FINANCIAL PLANNING ASSOCIATION *of* AUSTRALIA

Consultation on the Objective of Superannuation

FPA SUBMISSION | 6 April 2016

Division Head
Retirement Income Policy Division
The Treasury
Langton Crescent
PARKES ACT 2600

By email: superannuationobjective@treasury.gov.au

6 April 2016

RE: Consultation on the Objective of Superannuation

Dear Sir/Madam,

The Financial Planning Association of Australia (FPA) welcomes the opportunity to provide a submission to the Treasury on the objective of superannuation. Our submission responds to the issues raised by the Objective of Superannuation Discussion Paper, including concerns we have about aspects of the objective proposed by the Financial Systems Inquiry (FSI). We have also included alternative recommendations for your consideration.

Thank you for the opportunity to make a submission to the Treasury and we welcome further opportunities to provide feedback. If you have any questions, please do not hesitate to contact me on (02) 9220 4500 or dimitri.diamantes@fpa.com.au.

Yours sincerely,

Dimitri Diamantes
Policy Manager
Financial Planning Association of Australia

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Treasury Consultation

FPA submission to:
The Treasury

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Introduction

The FPA supports the establishment of broad social and economic objectives for the Australian retirement system. Superannuation is an important pillar in that system as it provides a tax-advantaged investment vehicle in return for preserving benefits until retirement. If appropriately targeted, these arrangements help bridge the gap between retirement expectations and outcomes.

However, the risk of changes to the system that are detrimental to the member can undermine confidence and reduce voluntary contributions. Given the need for stable policy settings, it is important that the Government sets policies that are fiscally sustainable for the long term.

With these issues in mind, we have recommended objectives to both help align Australians' retirement expectations with their retirement outcomes and respond to the fiscal challenges faced by Government. In developing alternative recommendations, we wish to retain a high degree of flexibility in the superannuation system. For example, we have recommended that the objective be drafted widely enough to clearly allow people to continue to draw their superannuation as a lump sum.

We also believe that most Australians can benefit from high quality financial advice. Such advice improves retirement outcomes by helping clients get and stay on track to achieving their goals. We believe most people would benefit from such coaching and guidance.

One way of encouraging more people to obtain high quality advice is making upfront advice fees tax deductible and ensuring advisers adhere to high educational, ethical and professional standards.

We have also suggested that, if possible, these objectives be enshrined in entrenched legislation. This would make it difficult to change or remove the objectives, thereby enhancing trust and confidence in the superannuation system.

Objectives of the superannuation system

Retirement income
The FPA agrees that provision of income is an important objective of the superannuation system. However, the FPA believes the primary objective of the superannuation system should include providing retirees with dignity and independence by achieving a comfortable standard of living in retirement, without those individuals needing to take excessive risk.

The FSI's formulation of the primary objective effectively sets the minimum acceptable standard of living in retirement as whatever is being provided by the Age Pension. Defining the objective in terms of a comfortable standard of living sets a higher minimum acceptable standard. With the higher standard, which is harder to achieve, some weight might be given to the individual member's role in not achieving the desired retirement outcome (rather than blaming the system alone).

It is not intended that a comfortable standard is exactly the same for everyone. It might be expected that two individuals have different definitions of what is comfortable for themselves. However, it is intended that a comfortable standard of living is higher than what is currently provided by the Age Pension.

The distinction between, on the one hand, a standard of living in retirement based on pre-retirement earnings and the standard provided by the Age Pension is critical. We'd suggest that the former (not the latter) drives most Australians' retirement expectations. We'd also suggest that setting the bar high will encourage policies that use limited Government resources more efficiently, to help Australians avoid disappointment.

Providing for a comfortable standard of living would allow the member to accrue enough wealth in superannuation to give them confidence they will achieve a comfortable standard of living. It is therefore appropriate to set aside savings to allow for contingencies such as unexpectedly low returns or living longer and unexpected costs in retirement. Without this reserve, there is not enough confidence the member will achieve a comfortable standard of living.

The objective should also be flexible enough to allow people to draw retirement savings as a lump sum, for example to: pay for a holiday or durable items; invest; or pay down debt. This is because different people might achieve the same standard of living in different ways. For example, one person might prefer to draw some of their retirement benefit as a lump sum to buy a car, and draw the rest as an income stream. Another person might prefer to take all their retirement benefit as an income stream and use this income to hire cars or take taxis from time to time. Each person might be optimising their consumption pattern based on their preferences.

