000 will also limit growth in the aggregate amount of tax concessions relative to GDP.

Improving private retirement income also helps take pressure off government to fund other age-related expenses. For example, without private pension income very few retirees would be able to afford private health insurance or fund various in-home care expenses. Other areas of budget expenditure such as health, aged care and pensions are projected to grow substantially over the next few decades compared to Age Pension expenditures and tax concessions for superannuation.

Overall sustainability of the retirement income system

In total the amount of government assistance to retirement incomes in the form of Age Pensions and tax concessions for private pensions is unlikely to exceed six per cent of GDP by the year 2050 and could be closer to 5.5 per cent. By international standards this is a relatively low figure. It is below the starting point for most other developed countries and well below the projected level for nearly all other developed countries and even many developing countries.

APRA publishes data on the number of pension accounts for each of the largest 200 APRA-regulated funds. These make up the great bulk of members and assets of APRA-regulated funds. In total such funds reported around 880,000 pension accounts as at June 2011. Around 270,000 of them were pension accounts in funds, mostly in the public sector, that primarily offer traditional defined benefit pensions.

Transition to retirement pensions make up a significant proportion of the number of pension accounts. In some funds they account for around one-third of pensions that are paid. However, in many (almost all) cases the recipients remain in full-time work and would not be classed as retired according to standard definitions of retirement. In total there could currently be around 100,000 transition-to-retirement pensions in place with total associated assets supporting such pensions of around \$20 billion.

6.1 Assets and members in pension phase in SMSFs

In 2009-10 around 150,000 self-managed super funds (SMSFs) made a claim in their tax return for exempt current pension income. Given that a substantial proportion of such funds would have two people taking a pension then around 200,000 people might have retirement income streams from their SMSF. The average balance per SMSF member in retirement phase might be of the order of \$1 million based on the size of the SMSF and the proportion of assets in pension phase.

6.2 Number of Age Pension recipients with a superannuation income stream

Administrative data indicate that around 500,000 current recipients of the Age Pension (who number around 2.3 million in total) are in receipt of a superannuation income stream. The average gross amount received is \$14,000 with the average assessed amount, after allowing for return of capital, around \$8,300. On the assumption of an average drawdown of five per cent of capital, this suggests an average balance of around \$280,000. Age pensioners might hold in aggregate around \$140 billion of the approx. \$400 billion in superannuation assets in the retirement phase.

6.3 Aggregate number with an income stream

These various figures suggest that there are 1.1 million people taking an income stream from a superannuation fund. The figure could well be higher given that a number of exempt public sector funds that pay pensions are not included in the APRA figures.

Over half of those taking an income stream from superannuation receive no Age Pension. There are a number of reasons for this, including.

- Being above preservation age but too young to receive the Age Pension;
- Not being eligible under the asset or income test; and
- Still employed and receiving a Transition to Retirement Pension.

6.4 Average balances by type of income stream

The figures for SMSFs suggest average account balances of around \$1 million for those taking an income stream benefit.

The average for those with a Transition-to-Retirement income stream is more like \$200,000.

For those with a retirement income stream that is not from a SMSF or TTR, the average is more like \$500,000. The entry point for taking up a superannuation income stream tends to be in excess of \$100,000 as there are little or no tax or social security advantages from income streams below this amount compared to investing outside of superannuation.

6.5 Amount in annuities

Statistics are not readily available on the amount of post-retirement superannuation monies in annuity products.

APRA publishes a figure on “the balance of statutory funds” which includes certain life office reserves along with annuities provided by life insurance companies. In June 2012 this amounted to \$43 billion. Term annuities are likely to form a major component of this figure, perhaps in excess of \$10 billion.

The balance of statutory funds has only shown modest growth over the last 10 years given that the equivalent amount in 2002 was around \$33 billion. At that less than \$5 billion was in life and other annuities.

6.6 The superannuation holdings of recent retirees

As shown by Table 7, superannuation coverage is at relatively high levels (around 90 per cent) for both women and men aged 55 to 64 who have not yet retired.

