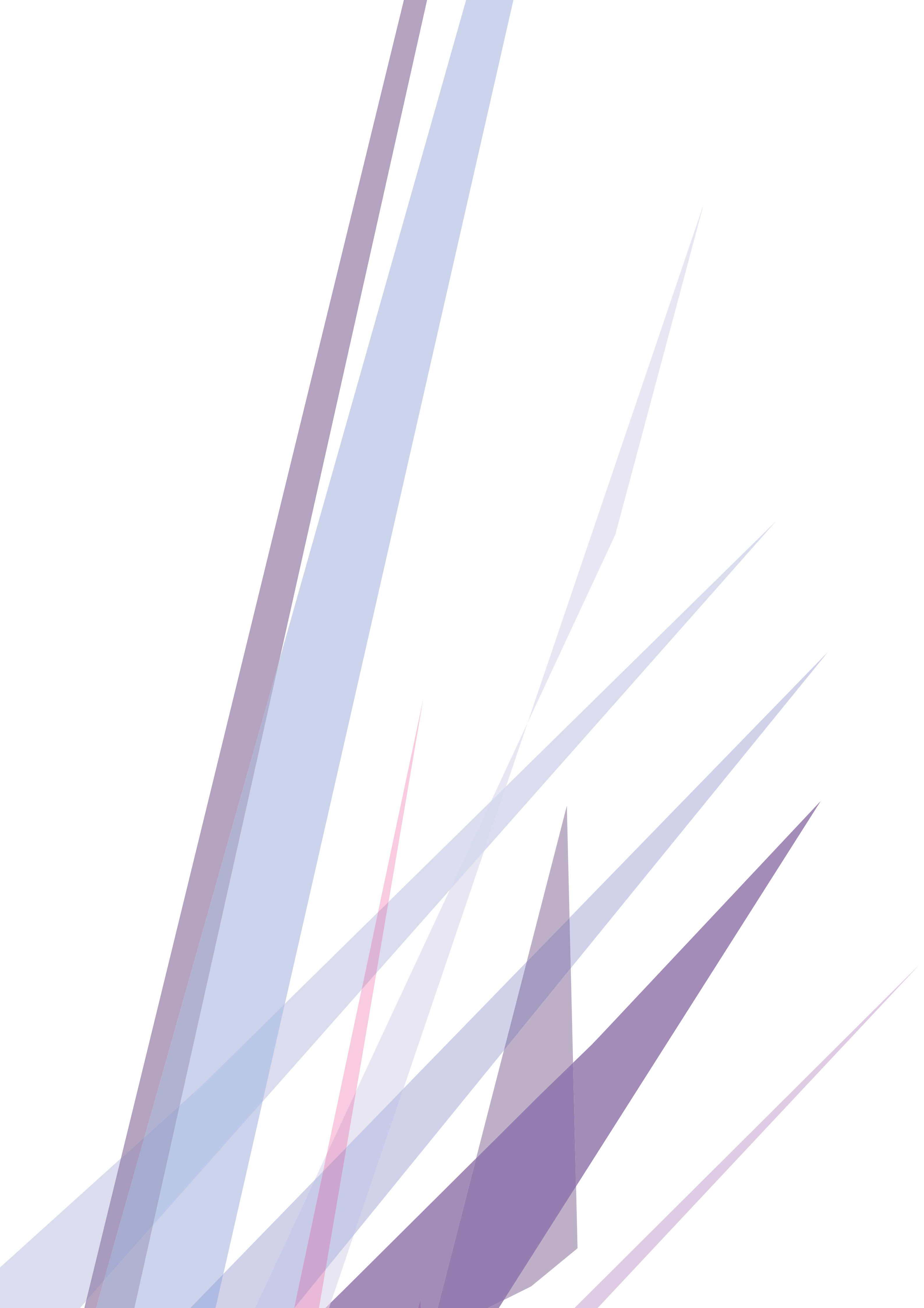
IFSA

INVESTMENT AND FINANCIAL
SERVICES ASSOCIATION LIMITED

RETIREMENT INCOMES AND LONG TERM SAVINGS LIVING WELL IN AN AGEING SOCIETY



SECURE THE FUTURE

Australia's retired population has never been so large. Australia had 1.3 million people over the age of 65 years in 1976, or nine per cent of the population. By 2002, this had increased to twelve per cent or 2.2 million people, and by 2030 it will be twenty-two per cent or 5.5 million people.

Australians are fortunate that they have had in place for some time a system that combines voluntary and compulsory savings for retirement with an age pension safety net.

Despite this foresight, the generation about to retire, the baby boom generation, will find that their private financial resources are not sufficient to provide them with the lifestyle they expect in retirement. Many baby boomers have planned inadequately for their retirement, and have limited savings outside of owning their own home. For many, the compulsory superannuation system has simply not had enough time to accumulate a level of savings to finance an adequate retirement income.

The Investment & Financial Services Association (IFSA) is concerned that, in the absence of a long term, comprehensive policy framework, the unrealised aspirations of the baby boomers – and, to a lesser extent, successive generations of retirees – could lead to a political auction for ad hoc retirement income 'fixes'.

