Investment & Financial Services Association Ltd
ACN 080 744 163

16 March 2005

Mr Ralph Lattimore
Assistant Commissioner
Productivity Commission
PO Box 80
BELCONNEN ACT 2616

Dear Mr Lattimore

Economic implications of ageing Australia

The Investment & Financial Services Association represents Australia's leading investment managers and life insurance companies. Our 100 members hold more than $730 billion in assets under management on behalf of nine million Australians who have superannuation and managed funds.

Retirement Savings Gap

IFSA's principal interest in this reference is retirement income. The key economic question here is whether Australians will have the income they expect in retirement.

Australians' expectations for their living standards in retirement are higher than their current levels of superannuation will provide. This was a finding of the Senate Select Committee on Superannuation Report *Superannuation and standards of living in retirement*, December 2002.

The Retirement Savings Gap is a single value, expressed in today's dollars. It estimates of the difference between the retirement living standard people currently aged 25 to 65 expect to have, and the retirement living standard that current compulsory and voluntary superannuation contributions, combined with the age pension, will eventually produce.

The Retirement Savings Gap is estimated to be $600 billion. This is larger than the current stock of superannuation savings.

IFSA commissioned Rice Walker Actuaries to quantify the Retirement Savings Gap. Dr David Knox of PricewaterhouseCoopers Actuarial independently reviewed the work.

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Target Retirement Income
The retirement income expectation is modest at 62.5% of pre-retirement earnings, within the range of 75 to 80% of pre-retirement living standards. The Senate Select Committee on Superannuation noted that this a consensus target for adequate retirement income.

Definition of 'Gap'
The Retirement Savings Gap is a measure of the current shortfall in national savings between two amounts:

- the amount required to be saved by the nation as a whole to ensure "adequacy" in retirement, and in particular non-reliance on the Age Pension; and
- the amount saved in the superannuation system, and estimated to be saved in future years up to retirement, by the current workforce.

Calculation model
In order to determine the Retirement Savings Gap, Rice Walker projected current superannuation savings, allowed for likely future contributions (assuming current levels are maintained) and compared the sum of these two amounts to the projected required amount of savings to meet the adequacy standard. This process was undertaken for each 5-year age group between 25 and 65 in 2003 earning 0.75 to 2.0 times Average Weekly Earnings. The total required savings amount was adjusted to reflect the retirement income provided through the Age Pension.

The model uses data from a number of sources; specifically the ATO for details of current taxable earnings and APRA for details on current savings. Based on these data, superannuation contributions higher than 9% were included: employers 11%; employees 4%.

Assumptions were selected which tend to understate the Retirement Savings Gap.

- The income range included was limited because: (a) the equalising effect of the age pension leads to higher replacement rates for lower income groups; and (b) people earning above twice average earnings are widely regarded as beyond the scope of retirement incomes policy.
- Retirement was set at 65 (actual retirement ages are lower than 65).
- No future career breaks were modelled for women.

General assumptions used:

Economic

- 7.5% gross return on the accumulation of assets / 4.5% salary inflation / 3.0% price inflation
- 1.25% expense rate
- 15.0% tax on future employer contributions / 6.0% investment tax on investment roll up

Demographic

- 30% of self-managed funds, 5% of corporate funds and 25% of public sector funds are in the "retirement phase".
- Mortality in accordance with the Australian Life Tables 1999 – 2001 (from ABS 3302.0), future improvement to post retirement mortality in

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accordance with the 25 year improvement rates published by the Australian Government Actuary in the Australian Life Tables 1995 – 1997

Table 1 - Retirement Savings Gap

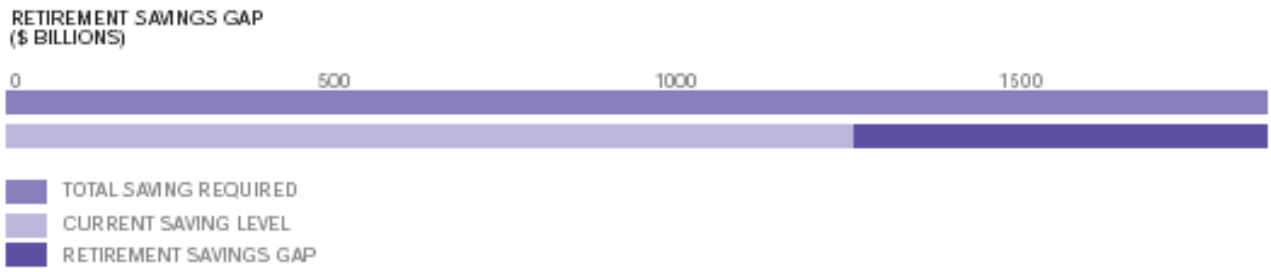

Table 2 - Retirement Savings Gap by age
This table shows the gap and contributions required, before allowing for the age pension.