Coverage of superannuation of the not yet retired drops away, particularly for women, after age 65 given that the self-employed make up a larger proportion of the labour force after age 65. As well, only a minority of both males and females are still in the labour force after age 65.

Also as shown by the table, for those not yet retired the mean balance for men aged 55 to 64 was around \$370,000 in 2010, with the median figure (half with an amount below and half with an amount above) of \$160,000.

For women the respective figures for the same age group were lower, at \$140,000 and \$60,000 respectively.

Table 7 – Superannuation coverage and superannuation holdings of men and women who were not yet retired

Age group	2006			2010		
	% with super	Superannuation balance of those with super (\$)		% with super	Superannuation balance of those with super (\$)	
		Mean	Median		Mean	Median
MEN						
15-19	36.5	3,300	1,000	37.6	1,924	800
20-24	83.8	9,096	5,000	85.8	8,102	6,000
25-34	91.4	33,759	23,000	91.6	33,532	25,000
35-44	92.2	78,464	45,000	94.1	87,173	55,000
45-54	94.2	149,960	80,000	93.4	153,363	82,570
55-64	82.0	269,805	130,000	91.3	276,618	160,000
65+	46.3	274,052	153,000	68.1	371,643	140,000
Total	82.8	97,636	35,000	85.1	109,198	40,000

WOMEN						
15-19	34.4	1,281	500	36.4	1,748	500
20-24	77.4	5,816	3,300	85.6	6,269	4,500
25-34	82.6	25,906	16,000	89.2	25,209	19,000
35-44	84.7	49,339	25,000	85.3	58,586	35,000
45-54	84.8	87,187	35,000	87.6	89,500	45,000
55-64	82.3	115,662	60,000	86.8	142,098	60,000
65+	28.3	143,094	55,000	39.6	197,433	82,000
Total	76.4	52,387	20,000	80.2	60,263	25,000

Source: HILDA database customised data table

The research data also indicate that a large majority of recent retirees retain their retirement savings in superannuation after they retire, particularly when larger amounts are involved.

As shown by Table 8, around 70 per cent of males aged 60 to 64 who have recently retired have superannuation, with an average balance of around \$380,000. This is a drop in coverage of around 20 percentage points compared to those who have not retired who are in the same age group. The average balance is also higher than for those not retired which suggests that those with lower balances are more likely to cash out and invest (or spend) elsewhere.

For women the drop in coverage is greater, but around 30 percentage points. Again, the average balances for those retaining retirement savings in superannuation at around \$255,000 is higher than for those in the same age group who have not retired.

Table 8 – Superannuation coverage and superannuation holdings of men and women who were *recently retired*

Age group	2006			2010		
	% with super	Superannuation balance of those with super (\$)		% with super	Superannuation balance of those with super (\$)	
		Mean	Median		Mean	Median
MEN						
<60	70.2	283,430	200,000	89.8	528105	386000
60-64	76.7	573,228	500,000	68.8	381703	250000
65-69	48.1	421,618	200,000	65.7	299161	164000
70+	41.6	*283,938	*162,000	32.3	*273218	*90000
Total	60.7	419,841	280,000	60.8	367336	245000
WOMEN						
<60	62.1	322,945	100,000	63.7	135,501	53,000
60-64	53.1	273,135	195,000	58.6	255,485	120,000
65-69	46.4	129,491	90,000	41.7	205,855	70,000
70+	*41.6	*48,358	*15,000	*7.1	*184,000	*184,000
Total	54.5	254,647	100,000	53.0	191,474	102,000

Note: Population weighted results. *Estimate not reliable. 'Recently retired' if 'currently retired and observed not retired (ie employed) at some stage in the last three years'.

These figures strongly suggest that the great bulk of recent retirees keep their retirement savings primarily in superannuation and draw down an income stream. Those retirees that take their retirement savings out of the superannuation system are a minority. However, even for this minority there is no evidence that the superannuation savings are used primarily for immediate consumption purposes, such as an overseas trip. While some commentators claim that frequently happens, such assertions are more in the line of urban myths than being supported by any objective research.

