BetaShares
Exchange Traded Funds

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Retirement Income Review Secretariat
The Treasury
Langton Crescent
PARKES ACT 2600

By email: retirementincomereview@treasury.gov.au

To whom it may concern

Retirement Income Review Consultation Paper, November 2019

BetaShares commends the Australian Government for commissioning an independent review of the retirement income system and welcomes the opportunity to comment on some of the issues raised in the consultation paper.

Retirement income systems are by their nature complex. By global standards, Australia has a highly regarded system. The three pillars (a means-tested age pension, compulsory superannuation and voluntary savings) ensure that all Australians have at the very least a safety net, and in most cases additional resources to provide for a good quality of life in retirement.

However, as the system has evolved, it has become complex. This has led to unintended outcomes in certain situations, which are not always in the best interest of either retirees or the Government.

In our submission, we focus on outcomes relating to the interaction between the means tested pension and the other pillars, superannuation and savings. Tapering of pension entitlements based on income and assets influences the behaviour of retirees when deciding whether to spend or save. Specifically, the progressive withdrawal of the pension as assets increase creates a bias towards short-term spending ahead of using assets to generate long-term additional income.

We strongly believe that retirees should be able to choose whether to spend or save, without having to consider how the system will respond to that choice.

We propose a model in which the pension becomes universal and the current means tests are removed. Where possible, this pension is funded by a portion of compulsory superannuation contributions being streamed into defined benefits schemes. To ensure that all Australians receive a minimum basic pension and level of benefits, the Government will still cover any shortfall. We realise that many assumptions are made in this model and that much work is required to make it complete, however, we believe it will result in a more consistent system with stakeholders' interests more aligned than they are in the current one.

We understand that changing the large and complex Australian retirement income system is a significant task. Changes are bound to be controversial as they will affect stakeholders in different - sometimes opposing - ways. Nonetheless, we urge the Panel to consider the issues and proposed solutions in our submission.

We are proud to contribute to the overall debate and discussion in the interests of improving the retirement income system, for all retirees and for Australia.

Again – thank you for the opportunity to be part of this review.

Yours sincerely

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Retirement Income Review

Response to November 2019 Consultation Paper

Executive Summary

The income and assets tests used to determine Government pension entitlements can, for retirees with certain asset balances, produce unintended and undesirable outcomes. These outcomes tend to bias retiree decision-making towards:

- choosing to spend additional money, rather than using it to generate retirement income;
- consciously reducing asset balances and/or income to ensure that some pension is received (so that entitlements such as a health care card are retained); or
- where additional amounts are invested, setting high and unrealistic return thresholds seeking to replace foregone pension entitlements.

We propose a model which seeks to create a more coherent system, where choices can be based on needs and requirements without influence from the unintended consequences of those choices. This model sees the introduction of a universal pension and removal of the assets and income tests. A retiree can choose to spend or save additional income or assets based on their circumstances, without that choice being distorted by the structure of the system.

Underlying this model is the requirement that any changes to current practice result in a system which leaves no retiree worse off than they are in the present system. Furthermore, it aims to reduce the fiscal burden on the government by requiring all (working) Australians to contribute towards funding their pension through superannuation contributions. This is achieved by streaming contributions into two components:

- stream funds into (future) pension entitlements via approved and regulated defined benefit schemes;
- stream funds into defined contribution schemes, much the same as those which exist currently.

Further work is required to determine the split between these two streams. Broadly, it would be based on age, income, current balances and future retirement income profiles.

About BetaShares

BetaShares is a leading Australian manager of exchange traded funds (ETFs). Based in Sydney, our first product was launched in December 2010. We now offer 60 products which are traded on the Australian Securities Exchange (ASX). BetaShares currently has ~$10 billion in assets under management. BetaShares is making this submission due to the position it has in the marketplace as a provider of low-cost, transparent investment products to a broad client base – many of whom are retirees or near retirement.

