Super Consumers Australia – Retirement Standards

FSC Submission

April 2022

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1 About the Financial Services Council

The FSC is a peak body which sets mandatory Standards and develops policy for more than 100 member companies in one of Australia's largest industry sectors, financial services.

Our Full Members represent Australia's retail and wholesale funds management businesses, superannuation funds, life insurers and financial advice licensees. Our Supporting Members represent the professional services firms such as ICT, consulting, accounting, legal, recruitment, actuarial and research houses.

The financial services industry is responsible for investing $3 trillion on behalf of more than 15.6 million Australians. The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange, and is the fourth largest pool of managed funds in the world.

The FSC's mission is to assist our members achieve the following outcomes for Australians:

- to increase their financial security and wellbeing;
- to protect their livelihoods;
- to provide them with a comfortable retirement;
- to champion integrity, ethics and social responsibility in financial services; and
- to advocate for financial literacy and inclusion.

2 Introduction

The FSC welcomes the opportunity to provide a submission to Super Consumers Australia on retirement standards. It is worthwhile that Super Consumers have considered the issue of retirement standards in some detail and have developed a new approach with different features.

The FSC's submission focuses on providing an alternative perspective on the approach to consider retirement income adequacy, an approach that is more consistent with the international approaches to this issue. Given this different perspective, this submission is not providing responses to the specific questions raised by Super Consumers.

3 Retirement adequacy standard

There are a range of ways to measure retirement income adequacy. International approaches to retirement income adequacy focus on the **replacement rate**, which is retirement income as a proportion of working age income. A higher replacement rate shows retirees are receiving income that is closer to the income they received when they were employed.

A replacement rate of 70 per cent has been adopted by the OECD, and has been adopted or accepted by various commentators and analysts including those that question an increase in the Superannuation Guarantee (**SG**) rate.[1] Replacement rates have also been used to determine retirement income adequacy by the Henry Tax Review and previous recommendations of the Senate Select Committee inquiry into superannuation and living standards in retirement.

The Retirement Income Review (**RIR**) also focussed on the replacement rate, making the following statement (see RIR final report, page 161 and following):

> Replacement rates are a preferred metric because they provide adequacy targets based on the income a person earned while they were working (Chart 2C-2). Since replacement rates are a proportion of working-life income, changes in working-life income and retirement income both affect the measure. They can account for the trade-off required between working-life and retirement income. For this reason, replacement rates align with the view that the appropriate objective for adequacy in the retirement income system is maintaining living standards in retirement. (pages 161–2)
>
> Replacement rates are the preferred tool for assessing the objective of maintaining living standards in retirement. (page 163)

The FSC broadly supports this view.

However, a replacement rate approach is not appropriate for all individuals. For example, for low income earners this 70 per cent replacement rate may be inadequate by community standards, and a higher replacement rate is likely to be warranted. A replacement rate of 70 per cent means a retiree who earned 50 per cent of average incomes would have retirement income of 35 per cent of average incomes which may not meet community standards. The RIR Final Report also supported this view (page 162).

The RIR Final Report used a range for replacement rate of 65 to 75 per cent; however, the figure used by the OECD of 70 per cent is used below to contextualise the FSC's analysis.

The alternative view is to use **budget standards**, which set a fixed dollar amount for retirement savings for all Australians, or several different fixed dollar amounts for particular cohorts (eg different fixed dollar amounts for women and men, and for low, medium or high standards of living in retirement).

The RIR Final Report also noted several weaknesses of budget standards (page 163):

- They are designed for a specific cohort, in a specific location at a given point in time.
- They are subjective. A specific bundle of goods and services and the lifestyle it delivers may not be adequate or preferred for all groups.

[1] See for example Daley, Coates, Wiltshire, Emslie, Nolan & Chen (2018) *Money in retirement: More than enough.*