6.7 Prospective retirement savings

The estimated and projected average member balances for pre-retirement members are shown in Table 9 below. These are Rice Warner projections.

Table 9 – Projected pre-retirement member balances (2011 dollars)

Age group	2011	2016	2021	2026
20-24	5,200	5,400	6,400	6,600
25-29	14,100	15,400	17,700	19,300
30-34	28,600	31,700	36,000	40,000
35-39	44,600	53,100	60,000	66,800
40-44	59,400	77,200	89,500	99,400
45-49	78,900	102,200	125,100	140,500
50-54	101,700	137,800	167,400	194,900
55-59	140,000	179,800	226,200	261,400
60-64	168,500	244,100	310,800	354,600
Average	65,100	80,600	96,600	111,700

If public sector unfunded liabilities were to be funded immediately, the average balances for pre-retirement members would increase by 25 per cent to approximately \$81,100. This is a function of the \$170 billion held as unfunded liabilities in public sector schemes, most of which are closed to new members.

The chart below is based on the exit data from a large fund. It shows the size of lump sums drops as their balance grows. A member with a \$50,000 retirement benefit might take it all as a lump sum; someone with \$500,000 might also take \$50,000. Consequently, the perceived problem could be solved by having a limit on the amount of lump sum withdrawals.

Figure 5 – Percentage taking lump sum at retirement



6.7.1. Debt levels of those approaching retirement

A recent report published by CPA Australia, *Household Savings and Retirement, Where has all my super gone*, looks at debt levels of those approaching retirement, amongst other things. However, the focus is on households where the oldest person is in the specified age group. So where there are adult children in the household the debt figures pick up the car and credit card debt and even investment property loans of such adult children. As well, the property loan figures even when they relate directly to the household head can be in regard to an investment property or where loan proceeds have been used for the purchase of income producing assets such as shares. Where the debt is held by someone else or there is an associated income producing asset, the statistics used can be misleading in terms of the impact of debt on retirement living standards.

As well, only a minority of households have debt around the time of retirement. For those households where the household head is aged 65 to 69 only around 18 per cent of such households have mortgage debt, often for relatively small amounts. Around 30 per cent of males aged 65 to 69 are still in the labour force which also assists in such debt being serviced.

At older ages where there is less labour force involvement the incidence of debt is lower. For instance, for households where the head is 70 plus, the percentage falls to six per cent. The behaviour of this age cohort could well be different but the kids are likely to have moved out by then.

There are a number of reasons why it is desirable that members consider purchasing an income stream during retirement:

- Most retirees will have life expectancy at retirement of 20 or more years.
- Consuming superannuation over a long period provides some protection against longevity risk – the risk of outliving one’s savings.
- The Government wants superannuation to be consumed over retirement rather than have too much left as a bequest when members die.

ASFA promotes a system where members optimise the use of their retirement benefit. We recognise that members will take a mixture of lump sums and income streams and we expect that members with larger account balances will take a greater portion of their benefit as an income stream.

7.1 Australia’s flexible superannuation system

Australia has a unique retirement system. Some of its features are:

Structure

- Means-tested Age Pension – set at a modest level
- Mandatory employer contributions rising to 12 per cent of earnings
- Limited tax concessions for voluntary additional contributions
- Almost all new employees receive defined contribution benefits – so members take on all risks
- All benefits (lump sum or pension) received at age 60 and over from a taxed fund are tax-free
- Returns on assets held to back pensions are tax-free

Pensions

- Only a third of those aged 65 and over do not receive a government financed Age Pension
- Most Australians are not saving enough for a comfortable retirement
- Increased longevity will reduce retirement income, particularly in later years, unless people save more or retire later
- Private pension assets are 30 per cent of all superannuation assets and this will rise to over 40 per cent in 15 years
- Members with large balances generally take account-based pensions – and a small lump sum
- Expenditure patterns in retirement are variable
- Members have not been attracted to lifetime annuities when there is no social security or other incentive and recent sales are extremely low

7.2 Tensions within the system

Superannuation suffers from regular tax and other changes and there is too much complexity.