We believe the current system can be improved to be better aligned with the interests of all retirees – irrespective of whether they are BetaShares' clients.

Introduction[1]

By world standards, Australia has a well-regarded retirement system. Compulsory superannuation and regulations around managing superannuation balances means that Australian retirees are relatively well-off[2], and can enjoy decent levels of income in retirement.

Despite this, the current system encourages outcomes which are not always aligned with increasing income in retirement and reducing the fiscal burden on the Government to provide for retirees. Retirees' decisions around how to use their savings are not solely based on the merits of their choice. Rather, they also factor in how the system will respond, through changed entitlements. Generally, a decision to spend or save will favour the former, as saving results in decreased entitlements, which in many cases are disproportionately punitive compared to the benefits of spending. This also applies when choosing whether to spend or save additional income or capital received during retirement.

Context

The current retirement income system is based on three pillars[3]:

- Government-funded age pension;
- Compulsory superannuation; and
- Voluntary savings (superannuation and other)

An assets test and an income test determine pension (and other) entitlements based on levels of superannuation and other assets, plus income from these and other sources (including employment). As these levels increase, pension entitlements are phased out. Above certain levels, all pension (and other entitlements) cease.

[1] This work does not comment on levels of superannuation contributions. All assumptions are based on current contribution rates. All thresholds and levels are based on their current values.
[2] https://www.monash.edu/__data/assets/pdf_file/0016/2010526/MMGPI-2019-Report.pdf
[3] https://treasury.gov.au/sites/default/files/2019-11/c2019-36292-v2.pdf

Structural Anomalies

A known consequence of the interaction between the first pillar and the other two pillars is that there is a band of savings levels where additional balances (from income or asset increases) can actually lead to lower levels of retirement income, because of the resulting reduction in the Government pension. This effect, variously termed the **"Retirement Trap"** or the **"Pensioner Taper Trap"**, has been illustrated and modelled by a number of researchers[4,5,6]. This is illustrated in Figure 1.

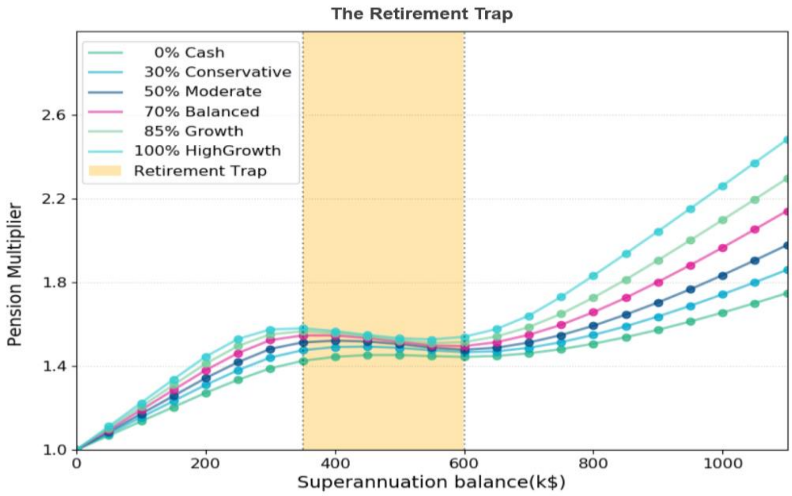


Figure 1: Illustration of increases in retirement income (as a multiple of the government pension) for various asset balances and investment strategies. Source: CSIRO.

This system does not encourage retirees within the "Retirement Trap" to deploy additional assets to generate income. Rather, spending, or directing resources towards assets which are exempt from the assets and income test (such as investing in the principal residence), can result in a benefit greater than the additional income that may be derived.

Outcomes from the current system include:

- Additional savings, when invested, do not always translate into additional - and in some cases can actually lead to reduced levels of - retirement income;
- Seeking to derive increased retirement income from additional savings may entail assuming levels of risk which are well beyond what is normally recommended for retirees;
- Spending, or directing additional resources towards exempt assets, rather than saving, is implicitly encouraged by the system.