The future additional cost of funding the age pension is expected to rise gradually as the population of retirees grows, to reach five per cent of Australia's annual national income each year by 2042. Widespread behaviour to maximise age pension payments could increase this cost by another one per cent of national income.

Australia is not alone among developed economies in facing the challenge to community living standards and economic growth of an ageing population. Australia must strive to meet this challenge by increasing its level of national savings.

IFSA represents Australia's leading investment managers and life insurance companies who are the custodians on behalf of more than nine million Australians of over $600 billion in superannuation and managed funds. IFSA has used this wide perspective to shape its vision and policy principles in the areas of superannuation, retirement incomes and long term saving. IFSA is a strong supporter of financial sector reform, which we believe will improve Australians' savings and investment decisions by delivering better financial advice and product disclosure.

IFSA believes that it is not feasible for governments alone to fund the level of retirement incomes that Australians aspire to in retirement, as this would place Australia's future prosperity at risk. This is because governments would have to fund retirement incomes at the expense of essential investment in health, education and economic infrastructure.

IFSA considers that Australia must adopt a broad range of economic, financial and social policies, and continue to increase productivity in the general economy, to maintain prosperity in an ageing society in the 21st century.

The most important immediate goal is to increase the level of national savings, both public and private. Further, it is critical that funds are used efficiently in investment markets to maximise returns to investors. At present, a significant amount of retiree savings is not invested in growth assets, in large part because of the impact of social security rules. This distorts Australia's long-term capital market.

The encouragement of all forms of self-provision should be a cornerstone of these reforms, because private saving and other forms of self-provision are the keys to financial independence. Improving the private financing of retirement will reduce the pressure on the public purse and provide greater capacity for improved community benefits for the most needy retirees, other welfare beneficiaries and for investment in health, education and other essential services

Education, information and quality advice are critical to the achievement of Australians' expectations of their retirement incomes. Investment markets are complex, and the taxation and social security rules on retirement incomes are intricate and changing. IFSA supports general education, targeted information, and – most importantly – high quality, appropriate ongoing financial advice.

The baby boom generation has little time to make up any savings shortfall. For succeeding generations, a cultural change is required to encourage saving early, and often, to ensure that living standards can be maintained into retirement. Change is also needed to broaden and deepen financial education, information and advice. The industry has a role to play in meeting customers' needs, through the range of products it offers, through transparency and quality advice – and above all through healthy competition.

On behalf of IFSA's one hundred member companies, I encourage you to read and respond to the issues and policies raised in this document.

Richard Gilbert
Chief Executive Officer

IFSA'S VISION FOR 2033

Greater financial security and a better lifestyle in retirement for Australians, through –

A progressive increase in the degree of financial independence of the Australian population in retirement.

Improving Australia's superannuation to help individuals close the retirement savings gap between the 2003 reality and their expectations of retirement living standards.

A strong and viable social safety net, with a minimum level of age pension that maintains the living standards of Australians relying on government support.

Changes in policy and in the community's attitude to saving in general, and superannuation in particular, are needed if IFSA's vision is to be realised.

In its December 2002 report on living standards in retirement, the Senate Select Committee on Superannuation found that:

– "the available evidence demonstrates that the current arrangements for superannuation may not provide an adequate income in retirement for most people and that strategies need to be identified to address the shortfall;
  - the current taxation treatment produces some inequities which need to be addressed;
  - the relationship between the superannuation and the age pension and other social security measures could be better integrated; and
  - the superannuation system in Australia is very complex and requires simplification."

IFSA supports these findings and proposes the following benchmarks to be attained by 2033.

– Many more retirees will have privately funded an adequate retirement income, compared with their pre-retirement living standards:
  - the desirable replacement rate is of the order of 75–80% of pre-retirement consumption expenditure or its equivalent, 60–65% of pre-retirement earnings;
  - one quarter of retirees will be fully self-funded (currently less than one fifth).

– The cost to the community of the age pension system, and related benefits, will be affordable:
  - no more than one-third of retirees will receive the full age pension (currently over half);
  - the age pension cost should be no greater than 5% of GDP (currently 3%).

– The safety net will meet community standards:
  - the full means-tested age pension will provide an income of no less than 26% of average weekly earnings (as now).

THE RETIREMENT SAVINGS GAP

Australians' expectations for their living standards in retirement are higher than their current levels of superannuation will provide. This was a finding of the Senate Select Committee on Superannuation Report on Living Standards in Retirement, December 2002.

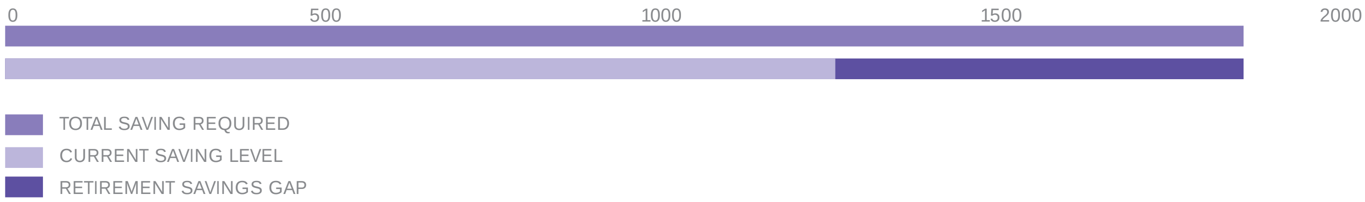
IFSA commissioned research to quantify this gap for the nation as a whole.