- Despite superannuation being the preferred structure for long-term savings, too many members are uncertain and lack confidence.
- The Government has a perpetual battle to hold down the current cost of tax concessions for members – yet wants to encourage self-sufficiency in retirement to reduce social security costs
- A significant amount of retirement benefits are taken as lump sums and leave the system rather than being used as retirement income. The tax-free benefits provide complete flexibility for members on how to use their super.
- Members are uncertain about how much they need in retirement. They face a number of risks including liquidity (for withdrawals) and longevity (for living longer than expected).

7.3 Suitable products

The high level of growth assets in accumulation funds will lead to higher retirement benefits for members. Subject of course to individual decisions in regard to exposure to investment risk and volatility, such exposure should be sustained throughout a member's career.

The volatility of markets means that at least some members will wish to shift assets into cash over the five years before retirement to prevent 'sequencing risk'. Sequencing risk is the risk of facing adverse investment market outcomes just prior to retirement which can be difficult to recover from because the individual starts drawing down on their retirement savings and will have only limited future contributions being made to their superannuation.

Shifting more to cash will allow them to cater for any required lump sum benefit and their initial pension drawdowns. Lifecycle investment options can provide such an investment strategy. However, while they are suitable for some individuals they may not be suitable for others.

7.4 Lump sums

In an ideal world, the objective of superannuation should be focused on the provision of income during the whole of retirement. However, there are a number of reasons why it is difficult to structure the Australian system around regular reliable pension payments. These include:

- Award Superannuation was introduced in 1986 as deferred pay (in lieu of an alleged productivity wage rise). It was promoted to members as an addition to the Age Pension. The Superannuation Guarantee has increased the value of contributions but the message has not changed – members consider that superannuation is their own money and they expect flexibility of payments.
- The government allows all members above age 60 to retire and draw a tax-free lump sum or pension. There is only a limited fiscal incentive to leave money in the system during retirement since most Australian retirees will pay a relatively low rate of tax on their income outside superannuation.
- There are no longer maximum withdrawal factors on account-based pensions, so no one is forced to draw their benefits over time.
- Members can buy lifetime annuities from the private sector (albeit a small number of suppliers), but most choose not to purchase them. Research conducted by Rice Warner shows that most people are unreasonable about the pricing of an indexed lifetime annuity and expect much more than fair value. Without compulsion, most members will not buy these products!
- Many members retire with small benefits and they appear comfortable with leaving the money in an interest-bearing bank account rather than in superannuation. This may be influenced by their perception of safety in the bank or by a short time horizon where they do not value higher (but uncertain) returns. They may also value instant access to their funds.
- Many people today retire with debt (including mortgages) and it is a rational decision to take a superannuation lump sum to clear all debts before retiring.

Members may have a need to make some large payments. Typically this includes financing a trip overseas, updating kitchens or bathrooms or buying a new car. This is rational and a good use of their 'deferred pay'.

However, in the same way insurance premiums divert income from retirement, it is appropriate to limit the amounts consumed this way. A limit of twice MTAW (about \$134,000) might be a reasonable limit for tax concessions and/or any limit on access to a lump sum if there was a move to compulsion to take an income stream. This amount should be indexed.

The above situation has made the provision of income streams, which can also protect members from their longevity risk, difficult. In addition, transitional arrangements can be problematic due to the plans made by those approaching retirement.

That said, for individuals with relatively modest retirement savings and in order to cater for the need for necessary capital expenditure for those with higher retirement savings there should be provision for access to lump sums.

In regard to any cap that might apply to incentives or compulsion to take income streams, one possible approach might be to limit access to lump sums to, say, no more than twice MTAW (about \$134,000 in 2012).