These effects bias the behaviour of retirees - especially those who receive a full or part pension – towards spending rather than saving. Ultimately, this puts an increased burden on

4 https://www.betashares.com.au/files/collateral/BetaSharesTheRetirementTrap.pdf
5 https://nationalseniors.com.au/uploads/End-the-pensioner-trap-media-release.pdf
6 https://nationalseniors.com.au/uploads/Taper-Rate-Fact-Sheet-for-Media-release-002-.pdf

the Government by discouraging retirees receiving pension entitlements from becoming more self-sufficient.

A Model to Avoid The Traps

There are many solutions - either as modifications to the current system, or as completely new systems - which do not suffer these same limitations.

We propose a system where:

- The government pension is universal (ie. the income and assets tests are discarded);
- As much as possible, the pension is funded by individuals;
- No individual is worse off than in the current system; and
- The financial burden on the Government is decreased from the present.

This model is described in detail in a collaboration between BetaShares and the Monash Centre for Financial Research: "Pitfalls in the Retirement System and some thoughts about Risk, Reward and Remediation"[7]. The reader is encouraged to refer to this source for further detail. A PDF copy of the paper has been supplied for completeness.

How This Is Relevant To The Retirement Income Review

Many of the issues raised in the Australian Government Consultation Paper[3] for this review are addressed by the framework proposed above. We now address some of the specific questions raised in the Paper, with reference to the proposed model.

Questions Addressed:

The retirement income system

1. Are there aspects of the design of retirement income systems in other countries that are relevant to Australia?

Australia can learn from the successes and failures of a universal pension provided in various countries.

Where the universal pension has failed, that failure has primarily been due to problems around ensuring that it is funded at sustainable levels. However, a full or partial universal pension is successfully part of the retirement system in many countries. In the recent Monash Mercer Retirement Survey[2], Australia's retirement system ranked third overall behind the Netherlands and Denmark, with Finland, Sweden, Norway, Singapore and New Zealand close behind Australia. Of this top cohort, the Netherlands and New Zealand have a universal pension, while Denmark, Norway, Finland and Sweden ensure that all retirees receive a minimum level of pension via a combination of state and private funding (some of which may be means tested). Australia, together with some of this latter group, has a means-tested pension, although the combination of an assets test and an income test is unique to Australia.

[7] https://www.monash.edu/__data/assets/pdf_file/0008/2044943/Pitfalls-in-the-Retirement-System-and-Some-Thoughts-about-Risk-Dec-6.pdf

Australia is well-positioned to use a best of breed approach to implement a best practice universal pension within its retirement income system.

Purpose of the system and role of the pillars

4. What are the respective roles of the Government, the private sector, and individuals in enabling older Australians to achieve adequate retirement incomes?

Superannuation savings are the backbone of Australia's retirement income system. The majority of super balances are managed by industry funds (27.18%), retail funds (26.7%) and SMSFs (32.3%), with the remainder in public sector and other funds[8].

Under our model, funds management will be segmented into defined benefit schemes (to fund the universal pension) and defined contribution schemes. Both schemes can exist within the public and private sector.

Defined contribution schemes will continue largely unchanged from the current system. Individuals will have flexibility and choice as to where their contributions are directed and how they are invested.

Defined benefit schemes will require (massive) pooled funds to be set up. These must operate within a rigorous actuarial framework, to ensure that they are run sustainably and efficiently. This will require the Regulator to manage and monitor the framework to ensure that it reflects its objectives. The Regulator will also monitor individual defined benefit funds, to ensure that they meet or exceed their objectives. This will require extensive input from both the Government and the private sector, with, ultimately, the Government setting the rules and governance framework.

Empowering the Regulator to provide the necessary oversight of the implementation and efficacy of the retirement system will be vitally important.

5. The Panel has been asked to identify the role of each of the pillars in the retirement income system. In considering this question, what should each pillar seek to deliver and for whom?

