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Australian Retirement Incomes: What's Next?

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Is the Australian retirement income system "all tip and no berg?" Does it have substance or only an appearance? Thirty years after the introduction of the first variant of compulsory private occupational superannuation, twenty-five years after the widening of the compulsion to all employees, and fifteen years after the contribution rate reached 9 percent of earnings, it is a reasonable time to ask the question: is it working? Is it doing what it was meant to? If not, why not and what can be done to make it work better? What next?

BACKGROUND

It is worth recapping the current state of the Australian retirement incomes system and how we came to be here. Australia has had a means-tested old age pension funded from general tax revenue on a pay-as-you-go basis since 1909. The level of pension is not overly generous, being set by government target to be approximately 25 percent of average ordinary time earnings. Currently, the maximum amount payable is approximately AU$35,000 per year to a couple living in their own home. Given the cost of living, that amount alone will not be sufficient for most retirees' needs and expectations. Nor should it be, of course. It is there as a safety net, to protect the poor, the aged and the infirm from destitution. While the pension amount is not large, it is worthwhile noting that to buy an annuity of that amount on the open market today at age 65 would cost a couple approximately AU$800,000, and more with inflation adjustment options and other favorable policy conditions.

The age pension is subject to a means test, both on assets and income. Most retirees will be eligible to receive part age pension rather than full age pension. Even so, the age pension and other welfare payments are the federal government's single largest expenditure item. For the 2017–18 year, 35 percent of federal government expenditure will go to social security and welfare payments. Income support for seniors is the single largest program in the social security and welfare category.[1]

By the late 1980s, the first form of compulsory occupational superannuation was implemented followed by the economy wide compulsory Superannuation Guarantee (SG) system. The SG started at 4 percent of earnings and gradually increased. It is currently 9.5 percent of earnings.[2] Employers must pay (at least) 9.5 percent of earnings for each employee (with some limited exceptions) to an approved superannuation fund. The money must be preserved until retirement. There are no conditions on how the money is received in retirement.

IS THE SG WORKING?

The SG system was introduced without any specified purpose. There was no objective established by the relevant government as to what the SG was for. In recent years, various attempts to define its purpose have been made, but as yet with no general acceptance. Therefore, it is difficult to assess how well it is doing. Broadly, it could be said that the aim of the SG is to supplement the retirement savings of Australians. But that is not specific—even $1 extra in retirement savings is a supplement. That objective says nothing about how much to supplement the savings, and nothing about the efficiency of the method in terms of minimizing opportunity costs.

Two structural points are worth highlighting. Firstly, the SG contribution is predominantly deferred wages. Other than those on the legal minimum wage (in many cases people are on the minimum wage during a transitional phase), the compulsory contribution is "paid for" by the employee in reduced wages, not as an extra amount on top of wages paid by the employer. Is it better for an employee to be forced into that position by law or to let that person make his or her own value judgments about the use of their money? Secondly, the age pension is means-tested. For every extra private dollar of savings, the age pension is reduced, and eventually phases out completely.

The data available on the size of savings that are being accumulated for retirement incomes are not particularly encouraging. According to the 12th annual HILDA[3] Survey, the median superannuation balance at retirement of men that retired in the four years prior to 2015 was approximately AU$325,000. For women, the figure was AU$110,000. The CSIRO Risklab Australia group published its analysis of Household Assets Among Australian Age Pensioners in June 2017.[4] It found that just over 50 percent of households were entering retirement with assets (excluding the family home) of less than AU$350,000. 85 percent of households enter retirement with assets less than AU$800,000.

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The bulk of Australians are entering retirement with assets insufficient to generate a retirement income payable for life at the rate of the age pension. It is true that the SG system is still maturing. It will take another 25 years before an Australian entering retirement will have had SG contributions at the level of at least 9 percent of earnings for their full working life. At this stage of the SG program, there must be some doubt about whether the Australian system is as good as some like to claim it is.

It remains common to hear some industry participants lobbying the government to increase the minimum rate of SG contribution to reduce the risk of inadequate retirement savings. While that is theoretically one way of improving retirement incomes, it is highly questionable on the grounds of efficiency. Not everyone will live longer than average—it is not necessary to assume a long retirement for all people. The higher rate of saving across all people during their working lives will result in more leakage of savings out of the retirement draw down phase from those that die after shorter periods of retirement. Those leaked savings could have been put to better use. The problem lies with our lump-sum delivery mechanism.