7.5 Income streams

There are a number of reasons why it is desirable that members consider purchasing an income stream during retirement:

- Most retirees will have life expectancy at retirement of 20 or more years. If they leave their benefit to grow in real (tax-free) terms over such a lengthy period, it will provide a higher value than taking it out early and leaving it in a bank account.
- Consuming superannuation over a long period provides some protection against longevity risk – the risk of outliving one's savings.
- The Government wants superannuation to be consumed over retirement rather than have too much left as a bequest when members die. In fact, Ken Henry⁵ recommended mandatory lifetime annuities as a means of ensuring all superannuation be used as retirement income. Under such a structure, there is a longevity buffer as those dying in the early years of their retirement subsidise those who outlive their life expectancy.
- In some cases, early consumption of superannuation will lead to a higher consumption of Age Pension benefits over the period of retirement. If this can be avoided, it reduces government outlays.

It should be noted that most retirees who have accumulated \$200,000 or more at retirement already purchase an income-stream, usually an account-based pension.

Funds need to take into account the following in setting up a suitable income stream product:

- The investment income of pension accounts is tax-free (whereas pre-retirement assets are taxed).
- No contributions can be made into pension accounts.
- Withdrawals for consumption are made from pension accounts.
- Expenditure patterns vary by individual and over time, so accounts must be flexible.

7.5.1. Account-based pensions

These flexible products can be very suitable for many retirees. The existing investment structure has a number of advantages but with greater take-up of after tax investment reporting it may be possible to take greater advantage of the tax-free status of these funds.

In order to better deal with managing the financial risks of longevity, ideally there should be maximum withdrawal values. It is possible that these withdrawal values could be based on the size of the pension at commencement.

There are a small, but growing, number of products where investment and longevity risks are shared between the customer and the product issuer. Some products offer (for a price) market-linked returns plus an income and/or capital guarantee and some also protect investors against longevity risk. Generally such products are annuities – either life, term, variable or deferred. Each type of annuity deals with different types of risk and has different types of characteristics.

7.5.2. Lifetime annuities

These products may be suitable for some fund members but they are inflexible and will not generally be suitable for those with an impaired life expectancy in the absence of reasonably sophisticated pricing and underwriting arrangements for them.

7.5.3. Deferred annuity

A deferred annuity is a type of annuity contract that delays payments of income, instalments or a lump sum until the investor elects to receive them.

For instance, an investor might at age 65 invest a sum with a life insurance company (or other permitted provider) in return for a promise from the life insurance company to pay a specified amount of income to the investor from, say, age 85. An alternative product design might be for the deferred annuity to be purchased through a series of annual payments during the accumulation stage or over the course of the drawdown stage of retirement income.

⁵ *Australia's Future Tax System Review (2010)*

7.5.4. Variable annuity

A variable annuity is purchased with either a lump sum or over time, with the premiums paid allocated among the various separate account funds offered in the annuity contract. The investment return and income paid by the variable annuity fluctuates with the performance of the underlying investments. However, in return for a fee the provider of such products may guarantee a minimum payment, either for a set period or for life. The more the guarantees, the higher the fees paid. Both variable and deferred annuities have been popular overseas, including in the USA, Asia and Europe. However, in Australia there have been only one or two providers of variable annuities. Deferred annuities have not really been on offer in Australia or purchased to any marked extent.

While a lack of demand for annuity products (with the recent exception of term annuities) has been partly responsible for this, regulatory and tax settings also have contributed to this outcome.

7.5.5. Housing tenure and implicit rental income

Housing tenure is very important in regard to the living standards of those in retirement. Housing expenses are much lower for those who own their home outright. If there is a substantial mortgage or a person is in private rental accommodation this will have a significant impact on what income is needed to support their retirement.

Around 75 per cent of age pensioners are home owners. Around 11 per cent receive rental assistance (are in private rental of some sort), five per cent are in public housing and five per cent are in residential aged care.

More generally, for all those aged 65 and over around 80 per cent are home owners reflecting the fact that those not on the Age Pension tend to have higher wealth and income on average. The great bulk (well over 90 per cent of such home owners) have no mortgage. While a small percentage might have a substantial mortgage, in many instances it will be for a relatively small amount and/or be serviced by income from shares or property that the mortgage loan was used to finance. It is also hard to establish the extent of mortgage loans by age of mortgage holder as typically the data available is for households. Many households headed by a person aged 60 to 64 will still have an adult child or children at home and the personal and mortgage debt of the children is included in the statistics for the household.