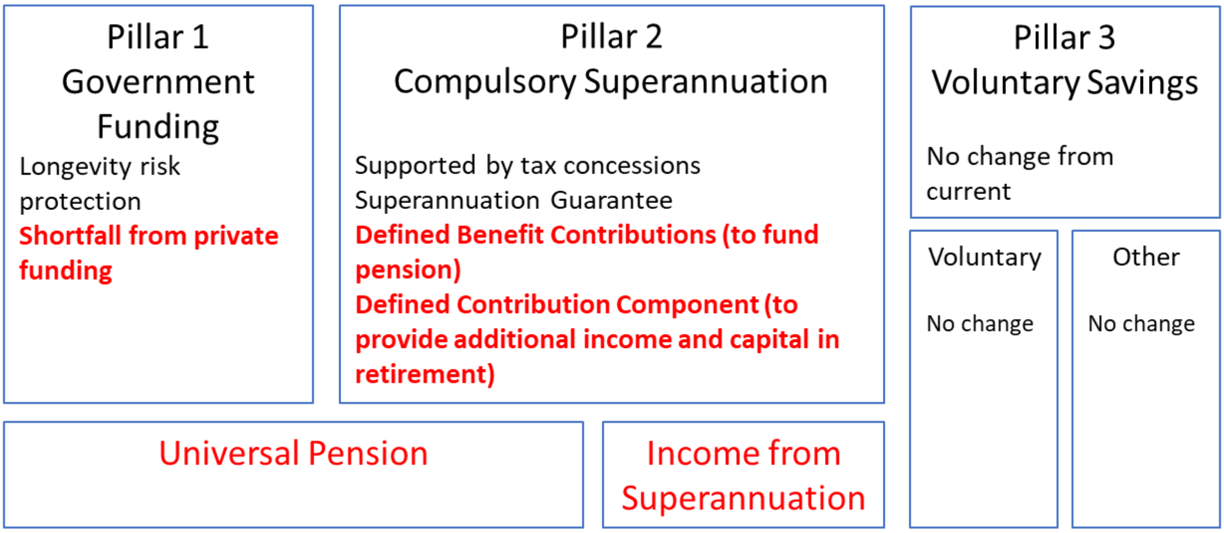
Under our model, the three pillars would be modified so that:

- Pillar 2 (Compulsory Superannuation) is streamed to fund in full, or part, the universal age pension, as well as to provide additional income and capital for retirees;
- Pillar 1 (Government Funding) would address any shortfall in funding of the universal pension; and
- Pillar 3 would remain largely unchanged.

A diagram of this appears in Figure 2.

[8] Source: 2018 data from https://public.tableau.com/views/KPMGSuperInsights/Super?:embed=y&:display_count=yes&:showVizHome=no

Figure 2: Proposed Three Pillars



6. What are the trade-offs between the pillars and how should the appropriate balance between the role of each pillar in the system be determined?

The major change to Pillar 2 (Compulsory Superannuation) is that contributions are streamed into the two components described above. Optimum streaming is complex and is still to be determined. Streaming too little towards funding the pension (through the defined benefit component) will increase the burden on Pillar 1, while streaming too much will leave retirees worse off than they are in the current means-tested system. Further work is required to ensure that the outcome is an improved system with a lower burden on the Government.

Principles for assessing the system

8. Are the principles proposed by the Panel (adequacy, equity, sustainability, and cohesion) appropriate benchmarks for assessing the outcomes the retirement income system is delivering for Australians now and in the future? Are there other principles that should be included?

Yes. It is these principles (especially that of equity) which have led to BetaShares identifying where the current system produces undesirable (or unfair) outcomes and suggesting how it can be improved.

Equity

14. What factors and information should the Panel consider when examining whether the retirement income system is delivering fair outcomes in retirement? What evidence is available to assess whether the current settings of the retirement income system support fair outcomes in retirement for individuals with different characteristics and/or in different circumstances (e.g. women, renters, etc.)?