The Retirement Savings Gap estimates the value, in today's dollars, of the difference between the retirement people expect to have and the retirement that current compulsory and voluntary superannuation contributions, combined with the age pension, will eventually produce.

The **Retirement Savings Gap** is estimated to be **$600 billion**.

This amount is larger than the current stock of superannuation savings.

RETIREMENT SAVINGS GAP
($ BILLIONS)



The Retirement Savings Gap is a call to action for policy makers and the superannuation community to boost retirement savings. Strategies for reform follow in this document.

The Retirement Savings Gap was calculated by Rice Walker Actuaries.

The Retirement Savings Gap is the sum of the retirement savings gaps calculated for each 5-year age group between 25 and 65 in 2003 earning 0.75 to 2.0 times Average Weekly Earnings. The retirement income expectation is modest at 62.5% of pre-retirement earnings, equal to 75 to 80% of pre-retirement living standards. Assumptions selected tend to understate the Retirement Savings Gap.

PRINCIPLES FOR REFORM

IFSA proposes four basic principles to test for any new initiatives, rules or reforms to superannuation and retirement incomes policy. The recommendations in this policy document should be judged against these principles, as should proposals from government, interest groups or the wider community.

S

Simple and Secure

Reforms should reduce complexity. The superannuation and retirement incomes system should be simple for consumers to understand so that it encourages a higher rate of take up in the community and lowers administration and compliance costs.

Superannuation must remain secure for its investors. Reforms must ensure that Australians can be confident their money will be safe over the long investment horizons of retirement saving.

A

Adequate

"Adequacy" means retirees will be able to maintain an acceptable lifestyle in retirement. Reforms should assist individuals to attain financial independence, including incentives for voluntary savings to assist individuals to achieve their aspirations.

V

Viable

Superannuation is a long-term process, and any changes should be viable for this duration. Reforms to the superannuation system should have bi-partisan support and the same longevity as the periods that members expect to be part of the system – from contributing to drawing down a retirement income. Frequent legislative changes have a negative impact, as they breach the implied life time contract on superannuation and lower Australians' trust in the system.

E

Equitable and Efficient

The superannuation system should be equitable between generations. Reforms should ensure that future generations are not left with unsustainable liabilities.

Further enhancement of competition in the financial industry will drive, and will be driven by, lower transaction costs, better risk management, greater transparency and disclosure to the benefit of consumers.

IFSA'S WAY AHEAD

Australia's basic retirement system is sound, yet solid reforms are needed to bridge the retirement savings gap.

A large number of Australians will be disappointed when they reach retirement, unless they do more than rely on current levels of compulsory superannuation. The problem is greatest for the baby boom generation and their immediate successors. It will become less as the superannuation guarantee system matures.

The retirement savings gap – between the outcomes of current policy and Australians' retirement expectations – is estimated to be larger than the current stock of superannuation savings. This gap is higher for people now aged over 45 than for those now aged less than 30, but a gap exists at all age groups.

The growth in retiree numbers will add significantly to Budget costs, although forecast increases are well below the projected impact of ageing populations in other countries.

The strain on the Budget, the costs to economic growth and taxpayers, will be greater if a disappointed retiree 'grey vote' places irresistible pressure on governments for ad hoc policy responses. These could include calls for an increase in the age pension benchmark and/or further tax concessions for retirees. Recent Federal Budgets have contained a range of measures that have extended eligibility for benefits and concessions to retirees, such as the cuts in the age pension income test withdrawal rates linked to the introduction of the GST, and the extended eligibility for tax rebates.

Fortunately, the twin challenges of future fiscal strain and an adequate standard of living in retirement are aligned. The means of addressing both lies with the superannuation system – yet the current superannuation system cannot deliver the expectations of the next generations of retirees.

As the Federal Government's modelling has shown, the age pension and the system of associated health and other benefits is an ongoing critical component of retirement living standards for most retirees.

IFSA considers that the central message of the *Intergenerational Report 2002-03* cannot be ignored. Demographic changes will significantly increase government expenditure over the next few decades. Australia faces some important decisions that need to be made now – given the time it takes for retirement policy initiatives to deliver full benefits.

IFSA suggests policy directions in this document to improve the design of the retirement incomes and long-term savings system. Their starting point is the necessity for political and bi-partisan leadership to commit to specific objectives for Australia's retirement incomes policy.

RECOMMENDATIONS

ADEQUACY p7

IFSA recommends

- Collaborative initiatives to develop and promote a savings culture.
- A public retirement incomes benchmark to encourage Australians to include a retirement income target as part of their lifetime financial goals and planning.
- Initiatives to increase voluntary retirement savings to a rate of 3% to 5% of current income;
  - co-contributions on voluntary contributions by Australians earning up to average weekly earnings,
  - progressive abolition of the superannuation contributions surcharge,
  - remove the work test for voluntary contributions, and
  - remove the annual contribution limits (retain lifetime limits).