There also are individuals who take out a reverse mortgage. As at 31 December 2011 the reverse mortgage market in Australia consisted of more than 42,000 reverse mortgage facilities with total outstanding funding of \$3.3 billion. The average size of loan increased to \$78,250 from \$72,500 in 2010.

Regulatory settings impacting on deferred annuities

8.1 SIS and APRA prudential standards provisions

A number of SIS regulations, including Regulation 1.06 (2), are major impediments to the development of a deferred annuity or pension market (life insurance companies provide annuities and superannuation funds provide pensions).

In essence, in order to meet the requirements of the regulations and thereby receive the benefit of the investment income backing the annuity being tax-free, an annuity must be paid at least annually throughout the life of the primary beneficiary or throughout the life of an eligible reversionary beneficiary. Regulation 1.06 also limits the amount by which the annuity payment can vary from year to year.

More generally the SIS regulations have tended to focus on the detailed characteristics of specific products rather than providing a generic framework which permits the development of new products which meet certain broad standards. There also are regulations specific to life companies and to superannuation funds, which has the potential to lead to an uneven playing field between the two types of provider. For instance, a greater range of products can be provided by life companies compared to superannuation funds.

Recommendation 1: The SIS regulations be amended to:

- Provide equivalent treatment of post-retirement products offered by life insurance companies and by superannuation funds, preferably through development of regulations which apply to both
- Set out general required characteristics for longevity products rather than mirror the specific characteristics of existing products in the market
- Allow products which provide a deferred benefit past normal retirement age to be offered

There is also an APRA prudential standard on minimum surrender values of pension and annuity products. While this standard is relatively technical in nature, the bottom line is that it makes it more expensive to offer such products and hence makes their pricing in the market less attractive to consumers.

The prudential standard sets out the requirements for determining termination values, minimum surrender values and minimum paid-up values. The key requirements of this prudential standard are:

- A life company must calculate the termination values of policies using the methods prescribed in this standard;
- Termination values cannot be less than the minimum termination values prescribed in this standard;
- Termination values are used in determining the capital base of a life company and its statutory funds (refer to Attachment H to *Prudential Standard LPS 112 Capital Adequacy: Measurement of Capital*);
- section 207 of the *Life Insurance Act* requires a life company to pay a surrender value to a policy owner in some circumstances;
- This prudential standard specifies the minimum surrender value that must be paid
- section 209 of the *Life Insurance Act* requires a life company to vary a policy in some circumstances if the policy owner requests that no further premiums be paid; and
- This prudential standard specifies the minimum amount of a paid-up policy.

Deferred annuities do not fit into the structure of that prudential standard as it is currently worded. Applying standard minimum surrender values to such products could make them unattractive from the point of view of a provider given that an individual might use the minimum surrender provisions if it comes apparent to them that they are not likely to reach the age at which the deferred annuity or pension is payable. This would impact on the pricing of such products and/or lead to inequities between deferred pension and annuity holders.

Recommendation 2: The APRA prudential standard applying to minimum surrender values of pension and annuity products be amended to reflect the special characteristics of such products.

8.2. Asset test treatment of deferred annuities

Under the current means test for the Age Pension the purchase price of a deferred annuity will generally be fully taken into account in the asset test. However, the purchasers of a deferred annuity are not able to access any capital or income until the qualifying age set out in the contract for the annuity. As well, individuals who do not reach the qualifying age will not receive any income or return of capital from the annuity.

In these circumstances and given that it would be desirable to encourage the take-up of deferred annuities, it is suggested that a deferred annuity be exempt from both the asset and income tests.

Asset test arrangements for the receipt of the Age Pension have a significant impact on the take-up of various types of income stream. Until 20 September 2007 there was a 50 per cent assets test exemption for qualifying non-commutable income streams taken out before that date. This included what are known as Term Allocated Pensions which, while non-commutable, are account-based income streams with special conditions applying to them. From 20 September 2007 onwards Term Allocated Pensions are no longer be able to be issued other than to change providers.