The Panel should ensure that the system is designed in such a way that no retiree is punished for increasing their savings pool, or is influenced by the system when choosing how to spend or invest their retirement savings. Evidence – from modelling, various researchers and direct observation – shows that currently these outcomes are not always being achieved.

15. Is there evidence the system encourages and supports older Australians who wish to remain in the workforce past retirement age?

Whilst the system does not explicitly discourage retirees from working, it does bias them towards spending their earnings, or channelling them into exempt assets (such as the family home), rather than using them to generate additional retirement income. A fair system would give the earner the choice of either using their earnings or adding them to their savings pool, without that choice being distorted by the structure of the system.

Cohesion

21. What should the Panel consider in assessing whether the retirement income system is cohesive?

There are many factors which make a system cohesive. From our perspective, the most important factor is that the system must be completely consistent, and without anomalies or flaws which influence behaviour or result in sub-optimal outcomes.

23. What evidence is available to show how interactions between the pillars of the retirement income system are influencing behaviour?

Research and anecdotal evidence showing that retirees are incentivised to spend or deploy additional savings into non-assessable assets is available from many sources[9]. This is an adverse consequence of the interaction between the eligibility for pension entitlements and the assets and income tests. Specifically, the withdrawal of, or reduction in the pension, and loss of other benefits as savings increase, influences retirees to spend (or move resources into assets which are excluded from these tests) rather than to invest and benefit from additional income and capital to draw down on over time.

26. Is there sufficient integration between the Age Pension and the superannuation system?

No. The age pension and the superannuation system are linked primarily by means testing applied to assets and income (there are secondary linkages such as healthcare and excluded assets). This linkage produces undesirable consequences (the Retirement Trap). Removal of these means tests improves integration, as it removes the punitive aspects of the reduction in the pension as means increase. Retirees would be able to make financial decisions (such as whether to spend or save) without taking into consideration the way the system will behave. Additionally, the resulting system will be simpler to administer and understand.

Summary and Conclusions

Structural changes to the retirement system that create a model with better outcomes for retirees and for the Government include:

[9] See: https://www3.colonialfirststate.com.au/personal/guidance/retirement-strategies/how-to-boost-your-pension-under-the-new-threshold-rules.html, https://www.northernstar.com.au/news/how-to-keep-your-assets-and-get-the-age-pension/3204330/, https://www.afr.com/wealth/superannuation/advice-on-how-to-trim-assets-to-keep-pension-irks-industry-super-funds-20151222-glt2wa for examples

- Removing the assets and income tests and introducing a universal pension;
- Streaming superannuation contributions into defined benefit and defined contribution components. The former will be used to fully or partially fund the universal pension. The latter would provide additional income and capital to retirees;
- Ensuring that where there is a shortfall (i.e. a retiree has not fully funded their pension through the defined benefit component of their super), the Government makes up the difference[10];
- Ensuring that any changes to the system do not result in any retiree being worse off than they are under the current system (consideration must be given to replicating the thresholds below which asset increases do not cause any tapering of pension entitlements);
- Reducing the overall cost to the government via efficiencies from a highly simplified system, which includes creating pooled defined contribution schemes using best of breed technology and practice to fund the universal pension; and
- Obtaining extensive actuarial input to determine how super contributions should be streamed.

We believe that with the implementation of this model, Australia can move from having one of the best retirement systems in the world, to having the best retirement system in the world.

Supplementary PDF Attachment: *Pitfalls in the Retirement System and Some Thoughts about Risk, Reward and Remediation, MCFS White Paper 01-19.*

File name: SUPPLEMENTARY MATERIAL - MCFS White Paper 01-19 - Pitfalls in the Retirement-System

[10] It is not envisaged that retirees will fully fund their pension as a priority. Rather, funding of both the pension and the defined contribution component of superannuation would occur simultaneously with the split determined by age, earning capacity and other factors. It would ensure that retirees are at least no worse off than they are in the current system.