Age Band	Retirement Savings Gap – Males ($millions)	Additional Contribution (Males)	Retirement Savings Gap – Females ($millions)	Additional Contribution (Females)
25 – 29	30,957	2.9%	67,396	5.6%
30 – 34	31,395	3.5%	76,039	6.7%
35 – 39	29,595	4.1%	84,939	9.0%
40 - 44	30,143	5.1%	88,143	12.2%
45 – 49	26,143	6.1%	84,160	17.0%
50 – 54	27,287	8.8%	78,950	23.3%
55 – 59	21,961	13.5%	55,071	34.3%
60 – 64	-	-	13,574	27.3%

Taxation of Superannuation

IFSA is also interested in possible changes to the taxation treatment of retirement savings (superannuation). We have commissioned a study of the benefits of changes to the various components of taxation, and their fiscal impact. The model developed for IFSA by Access Economics shows these impacts over the longer term, a feature which has not been public available before.

One of IFSA's critical questions has been to examine the relative merits of changes to he various components of superannuation taxation: contributions tax, earnings tax and benefits tax. Table 3 shows the impact on revenue of removing each component. Table 4 shows the benefit to retirees of this removal, while Table 6 shows the net cost / benefit over time.

- Of the three taxes, removal of contributions tax has the largest net benefit to retirees – however the main benefits do not accrue until Generation X is retiring. This change has least benefit to baby boomers

- Removal of earnings tax has an immediate benefit, particularly for baby boomers.

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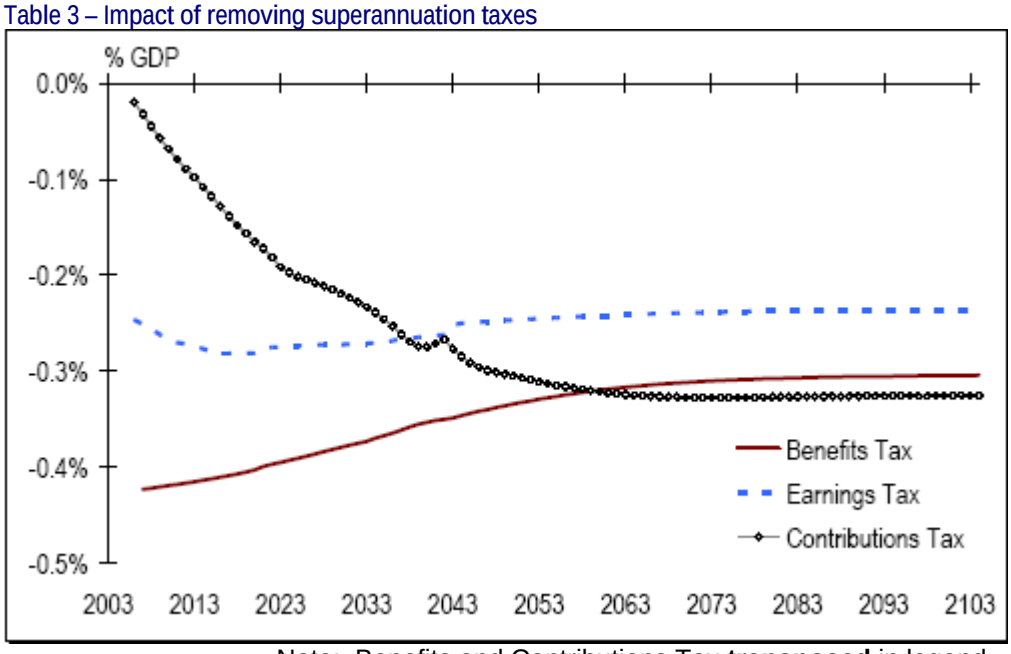
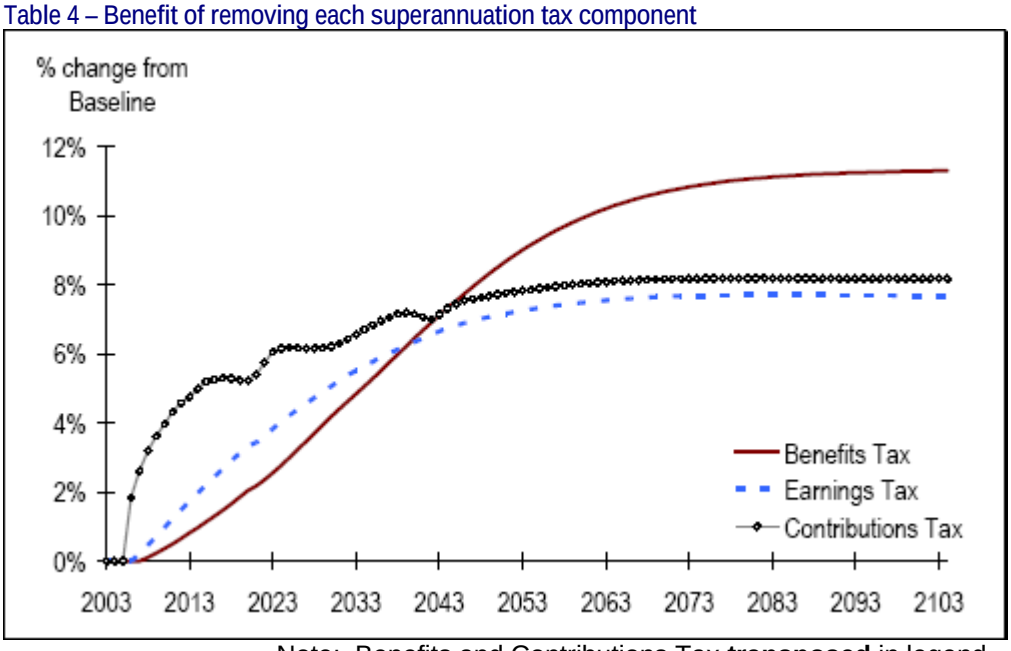
- Removal of benefits tax has a marked impact on baby boomers, but is a zero-sum game overall.