In the past the existence of full or partial exemption from the assets test for certain lifetime complying pensions and annuities added to the financial attractiveness of such products. The closing off of this concession from 20 September 2007 for any new income streams issued on or after that date basically led to very few such products being purchased after that date.

Recommendation 3: The means test applied by Centrelink should be amended to exempt deferred annuities from both the asset and income tests during the period prior to payment.

8.3. Approval processes for new post-retirement products

Product providers must deal separately with the ATO, APRA, ASIC and Centrelink when developing new post-retirement products. As well, each of these bodies might treat the product in an inconsistent way. For instance, the taxation and social security definitions of income may differ. In addition to any such inconsistencies, the need to deal with multiple regulators complicates and delays the development of new products.

Establishing a 'one-stop shop' for new post-retirement products which involves all the regulators would lead to a more efficient approval process and less inconsistencies in the prudential regulation, tax and social security treatment of such products.

Recommendation 4: A new administrative arrangement be put in place so that the ATO, APRA, ASIC and Centrelink undertake the assessment of new post-retirement products on a consistent and co-ordinated basis.

8.4. More education and advice to fund members

Better take-up of post-retirement products is also likely to occur when superannuation fund members are better educated and advised about such products. In this regard, the scaled advice model envisaged by the Future of Financial Advice reforms is intended to enable trustees (or those employed by them) to discuss issues such as adequacy of superannuation accumulation, interaction between the member's superannuation interest and Centrelink entitlements, and nomination of beneficiaries.

A smoother transition between the accumulation and drawdown phase is needed, particularly for individuals who have only a limited amount of superannuation and/or are not willing to pay for a holistic financial plan.

Recommendation 5: The scaled advice operating guidelines to be developed by ASIC allow for funds to provide members with limited advice relating to retirement products.

8.5. Taxation of deferred annuities

The current provisions of the taxation legislation were not drafted with deferred annuities in mind. This leads to ambiguities at best and adverse treatment of deferred annuities compared to other retirement products at worst.

The current provisions of the taxation legislation were not drafted with deferred annuities in mind. This leads to ambiguities at best and adverse treatment of deferred annuities compared to other retirement products at worst.

Consideration should be given to the amendment of a number of the tax provisions so that they provide appropriate treatment of deferred annuities and any other retirement products that are developed in the future. The drafting should be in broad terms rather than linked to the characteristics of specific products.

Importantly, the investment earnings which support longevity products should be tax-free. This treatment is currently provided to account-based income streams and there is no reason why it should not be extended to deferred annuities and like products. Not to do so results in a tax bias favouring products which do not provide any protection against the financial consequences of longevity. The cost to tax revenue of such an exemption would be minimal as in the absence of such an exemption superannuation fund members would make use of existing post-retirement products such as account-based income streams which are tax exempt in regard to investment earnings.

Recommendation 6: Legislative amendments should be made to provide tax treatment for deferred annuities and other products which is comparable to that provided for existing post-retirement products. Specifically:

- There should be clarification that benefits from deferred lifetime annuities and other longevity products purchased with superannuation monies are tax free when received at age 60 and over.
- The investment earnings supporting deferred annuities and other longevity products should be tax-free within the superannuation fund or life company.

8.6. Providing longevity protection for members of SMSFs

It is not easy to provide protection against the financial consequences of longevity within a SMSF as a number of SMSF trustees have discovered when they set up complying life pensions within their SMSF. Generally, given the small pool of members in a SMSF it is necessary to have a relatively large amount of assets and a relatively small annual drawdown amount to be able to ensure the provision of a benefit for a period of 25 years or more.

An option to facilitate the purchase of longevity products which protect the members of a SMSF would be to allow the trustee of a SMSF to purchase a deferred annuity or like product from another superannuation fund or from a life insurance company. Current legislative provisions in effect limit the purchase of such products to individuals in their own right.

Recommendation 7: Trustees of an SMSF should be permitted to purchase deferred annuities and like products on behalf of a member of the SMSF.

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