SIMPLE AND CERTAIN TAXES p9

IFSA recommends

- Simplifying and then stabilising the superannuation tax system.
- Moving the application of taxes over time, away from contributions and earnings on to benefits.

MAXIMISE RETIREMENT INCOME STREAMS p10

IFSA recommends

- Dialogue on the balance of risks in retirement income streams, in particular longevity risk, borne in the private market and by Government.
- Removal of distortions that prevent introduction of growth pensions.
- Better integration of the superannuation, social security and taxation systems.
- Clear legislation to allow non-superannuation savings to purchase retirement income products.
- Incentives to take retirement incomes in preference to lump sums.

TRANSITION FROM WORK p12

IFSA recommends

- Development of retirement income and labour market policies and regulation to support and encourage choices and opportunities for older workers to combine private and public pensions flexibly with some paid work.

EDUCATION, INFORMATION AND ADVICE p13

IFSA recommends

- Collaboration between Government and industry on the provision of targeted information to those seeking it about the benefits of long-term savings and superannuation, and some broader education for all Australians on superannuation and financial literacy.
- Communication to consumers about the role, benefits and costs of appropriate financial advice, particularly following the initiatives in financial sector reform.

CONSUMER CHOICE p14

IFSA recommends

- Changes to allow Australians to take control of their superannuation through choice of superannuation fund, and portability, with an appropriate disclosure regime and access to quality advice.

MEDIUM-TERM SAVINGS p15

IFSA recommends

- Introduction of simple vehicles and incentives for medium-term savings outside superannuation, to provide for non-retirement savings needs and to engender a stronger savings culture.

ADEQUACY

Policy objective: Encourage all Australians to save more to achieve an adequate retirement income, including a higher rate of voluntary contributions to superannuation.

Few Australians can be confident that they will have an adequate income in retirement.

The evidence shows a significant gap between the income consumers expect in retirement and the income they will eventually receive. The retirement savings gap facing the next generation of retirees is immediate, which increases the risk that disappointed expectations will lead to pressures on taxpayers to make up the shortfall.

Of the 2.7 million Australians aged between 50 and 64 years of age, evidence to the Senate Select Committee on Superannuation suggests that half expect an income in retirement of more than $40,000. This provides a standard of living equivalent to the then level of average weekly (ordinary time) earnings of $45,000 (May 2002). Only one third of this group expect to receive the age pension, despite insufficient savings to realise their expectations.

AMP NATSEM research suggests that the baby boomer generation - those closest to retirement – have average accumulated wealth of $240,000. This comprises $56,000 in superannuation, additional private savings of $58,000 and average equity in the family home of $126,000. Note that this wealth is unevenly distributed as the poorest twenty-five per cent have only $21,000 in superannuation and an additional $3,000 in private savings.

While a $56,000 average lump sum may appear reasonable, it has only a small capacity to generate a retirement income. If a consumer bought an annuity with this sum, say for example a sixty-five year old male bought into an allocated pension, it would only provide an income of $100 a week for fifteen years. If the annuity had to last for the consumer's lifetime, then the amount would be less.

Two thirds of this generation will be heavily or wholly reliant on the age pension, according to Government projections. In IFSA's view, government and industry leadership is critical to inform and persuade the community of the retirement savings gap, in time for something to be done about it.

Consumers need to be able to relate their retirement income goals to a requisite rate of lifetime saving, and be able to regularly review their progress. A replacement rate is a way to express the goal that retirees wish to maintain the same living standards in retirement as before retirement.

A strong consensus has emerged on the desirable replacement rate. For those on average earnings, this is a retirement income in the range of 75% to 80% of pre-retirement spending – or its equivalent, 60% to 65% of pre-retirement (gross) income. These ranges should be higher for the largest group of workers (on median incomes) i.e. up to 90% of pre-retirement spending and lower for those on higher incomes than the average. (A summary of recent debate on technical issues – projections and assumptions – is at Appendix 1.)

IFSA strongly supports these target replacement rates. All political parties should endorse these high level targets and commit to policy measures designed to ensure that a majority of people can realise this target retirement income. As a simple start, Government and the community could collaborate to set a public benchmark for adequate retirement incomes at 60–65% pre-retirement earnings.

Few individuals near retirement today can expect to achieve an adequate retirement income through the compulsory superannuation system alone, as it has been in place for a relatively short period of time. Consumers retiring after 2026 (or later still) will have the full benefit of the current system, and this will go a long way to meeting their expectations.

Baby boomers face the highest need to lift their savings rates above the super guarantee minimum to achieve an income in retirement that at least matches their expectations.

In the long run, the superannuation guarantee will make a significant difference to retirement living standards. However, it will not be sufficient to meet Australians' retirement income expectations. Proposals to increase contributions should be given serious policy investigation, in consultation with the community. Evidence to the Senate Select Committee on Superannuation inquiry into retirement living standards showed a wide agreement that many people would still need to save an additional 3% to 5% on top of the Superannuation Guarantee rate of 9% to achieve a target retirement income of 60–65% of pre-retirement earnings.

IFSA recognises that higher rates of compulsory contributions, from employers or employees, may be difficult to achieve without widespread community backing. Even then, it may need to be combined with nominal wage restraint, a tax cut and/or government co-contributions or similar incentives.