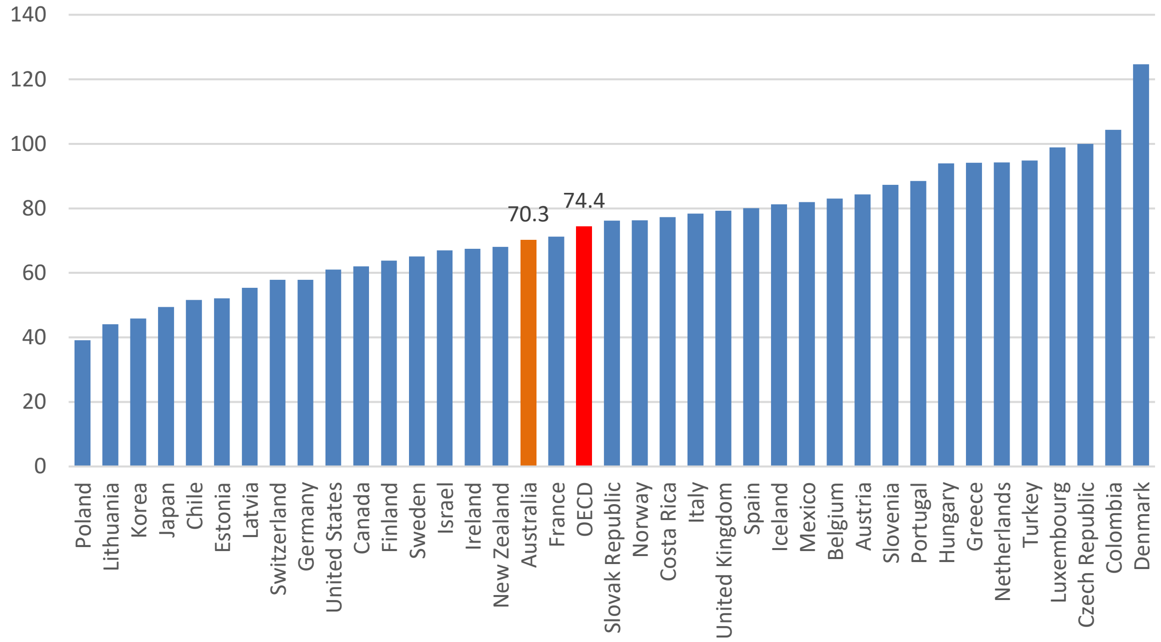
- They do not measure the trade-off between retirement and working-life living standards. A retirement objective is not effective if achieving it requires inappropriate sacrifices during working life.

3.1 International comparisons of retirement income adequacy

Based on a 70 per cent replacement rate standard, OECD data shows Australia provides adequate retirement incomes for low income earners, while Australia's provision for middle income earners and those earning a bit above the average is much less adequate.

The data shown in Figure 1 below shows the OECD's projected retirement income replacement rates in OECD countries for low income earners, or those earning 50 per cent of average incomes. The figures are for an individual who starts work in 2020 at age 22 and works to (an assumed) retirement age, and covers both mandatory private and public pensions.

Figure 1 – Net replacement rates for low income earners in OECD



OECD Pensions at a Glance 2021, Figure 4.5.

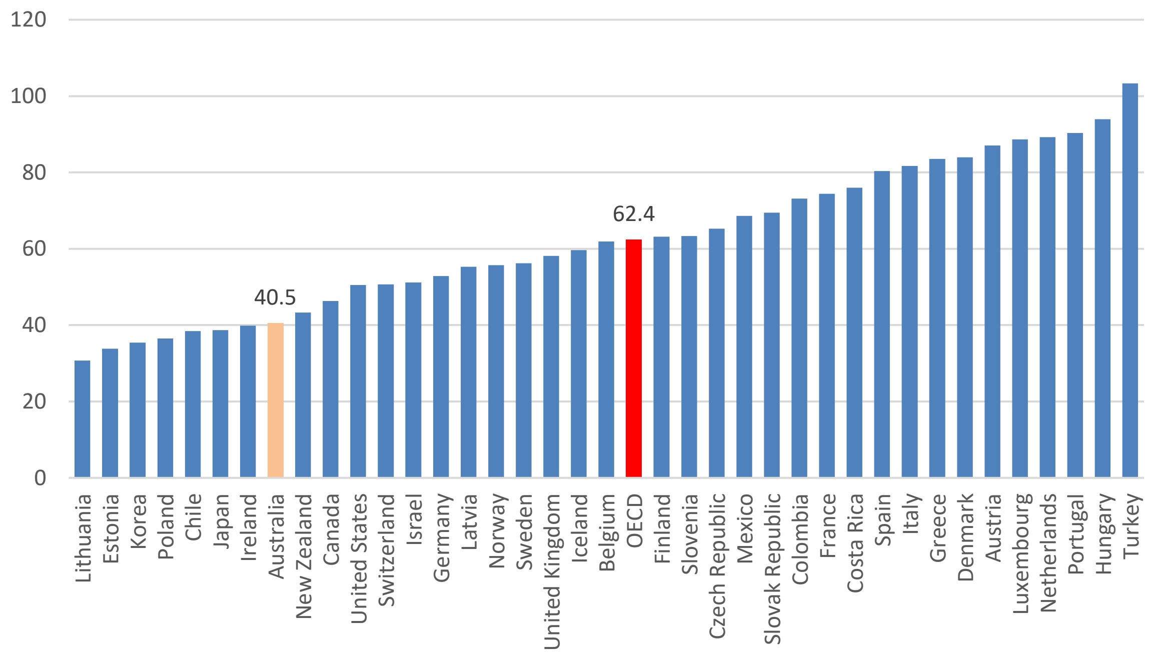
Figure 1 shows Australia provides retirement incomes for low income earners that are 70 per cent of working age incomes, somewhat below the OECD average for this group of 74 per cent.