A significant clue to the effectiveness, or perhaps lack of effectiveness, of the Australian retirement income system unfolds annually. Virtually every year since 1983, the rules and policy settings for superannuation have changed. Some of the changes have been massively structural, some less so, but change after change is implemented by the government. If the system were working, then changes would be less frequent. The scale of the changes suggests the system is not working. Layer over layer of regulations have been added. Some layers created outcomes that had to be corrected by other layers of regulation. The regulatory burden on superannuation funds is enormous. Still the regulator is not happy. The Australian Prudential Regulation Authority (APRA), charged with the responsibility of prudential supervision of financial institutions in Australia, has announced that it intends to force funds that do not meet the interests of members, as judged by APRA, to wind up and transfer their obligations to another fund. Exactly what standards APRA will use to judge which funds it should terminate is not clear.

THE MISSING INCOME

The main topic of the current day is how to put the "income" into retirement income policy. The amount of retirement savings taken in the form of an income that has some form of protection against longevity or market risk is relatively small. Mostly, the retirement savings are accumulated in lump sum form, used in many cases to pay off debt or fund a holiday and then drawn down at whatever rate the retiree chooses. The retirees retain the market risk, the inflation risk and the longevity risk (along with operational risk of the institution entrusted to manage their investment). If they live too long, they rely on the pension. If they die early, they can pass on their residual assets to their estate.

With interest rates at current levels and with the prospect of increasing longevity, financing a retirement income of any meaningful amount on an individual basis without any component of mutuality, becomes ternary: a retiree will live too long, beyond what they were able to save for; or, they will die early and didn't need to save very much at all; or, they will get it right by dying approximately on time. The chances of getting it about right are less than the combined chances of getting it wrong. All the education and nudging and compulsion in the world to save more will not change the ternary nature of the problem.

The best outcome is to have people save what they need to fund retirement, no more and no less. The concept of mutuality allows this solution. Older style products with mutuality built in have fallen out of favor. Now the search is on for a modern day mutual product that will appeal to the retirees.

To get the income into retirement, there are two solutions currently available on the market. The first requires a financial promise underwritten by an institution. An annuity is one example. It requires capital to meet the financial promise and comply with regulatory capital adequacy requirements. Capital is not free and pricing a product to pay for the capital generally makes the product less attractive to consumers, where those consumers place too little value on certainty. The second requires voluntary pooling of risks with benefits limited to the existing remaining pool of assets. A longevity risk pool is an example. Pooling products exist, but the take up rate has been low.

The federal government released a consultation paper in December 2016 on the topic of comprehensive income products for retirement, or CIPRs. An earlier inquiry into the financial system had recommended development in this area. The government will now be considering stakeholder feedback. We are yet to know how government thinking will develop on the topic but there is potential for encouragement, or requirement, of the use of retirement income streams delivered by way of a product, in place of the long established practice of lump sums. It is too early to tell exactly what form such products could take.

WHAT NEXT?

What happens next for the retirement incomes of Australia depends on politics. If the federal government continues in the same vein as it has over the last 30 years, then not much will change in the way of effectiveness. Compulsion and restriction will continue to inhibit innovation. At best, we may see marginal improvements in efficiency driven mainly by technological advancements. However, the age pension will continue to be the dominant expense of the government's budget, policy makers will exhibit frustration that ordinary people are not saving more and may react with further layers of regulation. Some kind of pooled risk product may become compulsory for retirees to use. The community will remain uninterested in superannuation. Those firms that provide the intermediate services such as investment management, administration, insurance, consulting, and advisory will continue to take their cut and be criticized for doing so. Whole careers of people will come and go as discussion continues through future years as to what the real purpose of the SG is. Someone will ask the question in 2040 as to whether the Australian retirement income system is all tip and no berg.

Alternatively, the politics could change. Economic stagnation results in frustration among the people and in such times, genuine change in governments can emerge. It has happened before and could happen again that a reforming government could gain power and strip away various layers of regulation and compulsion. If that occurred, there would be greater incentive for innovation in financial product design. There is growing evidence that the SG system in Australia has not had as much effect on the cost of the age pension as might have been expected 25 years ago. Our system requires the deferment of wages into savings that then reduce the taxpayer-funded age pension. Is it not reasonable for many people to then minimize such savings, or spend those savings on other items so as to maximize the pension? Is our system inherently self-defeating? Compulsion is not a substitute for good policy.

Disclaimer: The views expressed in this article are those of the author and are not necessarily those of Willis Towers Watson, the Society of Actuaries or the International Section.

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ENDNOTES

1 see Budget Paper: *http://www.budget.gov.au/2017-18/content/bp1/download/bp1_bs6.pdf.*

2 Earnings are capped for this purpose. Currently SG contributions are not required for earnings in excess of AU$206,000/ann.

3 Household Income and Labour Dynamics in Australia Survey. (*https://melbourneinstitute.unimelb.edu.au/__data/assets/pdf_file/0010/2437426/HILDA-SR-med-res.pdf*)

4 *https://publications.csiro.au/rpr/download?pid=csiro:EP174179&dsid=DS1*