In the first instance, government should seek to increase the rate of voluntary contributions through targeted incentives, and to broaden the participation in the superannuation system to include those outside the workforce and the self-employed. Voluntary savings make up the third pillar of Australia's retirement incomes system, and they have a vital role to play.

The current age-related limits on annual contributions tend to work against the flexibility people may need to achieve adequate retirement savings, particularly for those with broken labour market participation patterns. The 2003–4 limit for deductible contributions for those under age 35 is $13,233 and for those under age 50 is $36,754. Women are most adversely affected by this inflexibility. Both older and younger women may wish to make up for periods out of the labour market, or to contribute ahead of a career break by putting more of their salary into superannuation.

IFSA believes that removing these limits will improve the equity of the superannuation system, and to the extent it reduces fund administration costs, all members will benefit. Equity objectives can be achieved using the lifetime limits, currently imposed by the Reasonable Benefits Limit regime.

Under current rules, voluntary contributions can be accepted from many people – though not from everyone. Significant groups remain excluded from superannuation. It would be more equitable, and considerably simpler, to allow anyone to make after-tax contributions to superannuation.

The superannuation surcharge is having unintended consequences. IFSA member companies have found surcharge levied upon people aged over 50 with low superannuation accumulations, which seems to strike against equity in superannuation. As we discuss later, annual income is an inappropriate tool for targeting equity measures in retirement saving. This is a key reason for reduction and/or removal of the surcharge.

These measures, coupled with the recommendations on simplifying the retirement incomes system could provide a suite of effective incentives for people to make additional superannuation contributions.

Recommendation 1

IFSA recommends

- Collaborative initiatives to develop and promote a savings culture.
- A public retirement incomes benchmark to encourage Australians to include a retirement income target as part of their lifetime financial goals and planning.
- Initiatives to increase voluntary retirement savings to a rate of 3% to 5% of current income;
  - co-contributions on voluntary contributions for Australians earning up to average weekly earnings,
  - progressive abolition of the superannuation contributions surcharge,
  - remove the work test for voluntary contributions, and
  - remove the annual contribution limits (retain lifetime limits).

SIMPLE AND CERTAIN TAXES

Policy objective: Taxes should be simple to understand, and certain. They should be progressively moved away from application to contributions and earnings and towards application in the drawdown phase.

The complexity and uncertainty of taxes on superannuation reduces people's confidence and willingness to save through superannuation.

IFSA's *Retirement Savings – Desires and Drivers* research, released at its 2001 Conference, found that legislative change was a major reason consumers chose not to make additional contributions to superannuation. Typical comments included:

"The government keeps changing the superannuation rules, and will therefore probably continue to do so."
"The superannuation surcharge has reduced the incentive to save within the superannuation system."

The various superannuation flows – contributions, fund earnings and benefits – are taxed differently to income, as highlighted in the Treasury's annual tax expenditure statement. However, in accordance with international best practice, and as the OECD has recently reiterated, savings ideally should not be taxed.

IFSA argues that superannuation is taxed at the wrong time. For example, contributions taxes remove savings from the system before they have had any opportunity to benefit from compound interest.

There have been calls by many participants in, and commentators on, the Australian superannuation system to reduce the burden of taxation on long-term savings, and superannuation contributions and earnings in particular.

IFSA has long supported the wind-back of front-end taxes on superannuation, so that taxes would only be imposed once, at the time that the benefit is taken. Equity would be assessed and adjusted at the point when the actual level of retirement accumulation is known. Those with similar wealth levels at retirement would be treated the same, irrespective of the pattern and timing of contributions. There would be significant benefits for those groups that move in and out of the workforce during their working life.

Just as the tax bring-forward in the 1988 Budget added to revenue flows in the Budget forward estimates, IFSA acknowledges that returning revenue to the end benefits stage of superannuation would be at a cost to the forward estimates.

As there is a greater need for future taxation revenues than there is in the current Budget and forward estimates period, unwinding some of the tax bring-forward and returning that revenue to future years would ameliorate some of the future fiscal strain outlined in the Government's *Intergenerational Report 2002–03.*

IFSA recognises that the cost to government of changes in tax will need to be managed carefully. IFSA suggests that the gradual removal of front-end taxes would increase living standards for future generations of retirees without a sudden and significant fiscal impact on Commonwealth revenue.

There are compelling efficiency reasons for pursuing this change, and at the same time eliminating the grandfathering of earlier concessional treatments that plagues the current arrangements. When grandfathering is taken into account there are in effect up to six superannuation systems in place in Australia, and not just one.

It is possible to crystalise the worth of grandfathered concessions by calculating this worth for each individual as a single value. The value could then be taken forward to retirement, and the grandfathered provisions removed. This would leave a simpler and more seamless superannuation system. A variety of technical methods could be used, and the process and timing could easily be adjusted to match fiscal freedom at the time.

Contributions and earnings taxes will continue to grow ahead of prices, wages and the economy. As a start, government should fix the overall tax take to an appropriate index. The longer this is postponed, the harder the task becomes, and government's dependence on taxes at these undesirable points in retirement saving increases.