While this figure is just adequate based on the OECD replacement rate of 70 per cent, we note it is arguable that retirement income that is 70 per cent of 50 per cent of average incomes (ie about 35 per cent of average) may not be adequate in its own right, and a higher target replacement rate might be appropriate for low income earners.

On the other hand, the OECD approach appears to underestimate the Age Pension paid to retirees, as it assumes that retirees will purchase a lifetime annuity at retirement, but their calculations do not adjust the Age Pension means tests to reflect the different test applying to annuities.

Noting the above issues, the OECD results show Australia's replacement rate at average incomes is significantly lower. The projected retirement income for an Australian average income earner starting work in 2020 is 41 per cent of work income, well below the OECD average of 62 per cent for this group, see Figure 2 below. This is also well below the target replacement rate of 70 per cent.

Figure 2 – Net replacement rates for average income earners in OECD



OECD Pensions at a Glance 2021, Figure 4.4.

The replacement rate for workers on incomes at 150 per cent of average is 39.1 per cent, also substantially below the OECD average for this group of 54.9 per cent.[2] Again, this is also well below the target replacement rate of 70 per cent. While this income is above the average, it is not particularly high income as it represents an income of about $136,000 per year before tax.[3]

[2] OECD Pensions at a Glance 2021, Table 4.4.

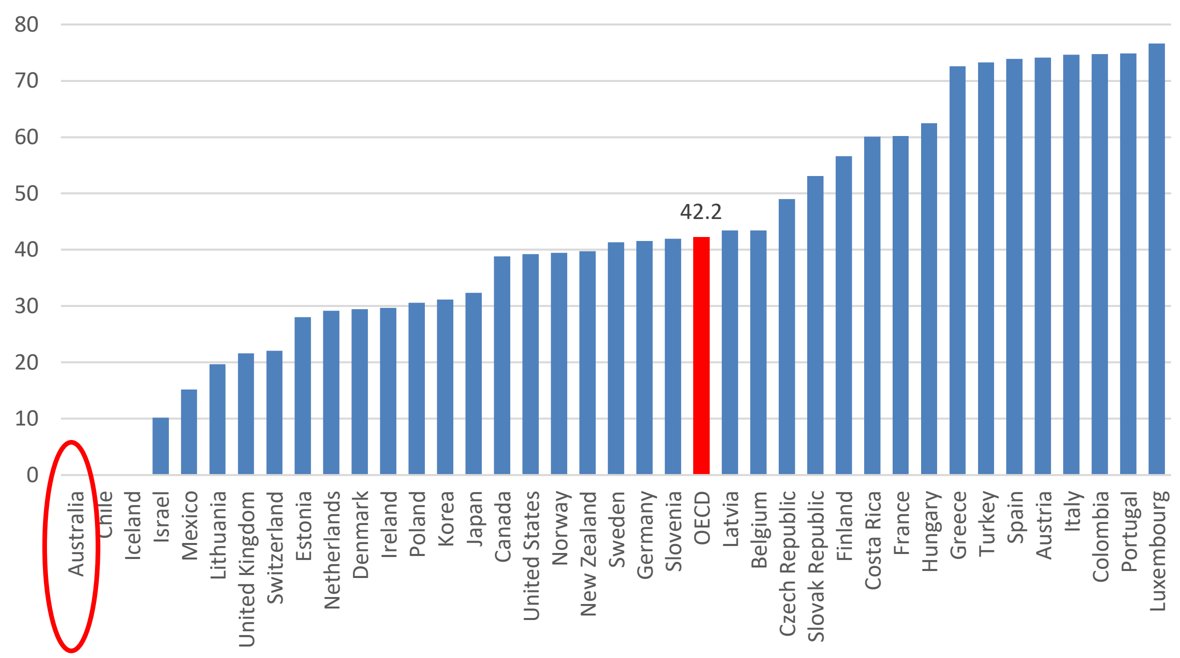
[3] OECD Pensions at a Glance 2021, Table 7.5. Defined as gross wages before deductions of any kind, but including overtime pay and other cash supplements paid to employees.