Some might be concerned that providing lump sums increases the risk that people will use their retirement savings without first ensuring they would still be on track to achieving the desired living standard. However, in 2013-14 83% of the value of superannuation retirement benefits was invested in superannuation income streams.[1] Only 10% of retirement savings were taken as full lump sums, the rest being taken as partial lump sums.[2] Lump sums were generally used to save, with at least one-third of the lump sums being reinvested and much of the remainder used to pay down debt, a form of saving.[3]

Policymakers might be concerned that reinvesting retirement savings outside the superannuation system removes Government control over how the savings are subsequently drawn down, meaning people could squander their nest egg. However, if our starting point is that individuals should be free to use their savings unless there's a good reason to limit or deny that freedom, the onus would be on those who assert that superannuation should only be assessed as income to justify their claim.

87% of superannuation accounts (excluding SMSFs) with balances of $300,000 or greater were taken as an income stream, compared with only 28% of accounts with balances of $50,000 or less. It might appear that those on the lower balances could increase their Age Pension entitlements by withdrawing a lump sum. However, it would seem reasonable to assume that those with the lower account balances

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[1] Rice Warner and CFS, *Colonial First State Income Stream Index* as found in Pre-budget myth breaker: we are not a lump sum society http://ricewarner.com/pre-budget-myth-breaker-we-are-not-a-lump-sum-society/
[2] *Ibid.*
[3] *Ibid.*

would be more likely to be entitled to the full Age Pension even if they took their superannuation as an income stream.

The FPA's recommendation supports income provision as an important purpose of superannuation, while also supporting the need for flexibility as to the form in which benefits are withdrawn. The FPA's recommendation also supports a higher target standard of living – a comfortable living - than that currently afforded by the Age Pension.

Recommendation 1: The FPA recommends that the primary objective of superannuation be the following: *To provide income and capital in retirement to provide a comfortable standard of living.*

Death benefits

It is likely - based on life expectancy statistics - that many retirees who save enough for a comfortable retirement will have money left in the superannuation system on their death. Any leftover savings at death might not represent excessive wealth but simply the product of good risk management or the member not meeting their estimated life expectancy.

Further, retirement funding should be understood in a broad sense. For some people, a comfortable retirement includes providing financial support to others. The objective of superannuation should be broad enough to allow for a bequest motive based on the financial support members might have provided to others during their lifetime.

As such, the FPA recommends that superannuation benefits remaining at the member's death are generally treated as a form of normal retirement benefit (rather than excessive benefits, which could potentially be subject to unfavourable treatment).

Having an objective of providing superannuation benefits on the death of a member sends a strong signal that members can provide for contingencies (rather than just enough to meet their desired standard of living if everything went to plan) without these benefits being undermined on the member's death. To do otherwise, would create complexity as there could be an incentive for members to hold their savings for contingencies outside superannuation.

Such an objective also allows for the bequest motive discussed above.

Recommendation 2: The FPA recommends that a subsidiary objective of superannuation be the following: *To provide superannuation benefits on the death of the member.*

Consumption smoothing

While the FPA recognises that consumption smoothing is a key function of superannuation, use of some savings (for example, for large, one-off purchases) is covered by that function, as such use of resources can provide a better quality of life for some individuals than using those savings to fund an income stream. For example, a person who buys a car will typically use the vehicle over an extended period of time. The use of the vehicle over time is a form of consumption. It is this subsequent consumption that is relevant in assessing the smoothness of consumption over time.

When durable assets are seen as consumed over time, it is easier to see that withdrawing a lump sum to pay for such an asset may lead to the same ultimate consumption as, say, hiring an asset from time to time using income drawn down from retirement savings. For example, hiring a car or taxi may lead to as smooth a consumption outcome as buying a car and using it over an extended period.

Further, consumption smoothing should not be equated with maintaining real income over time. Smoothing merely implies some reduction in the peaks and troughs of consumption than would be the case without saving.

As discussed above, superannuation should be flexible enough to allow people to withdraw benefits as income or lump sums. Similarly, consumption needs to be understood broadly so as to cover the use of an asset over time. Finally, consumption smoothing should not be taken as maintaining real income over time.

Recommendation 3:

The FPA recommends that a subsidiary objective of superannuation be the following: *To facilitate consumption smoothing.*

Managing financial risks in retirement

The FPA agrees that helping manage financial risks – such as longevity risk, investment risk, inflation risk and sequencing risk - is an objective of the superannuation system. The FPA understands that the intention of this objective is to facilitate the provision of strategic and product solutions (including risk transfer products) to such risks.

As already discussed, good risk management involves setting aside savings for contingencies. Further, the system needs to provide flexibility to allow members to deal with catastrophic events (for example, a global financial crisis around retirement age). Members need the flexibility to make additional contributions to ensure they can still meet their retirement goal (even if they've already contributed what would have reasonably been expected to be enough to live comfortably and with confidence).