Simplification and reduction in administrative complexity will increase the level of understanding of superannuation in the community, assist people to save more and reduce costs.

Access to the Treasury's Retirement Incomes Model (RIM), or a collaborative project between government and industry, could assist an open debate on options to achieve this simplification. Consideration of front-end tax impacts, and their removal, would be incomplete without a full fiscal analysis of the changes in revenue amounts and timing, extent of tax deferral and of future savings to outlays. This analysis requires access to the data and models used by RIM.

Recommendation 2
IFSA recommends
- Simplifying and then stabilising the superannuation tax system.
- Moving the application of taxes over time, away from contributions and earnings on to benefits.

MAXIMISE RETIREMENT INCOME STREAMS

Policy objective: Enhance opportunities for retirees to maximise their retirement income streams, and remove distortions created by current rules.

Australians who have accumulated savings for their retirement must invest wisely if those savings are to maximise their living standards throughout their retirement.

There is no compulsion for savings to be converted to income streams in retirement, and by preference many Australians opt to take a certain amount of their savings as a lump sum. It is sensible for some lump sum amounts to be used to pay off debts on retirement – housing debt in particular. However, the leakage of capital through lump sums lowers retirement incomes. Consequently, there is a useful role for incentives to encourage retirees to use income streams to help them draw their capital down progressively over retirement. Ideally, incentives should fit with retirees' own preferences – especially where these mesh with retirement income policy objectives.

Longevity Risk

Another factor affecting the capacity of the market superannuation system to maximise retirement incomes is the uncertainty of life expectancy of retirees. Although the population is ageing, life expectancy is increasing steadily and therefore savings have to stretch further. Critically, future life expectancy is very hard to assess, particularly because of likely future advances such as in genetic medicine. The longevity of a given age group (cohort) could well increase quite significantly. This means the range of possible outcomes is very wide.

The challenge in market provision of retirement income stream products, such as lifetime annuities, is to match the premium charged for the benefit of security to the potential costs and risks the provider must bear. The uncertainty around longevity risk means it is difficult, if not impossible, to reinsure longevity risk. Much of the risk simply cannot be sufficiently quantified or priced. Providers effectively must carry this risk on balance sheet – and there are limits on private capacity to do this.

IFSA suggests there is a need to begin a dialogue about the respective roles of the private market and government in income stream provision.

Distortions from current rules

Retirement income providers face another challenge: to design products that maximise investment income and still comply with the income and assets tests. The key limitation of these tests is that income paid from the annuity must not vary, except for indexation. It is unrealistic to expect private providers and their shareholders to bear the risk of market volatility, by guaranteeing constant income levels, and still pass on the premium for this very risk to consumers. In addition, transferring returns across different periods of the business cycle to manage this risk requires some reserving facility – which would be inappropriate for accumulation superannuation funds and managed investments. To avoid undue volatility and mismatched risks, and so lower the risk premium implicit in these annuity products, complying income streams use interest-bearing investments. This creates a distortion away from long-term assets, such as equities and property, and results in lower long-term returns to retirees.

This decision affects capital markets, and the cost of these rules to the Australian economy, and to individuals, will become more significant in the future as higher levels of retiree savings are forced into low volatility, low return investments.

By way of example, IFSA calculates that a retiree (with $100,000 to invest in a 15 year income stream) would be $30,000 better off in real terms with a growth pension than investing in a CPI-indexed guaranteed pension or annuity.

To invest wisely and maximise retirement incomes, consumers must negotiate their way through a myriad of rules – social security benefits tests and income taxation law – given that the majority will rely on both an age pension and income from their own retirement savings in the foreseeable future.

Integration and incentives

A practical review process to identify opportunities for integration of desirable income stream features, tax and social security rules – and to implement them – could also address the most effective and well-accepted incentives for consumers to draw down their savings as income streams and not lump sums. This review could also include a rationalisation of legislation to remove anomalies and impracticalities.

IFSA considers that an individual will have an incentive to maximise their retirement income if they could use non-superannuation savings to access allocated retirement income stream products, currently prohibited under tax rules. The design of these products facilitates the orderly drawdown of capital across retirement, and as such these products are important to help retirees achieve adequate income across their whole retirement. There is no parallel provision in the social security rules, which supports the case for removing these rules.

Finally, as the AMP NATSEM research has highlighted, the fact that the bulk of older Australians' wealth is tied up in their homes creates an imperative to enable retirees, who wish to do so, to apply this value towards retirement income.

Recommendation 3

IFSA recommends

- Dialogue on the balance of risks in retirement income streams, in particular longevity risk, borne in the private market and by Government.
- Removal of distortions that prevent introduction of growth pensions.
- Better integration of the superannuation, social security and taxation systems.
- Clear legislation to allow non-superannuation savings to purchase retirement income products.
- Incentives to take retirement incomes in preference to lump sums.

Policy objective: Develop flexible policies consistent with the phased transition from full time work to full time retirement

Australians are living longer, while the trend is to take earlier retirement than preceding generations. Yet early retirement is only feasible if consumers have sufficient savings to draw on.

Many older Australians now combine part time work with living off their savings, either by choice or reflecting changes in the availability of full time work, particularly for older males. For older women, this is to a certain extent a continuation of a traditional employment pattern.

