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A Robust Retirement Income System

The Retirement Income Consultation Paper released on 10 December 2008 contains the following question:

> Q4.2 What is the role of individuals in dealing with investment and longevity risk in accumulating and drawing down their retirement income? Do financial markets provide the means to deal with these risks? If not, is there a role for government to address these shortcomings?

The answers to these questions depend upon the structure of the retirement income system.

To be robust a retirement income system must take account of the following:

- the decisions of individuals have an important part to play in managing their retirement income risks;
- financial markets can provide some assistance in meeting these risks if skilfully employed but, if not, can increase the risks; and therefore
- there is a crucial role for government in regulating the structure of retirement income provision to meet inherent risks.

Australia's three pillar retirement income system provides the three basic elements, namely:

- A government-provided Age Pension;
- compulsory savings enforced through the superannuation guarantee (SG); and
- voluntary savings (both through superannuation and other sources).

The Age Pension has been seen primarily as a means of providing basic support for those unable to save for their retirement, but it has also become through payment of partial Age Pension an important supplement where other sources of retirement income are insufficient. Thus it is also a means of offsetting the risks inherent in retirement income provision.

For the majority of the working population, the key retirement income provision is made through the employment related superannuation guarantee (SG) scheme or other employer related superannuation provision. At present the SG is limited to 9 percent of salary or wages, although it is understood to have been intended originally to be higher.

Indeed it is clear that the present level of compulsory SG contribution is too low. The current economic circumstances, however, do not favour an increase right now. But the percentage needs to be increased as soon as practicable. It is noted that the recent Review of Military Superannuation put forward figures ranging from 16.5% to 28% depending on length of service.

The context in which SG contributions are made is normally to a defined contribution scheme, within which funds are accumulated and invested, and are payable either as a lump sum for investment by the recipient at the time of retirement or as an account based pension. Employer based superannuation schemes, such as public service superannuation schemes were traditionally defined benefit schemes, under which a specified percentage of final salary was paid as superannuation, in some cases with a specified basis for indexation of benefits to keep abreast of cost increases. There has been a shift away in all sectors from defined benefit schemes to defined contribution schemes.

To the extent that the SG or other employee based superannuation schemes place upon the individual employee the decision as to the investment of his/her superannuation fund, the individual becomes responsible for important elements of risk as well as the potential for growth in the size of their potential retirement benefits.

It is understood that many SG and other employer based funds would limit the choices of individuals to certain specified broad categories of investments, at least until retirement, and would provide guidance for the post retirement investment of funds. Although investment in equity and other market based funds can be expected to generate good returns and capital growth in the long term there remains, however, considerable risk in the event of substantial downturn in equity and other markets. It is not easy to see a means of protecting individuals who enter into retirement at a time when the market is substantially depressed as is the case now.

Another problem in reviewing an income retirement system is longevity risk, the risk that people may outlive their superannuation resources or other retirement savings. This, of course is a simple fact of life and again it is not easy to see how existing structures can provide a solution.

Both these risks (investment and longevity) justify some further Government intervention. At present there is a form of Government assistance for individuals adversely affected by these risks i.e. the Age Pension which can and often does provide essential back up support.

In looking at the Retirement Income System one should not neglect the third pillar although it is predominantly a matter for private savings. It has long been recognised that the main form of saving for retirement of a substantial proportion of the population has traditionally been the ownership of the family home. This has been encouraged by various forms of public policy ranging from grants for new home buyers, to exemption from capital gains tax and lenient treatment of the asset value of the family home in age pension asset tests. A common practice for many retirees is to use up their lump sum superannuation benefits to pay off the mortgage on their home.

In general measures through the taxation system or otherwise to encourage private saving are helpful in ensuring that the retirement income system is robust.

However it does seem that further government regulation or assistance is required to provide a workable degree of insurance against both investment and longevity risks.

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