The much lower replacement rate in Australia for average income earners, and people earning somewhat above the average, could be attributed to factors including:

- the Australian Age Pension is much more targeted than in other developed countries, meaning the pension spending on average earnings is (much) lower than in other developed countries – see Figure 3 below;[4]
- compulsory contributions for retirement are lower in Australia than in other developed countries (see Figure 4 below);[5] and
- the Australian tax concessions for private retirement savings are smaller at average income levels than in other countries.[6]

The targeting of the Australian Age Pension is particularly shown by Australia being only one of two OECD countries (along with Chile) that initially provides no Government age pension to individuals with average pre-retirement income. This is shown in Figure 3 below with Australia circled in red. Across the OECD, almost all other countries provide Government pensions to this group at the time of retirement, with the average pension being 42 per cent of pre-retirement income; the Australian Government pension is zero for this group at time of retirement (in Australia, this group of retirees may receive a pension later in retirement if their assets run down).

Figure 3 – Government spending on age pension for average income worker (as a replacement rate)



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[4] See FSC submission to Retirement Income Review at Section 8.3.
[5] Note that the compulsory contributions in Figure 4 for Australia only include contributions for private saving (superannuation), while in many other countries their compulsory contributions cover both public saving (age pension) and private saving.
[6] See FSC submission to Retirement Income Review at Section 7.2.1.

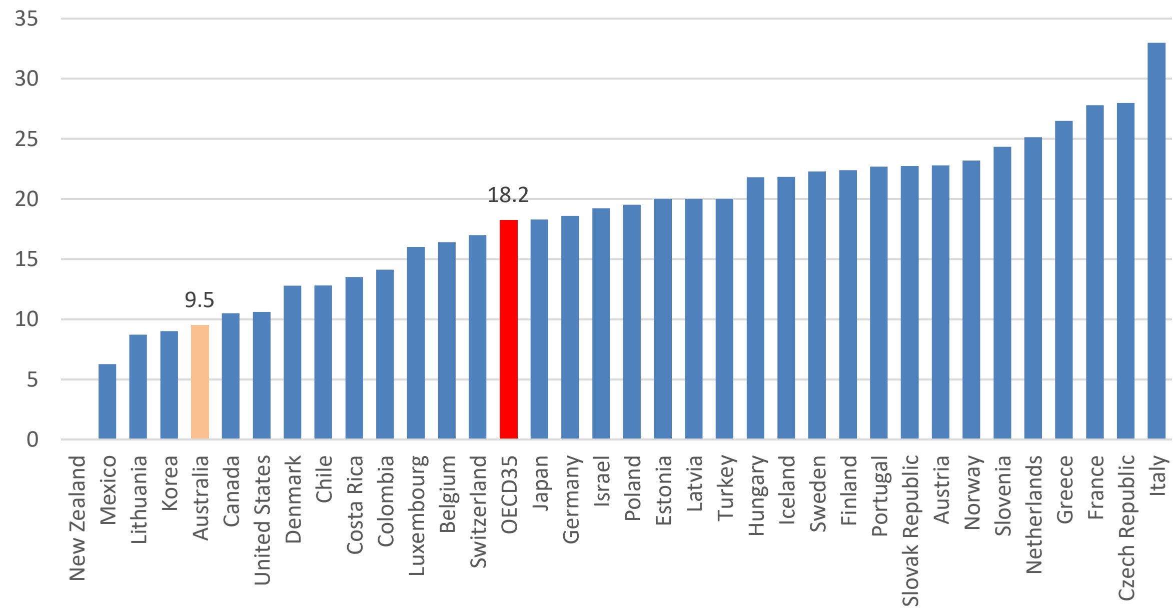
Source: OECD Pensions at a Glance, 2021, Table 4.2. This is the Government spending on pensions for a retiree in their first year of retirement, as a percentage of pre-retirement earnings.