Baby boomers, and other workers who will not benefit fully from the maturing superannuation guarantee system, may wish to work longer to improve their living standards in retirement. Many will have very strong incentives to do so – to build up retirement savings, to prepare for retirement such as by paying off a mortgage, to postpone retirement to increase income in retirement, or to supplement retirement income with part-time work. Where older Australians wish to, and are able to find work, this is firmly in line with retirement incomes policy objectives. Many superannuation rules, some of them overly prescriptive or simply outdated, cut directly across this policy objective.

To facilitate opportunities for older Australians to make a phased transition from full time work to full retirement, community attitudes to older workers may need to change. More importantly the superannuation system and the income stream product legislation must be more flexible.

Outdated assumptions need to be challenged and discarded. For example, the assumption that a person retires once, on a day they have selected in advance, pervades the regulatory system because much of the original legislation was drafted prior to 1990. Problems for people moving between work and retirement include:

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

Whether Australians would want to take flexibility one step further and increase the retirement age for men and women beyond 65, is a matter for community debate. One reason advanced for such a policy is that average life expectancies have increased significantly since the age pension system commenced. Some countries, notably USA, Denmark, Iceland and Norway, have already moved in this direction. If such a policy was agreed, it should be phased in gradually with considerable notice. No one currently aged over 55 should be affected, while those below aged 55 would be encouraged to work longer, save more or both. An arrangement similar to the mature age allowance should be used to prevent any increase in financial hardship.

Recommendation 4

IFSA recommends

- Development of retirement income and labour market policies and regulation to support and encourage choices and opportunities for older workers to combine private and public pensions flexibly with some paid work.

EDUCATION INFORMATION & ADVICE

Policy objective: Improve Australians' retirement savings and investment decision-making through education, targeted information for those seeking it, and access to quality financial advice.

IFSA's research into the drivers of retirement savings, as part of its Retirement Savings – Desires and Drivers project in 2001, found that the perception of a retirement savings 'gap' did not appear to be a major driver of discretionary retirement saving. This means setting retirement income targets, while a necessary first step on the path to adequacy, will not be sufficient to foster a stronger savings culture on its own. Education, information and advice must combine to equip people to plan for and realise a range of short term and long term financial goals.

IFSA's qualitative research identified that there were very low levels of planning for the financial aspects of retirement among pre-retirees. The main reasons for this included other commitments, a poor ability to save, and lack of disposable income. Those people who did pre-plan shared a number of characteristics, including the realisation that that they had an asset, through superannuation or other means, that commanded their attention.

Given these research findings, IFSA considers that consumer education and information are critical for individuals to develop realistic financial goals. It is critical for consumers to assist them to implement strategies to achieve these goals, in particular long-term goals. There is a need to improve the understanding that Australians of all ages have about financial issues, including superannuation. The capacity to manage finances is an important life skill, but there are major gaps between the understanding required and that provided by schools.

IFSA sees three distinct stages in developing consumer understanding – general education at a community level, information when people are motivated to seek it, and advice to people who are making decisions.

Investment in education and information that leads to improving the adequacy of retirees' financial resources in retirement would be repaid many times over by the lower costs to government of providing age pensions. The private sector could collaborate with government to provide a substantial component of the information and education required.

IFSA believes that there is significant potential to improve the financial position of many retirees through improved access to, and utilisation of, quality financial advice. Advice can go hand in glove with choice in superannuation, if consumers are to make the most appropriate choices to suit their individual circumstances. Given the size of many retirees' lump sums, and the complexity of tax and social security rules, it is important that retirees have access to quality advice.

Selecting an investment strategy is just one example where education, information and/or advice could improve retirees' outcomes. For example, most retirees are understandably conservative in their investment strategies. After all, they are investing their life savings without the ability to replace any losses from poor investment decisions with employment income. Nevertheless, many of these retirees are overly conservative in selecting investment strategies and this has the effect of reducing their own incomes and adding to the numbers of people reliant on the age pension.

Changes to the regulatory environment, both in licensing of advisers and in disclosure of remuneration, will improve the quality and objectivity of financial advice across the industry. IFSA strongly supports these improvements. Armed with the best available advice, consumers can take responsibility for their financial planning, and for making informed decisions.

Recommendation 5

IFSA recommends

– Collaboration between Government and industry on the provision of targeted information to those seeking it about the benefits of long-term savings and superannuation, and some broader education for all Australians on superannuation and financial literacy.
– Communication to consumers about the role, benefits and costs of appropriate, quality financial advice, particularly following the initiatives in financial sector reform.

CONSUMER CHOICE

Policy objective: Support choice and portability of superannuation funds to promote consumer sovereignty and competition.

The Australian superannuation industry includes a large range of customer segments, industry providers and product choices, varying in their complexity and their suitability for different individual circumstances. Some products are straightforward, simple to use and therefore can have lower costs to consumers. Other products, with more features, wider choice and greater sophistication, have higher fees. Consumers should be able to choose which of these products are most appropriate for them.

In Australia there is a high level of price and product competition among providers of superannuation to meet customers' needs.