Recommendation 4:

The FPA recommends that a subsidiary objective of superannuation be the following: *To help people manage financial risks in retirement.*

Be fully funded from savings

The FPA holds that this objective is unnecessary as, we understand, it is only intended to restrict unfunded superannuation schemes (rather than insurance or other risk-transfer products). Such schemes are rare and there does not appear to be any appetite to increase the scale on which they are provided.

Recommendation 5:

The FPA recommends that the proposed subsidiary objective of superannuation, *To be fully funded from savings,* not be included in the final objectives.

Invested in best interests of superannuation fund members
The FPA agrees that superannuation should be invested in the best interest of fund members. However, the FPA also believes this objective should clarify that there may be appropriate considerations other than simply maximising risk-adjusted returns (for example, pursing a common social goal of the members or only investing in ethical projects).

The FPA takes the term ”best interests” to cover this broader range of interests discussed above. However, for clarity’s sake, we would recommend that the explanatory material for the legislation enshrining these objectives expressly state that “best interests” include financial and other interests, such as ethical and social interests.

There is a concern that explicitly promoting the other interests of members may inadvertently promote the abuse of the superannuation system, for example, by providers investing superannuation assets in projects suited to their own interests or purposes rather than those of the members. However, this concern needs to be balanced against the need to allow members to determine their own interests (including beyond just financial interests).

The FPA believes balancing these competing concerns is a matter for specific policy rather than the high-level principles reflected in the objectives.

Recommendation 6:

The FPA recommends that a subsidiary objective of superannuation be the following: *To be invested in the best interests of superannuation fund members.*

Alleviate fiscal pressures
The FPA understands that the retirement income system needs to be fiscally sustainable for Government. However, setting an objective of alleviating fiscal pressures on Government potentially means the system is still exposed to constant change. This may be counter-productive to the policy objective of ensuring people achieve a comfortable standard of living in retirement, as some members who do have savings capacity may be less inclined to save than if the superannuation system were expected to be stable.

A more strategic approach would be to build trust and confidence in the system (including by committing to policies for the medium to long term), which would encourage those that have savings capacity to contribute to the system.

The FPA accepts that taxation and other incentives to contribute to superannuation are important as they help bridge the gap between retirement expectations and outcomes. Given the need for stable policy settings, it is important that the Government commits to policies that are fiscally sustainable for the long term.

Given the fiscal constraints, improved retirement outcome – broadly, more people having a comfortable retirement - can only be made through allocating Government support more efficiently. The most efficient way of using limited Government resources is to target – in as simple a way as practical - Government support to those who wouldn't otherwise save for themselves.

Recommendation 7:

The FPA recommends that the proposed subsidiary objective of superannuation, *To alleviate fiscal pressures on Government from the retirement income system,* be replaced with: *To build trust and confidence in the superannuation system.*

The FPA also believes that the objective should clarify that the Government support should be targeted in a consistent and fair way. Fiscal management that is not consistent or fair is not only of inherent concern, but also has the potential to undermine public confidence in the system. As already discussed, lack of confidence in the system discourages people from investing in super, without any social or economic benefit in return. Explicitly including consistency and fairness in the objective will reduce such an effect on investment decisions.

It should be noted that consistency and fairness may allow different people to be treated differently. For example, it may be considered fair to target tax concessions to those who find it more difficult to save for their retirement. The point is that relevant criteria need to be identified to justify different treatment.

Recommendation 8:

The FPA recommends that a subsidiary objective of superannuation be the following: *To ensure the superannuation system is consistent and fair.*

Simple, efficient and safeguarding

The FPA agrees that the superannuation system should be simple and efficient, and provide safeguards. A compulsory system should be simple to use and understand, as the users of the system are generally not experts in the system they're using. For the same reason (and also because some users are disengaged), the system needs prudential oversight to help align outcomes with the best interests of members.

The need for oversight requires some complexity. For example, more detailed technical rules may be required to ensure artificial and contrived strategies to access Government support are curtailed. However, in the range of interactions an ordinary user would have with the superannuation system, the user should find the system easy to use and understand. This minimises the costs associated with uncertainty and misunderstanding.

Simplicity is undermined through constant changes to the system. A stable system that is simple in design will have lower operational costs as well as costs associated with uncertainty and misunderstanding, enhancing both operational and allocative efficiency.

Efficiency requires minimising costs through competition and productivity. The general disinterest of superannuation members in the Australian system[4] - which is, perhaps, not unexpected in a broad-based compulsory contribution system – hampers efficiency because members tacitly accept the costs of their default fund/investment (regardless of the competiveness of that default).