The results in Figure 3 are for average income retirees; but even for retirees at incomes of 150 per cent of average, Australia and Chile still are the only countries that initially provide no Government spending – all other OECD countries provide some Government pension to this group at the time of retirement.[7]

The comparatively low level of retirement contributions in Australia are shown in Figure 4 below. In 2020, mandatory contributions in Australia were at 9.5 per cent, which was among the lowest rates in the OECD, and well below the OECD average of 18.2 per cent. Note in some other countries mandatory contributions fund age pensions, but Australia funds our Age Pension from general tax revenue.

The scheduled increases in the superannuation guarantee will raise this figure, but it will still be well below the OECD average.

Figure 4 – Mandatory pension contribution rates for an average worker



Source: OECD Pensions at a Glance 2021, Table 8.1. Figures are for 2020.

3.2 Further comments about adequacy

3.2.1 Superannuation returns

Retirement income adequacy depends heavily on the assumed superannuation returns, as the impact of compounding over decades can be large. As an example, $1.00 contributed today at age 20, after tax becomes $0.85, which then turns into the following amounts at age 65:

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[7] Source: OECD Pensions at a Glance, 2021, Table 4.2

Table 1 – impact of compounding in superannuation returns

If rate of return is…	Then savings at 65 are…
5.5%	$7.85
6.5%	$11.62
7.5%	$17.14

Source: FSC calculations.

This shows the large impact of differences in returns. Even a small reduction in returns from 6.5% to 6.4% reduces the retirement balance by $0.45, just over half the size of the contribution at age 20.

Most relevant studies find superannuation returns have been around 6.5% to 7.2% per year.[8] However, it is quite uncertain that these returns will continue into the future. Bond yields have fallen dramatically over recent years, while equity returns have remained strong.[9] This implies a large increase in the equity premium, which appears unsustainable in the long term. So, if bond yields remain below their historical average, equity returns will very likely decline over time to be much closer to bond returns. This will mean a decline in overall superannuation returns.

If a substantial decline in superannuation returns occurs, this will have a large impact on retirement savings. Either retirees will be worse off, or Governments will have to spend much more on the Age Pension, or both.

3.2.2 Longevity and future costs of ageing

Adequacy forecasts also depend on longevity and the costs of living in retirement.

It is well known that Australians are living longer, and this increases retirement income needs.

The inadequacy of Australian retirement incomes (see Section 3 above) is made worse when increases in longevity are factored in. The OECD projects substantial improvements in life expectancy at retirement. On average across the OECD, the life expectancy for a man aged 65 expected to increase by 4.5 years by 2065, and a woman aged 65 expected to increase by 3.9 years.[10] Any life expectancy increases mean retirement incomes fall even shorter of adequacy as savings will need to cover more retirement years. Furthermore, the probability of actually dying in the year of life expectancy is low (in other words, there is wide variation around the average). This means retirees either need to invest in longevity insurance (for example, annuities) or increase retirement savings to self insure.

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[8] See footnote 406 of Daley, Coates, Wiltshire, Emslie, Nolan & Chen (2018) *Money in retirement: More than enough*.
[9] The S&P/ASX 200 Total Return (gross) index grew by 11.9% p.a. in the three years to 3 February 2020. The RBA has said: "In many cases, [bond] yields are close to, or have reached, historic lows, and in some cases are negative" see: https://www.rba.gov.au/publications/smp/2019/may/box-b-why-are-long-term-bond-yields-so-low.html
[10] OECD Pensions at a Glance 2021, page 170.

The costs of living in retirement are also increasing. Many of these costs are being met by the Government, which is causing increased Budget pressures over time. The Parliamentary Budget Office (PBO) has argued[11] that an ageing population would subtract 0.4 percentage points from growth in revenue and add 0.3 percentage points to growth in spending over the decade 2019 to 2029. The total cost to the budget of ageing is forecast to be $36bn per year by 2028–29 in today's money. This includes increased Age Pension spending of $9bn, increased health spending of $3bn and increased aged care spending of $5bn.

This result assumes the Government is paying for all this increase in costs – but if retirees are expected to increase their contributions to costs then there is a greater need for increases in retirement incomes to pay for these increased costs.

[11] See: https://www.aph.gov.au/About_Parliament/Parliamentary_Departments/Parliamentary_Budget_Office/Publications/Research_reports/Australias_ageing_population_-_Understanding_the_fiscal_impacts_over_the_next_decade