IFSA strongly supports the principle that Australians should be able to choose their superannuation fund, providing that the funds comply with retirement incomes policy and prudential regulation. With the introduction of full portability, consumers can consolidate multiple accounts and have the potential to switch superannuation providers, as well as nominate an investment strategy.

The opportunities to choose brings a range of fees or charges that reflect the features or complexity of different products. The more transparent the choices, the easier it is for consumers to readily make comparisons on value for money.

IFSA supports the Financial Services Reform Act provisions on fee disclosure, as they allow comparability of ongoing fees across industry segments and products.

Recommendation 6

IFSA recommends

– Changes to allow Australians to take control of their superannuation through choice of superannuation fund, and portability, with an appropriate disclosure regime and access to quality advice.

MEDIUM-TERM SAVINGS

Policy objective: To engender a stronger savings culture, beyond home ownership, to medium term savings horizons of 5 to 15 years.

The causal relationships between savings incentives and levels of private and national saving are not well understood, notwithstanding considerable research efforts. In the context of the macro economy, there is little to distinguish savings with durations of above 10 years – as Dr Vince Fitzgerald noted in his report on national savings. IFSA believes that the comparatively poor state of discretionary household saving outside of home ownership in Australia warrants action to boost private saving and help engender a stronger savings culture.

Individuals and families have medium to long-term savings and dissaving patterns associated with lifecycle needs – including parenting, study, and children's education.

IFSA supports the development of simple vehicles and incentives for medium-term savings outside superannuation. The structure of any tax-advantaged non-retirement savings vehicles should target and encourage medium to long-term savings rather than provide immediate tax offsets.

In principle, the most effective incentive would be full deferral of tax on amounts saved and on the earnings from that saving until they are withdrawn at or before a specified time, to avoid indefinite deferral. Alternatively, a rebate system could be a means by which a more significant benefit can be provided to middle-income earners, whose capacity to save is more limited than that of high income earners. Rebates could be paid directly into savings vehicles.

Any incentives could be in place of any prospective future tax cuts for high income earners, who have the greatest propensity to save. While the Government would be faced with some revenue deferral arising from such incentives, the options could be structured so that investors eventually pay full tax, enabling the Government to recoup its revenue.

Tax preferred savings vehicles exist in many countries. Some would be readily adaptable for Australia.

IFSA believes superannuation should continue to be used exclusively for retirement.

Recommendation 7
IFSA recommends
– Introduction of simple vehicles and incentives for medium-term savings outside superannuation, to provide for non-retirement savings needs and to engender a stronger savings culture.

APPENDIX 1
HOW MUCH IS ENOUGH?

The critical questions for policy makers and for individuals are: how much income will retirees need to live well; and at what rate must they save to meet their expectations?

A major finding of the Senate Select Committee on Superannuation inquiry into retirement living standards is that Australia's superannuation system, as it is currently framed, lacks targets for retirement incomes by which the community can judge whether it is saving sufficient today to maintain their living standards in retirement. The first recommendation of the Senate Select Committee on Superannuation was:

"The Committee recommends that the Government announce a clear statement of objectives for Australia's retirement income system, including target retirement incomes for representative groups."

A more controversial question is whether Australians' current saving is sufficient to meet these targets, or their lifestyle expectations in retirement, which imply higher targets still. The debate is summarised at Chapter 2 of the Senate Select Committee on Superannuation Report.

The broad consensus, of which IFSA is part, was that an adequate retirement income was in the range of 75% to 80% of pre-retirement consumption expenditure, which equates to 60% to 65% of pre-retirement earnings.

The Senate Select Committee on Superannuation drew some important conclusions with the assistance of the Institute of Actuaries, in particular about replacement rates and projections of income expressed.

The Institute of Actuaries notes that the net of tax retirement income replacement rate (ie the level of retirement income for a 65 year old male, after a 30 year career, compared with earnings immediately prior to retirement):

- *is close to 60% (best estimate assumptions Institute of Actuaries);*
- *of which more than half is provided by the age pension (35% of pre-retirement earnings);and*
- *the superannuation pension component is 25% of pre-retirement earnings.*

This replacement rate of 60% in a mature Superannuation Guarantee system is somewhat lower than the consensus target rates noted earlier, and is considerably below some reported retirement lifestyle expectations, which imply a replacement rate up to 100% of average earnings.

Further, there is considerable variability in the outcomes for individuals, and the Institute of Actuaries highlighted the factors that contribute to both variability of age pension outcomes and variability of private incomes. This variability can create major problems for consumers in assessing the likely adequacy of their individual outcomes from the superannuation systems and age pension arrangements.

The Institute of Actuaries has concluded that replacement rates are a better measure than retirement incomes expressed as dollar figures.

Given that variations in assumptions can have a major impact, the Institute of Actuaries projected the following range of retirement incomes and replacement rates, and concluded that additional contributions might well be required to meet the generally accepted replacement rates.

Assumptions	Retirement Income 2003 dollars	Replacement Rates
Best estimate	$20,290	59.2%
Lowest estimate	$17,687	51.6%
Highest estimate	$23,971	69.9%

IFSA is convinced that this evidence shows that a higher level of contributions will be needed to fund the retirement savings gap between consumer expectations and the retirement income actually delivered by present contribution rates.

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