While some of this wastage in costs to consumers is offset by tax concessions or transfer payments, the same outcome could be achieved (for a lower level of Government support) where costs were minimised for the value provided.

Efficiency also requires minimising the system's distortion of users' decisions, except to achieve a desired policy outcome. For example, the Government provides tax concessions to encourage people to contribute to superannuation; in return for people deferring access to savings to help ensure they have the threshold standard of living in retirement.

As already mentioned, the most efficient way of using limited Government resources is to target Government support to those who wouldn't otherwise save for themselves. Where the existing policy levers (and just those levers) and Government funding levels can be used to reduce the gap between retirement expectation and outcomes by the around the same amount as an alternative framework, the existing framework should be preferred. This is because there is less drag on efficiency due to change and complexity.

As already mentioned, high quality advice is one way of achieving the desired policy outcome of bridging the gap between retirement expectations and outcomes. One way of encouraging more people to obtain advice is making upfront advice fees tax deductible and ensuring advisers adhere to high educational, ethical and professional standards.

While fees relating to superannuation can, in effect, be paid pre-tax, a client may require advice that goes beyond this field. While superannuation is an important part of funding an individual's retirement and a pillar in the retirement system, it is not the only savings vehicle. There are a number of other mechanisms that can assist self-provision in retirement.

Members should be encouraged to maximise their self-funded retirement through superannuation and other means. One of the most comprehensive ways to achieve this is through considered personal financial advice. We should maximise the opportunities for people to save for their own retirement by encouraging them to seek advice.

[4] Murray, D., Davis, K, Dunn, C., Hewson, C. and McNamee, B. 2014, *Financial System Inquiry Final Report*. Final Report, November, http://fsi.gov.au/files/2014/12/FSI_Final_Report_Consolidated20141210.pdf (accessed 1 April 2016).

While this will be a drain on Government revenue, there will be a social payoff by reducing the gap between people's retirement expectations and outcomes.

The FPA agrees with the FSI's proposed formulation of the objective as it covers all the relevant elements (as discussed). The FPA believes that a more detailed understanding about the balancing of potential conflicts between, on the one hand, the degree of simplicity required for ordinary members, and, on the other, the need for sophisticated safeguards is best developed over time as specific cases are considered.

Recommendation 9:

The FPA recommends that a subsidiary objective of superannuation be the following: *To be simple and efficient, and provide safeguards.*

Location of legislation

The FPA accepts that the purposes of the objectives do not include influencing the interpretation of other law. Presumably, the risk of the objectives affecting the interpretation of other legislation is minimised by locating the objectives in a stand-alone Act.

Presumably, the purpose of the objectives is to provide principles by which the design and performance of the superannuation system will be assessed. The FPA recommends that the stand-alone Act also contain provisions mandating that an independent body periodically assess the superannuation system (both in its performance and its design) against the objectives. The stand-alone legislation should also be accompanied by explanatory material that covers the points raised in the FPA's commentary in this submission about each of the objectives.

Further, all legislation, regulations and other instruments - as well as government administrative decisions - that fall within the field of superannuation should be assessed against the legislated objectives of superannuation before being made. For example, the explanatory material accompanying superannuation Bills should have a section on the compatibility of the Bill's provisions with the objectives of superannuation.

Finally, a mechanism for entrenching both the objectives and that mechanism itself should be considered. (It is understood there are practical difficulties in enshrining the objectives in the Constitution; and that there are different views about whether the Federal Parliament has the power to prescribe the manner or form required to change legislation.[5]) Building trust and confidence in the superannuation system also requires trust and confidence in the permanence of the objectives against which the superannuation system will be judged.

[5] See, for example, George Winterton, 'Can the Commonwealth Parliament Enact "Manner and Form" Legislation?" (1980) 11 *Federal Law Review* 167 and Aroney, N. *et al*, *The Constitution of the Commonwealth of Australia History, principle and interpretation* (Cambridge University Press, 2015) 109-111

Recommendation 10:

The FPA recommends that: *The objectives of superannuation be legislated in a stand-alone Act that requires an independent body to periodically assess and publicly report on the design and performance of the superannuation system against the objectives.*

Conclusion

Our recommendations are based primarily on the need to build trust and confidence in the superannuation system; and the need for flexibility to allow individuals to make decisions in their own interests. While we recognise the fiscal challenges facing Government, we believe that better targeting of tax concessions and support will allow the Australian superannuation system to provide a higher standard of living in retirement to most Australians than would be afforded by the Age Pension alone.