Table 3 – Impact of removing superannuation taxes



Note: Benefits and Contributions Tax **transposed** in legend

Table 4 – Benefit of removing each superannuation tax component



Note: Benefits and Contributions Tax **transposed** in legend

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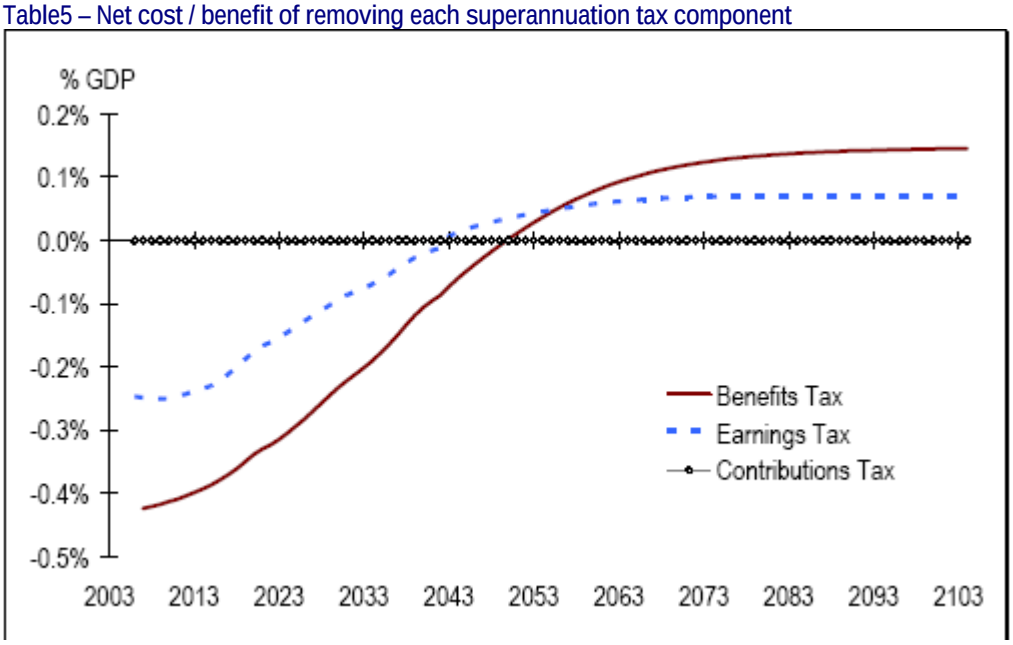
Table5 – Net cost / benefit of removing each superannuation tax component



Note: Benefits and Contributions Tax **transposed** in legend

Retirement Income Streams

IFSA represents the providers of retirement income stream products. We have long argued for better retirement income stream regulations, which would improve the retirement incomes of Australian retirees. The recent introduction of term allocated pensions (market linked income streams) will improve retirement incomes by allowing retirees to hold better portfolio of investments in complying income streams than was possible under previous rules.

A number of changes made in 2004 and 2005 will provide more flexibility to Australians in transition to retirement. As the traditional work patterns change and retirement becomes more of a prolonged transition out of the labour market than a single event, this flexibility is of increasing importance. IFSA believes that more flexible rules will allow those who wish to work longer, and who can find work, to do so. Economic benefits include an increase to national income as well as improved overall retirement income for those who can and do combine work and retirement in new ways.

Ordinary Money into Retirement income streams

A key 'missing link' in the retirement income stream rules is inability to put 'ordinary money' into income streams once a person is aged over 65 and no longer working. This means people who wish to use a superannuation income stream or allocated annuity to manage the regular, orderly drawdown of money they receive after age 65, may not be able to do so. After age 75, no additional money can be moved into these income streams.

Since some of this money will be from intergenerational transfers, increasing longevity means an ever larger proportion of retirees will receive these lump sums after they are able to place them into income streams under current rules. Much or all of this money will be after-tax money, that is, there would be no tax deduction available were it able to be contributed to superannuation.

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Retirees currently prefer allocated income streams to any other type, by an overwhelming margin. This is largely because of their wish for control. For this reason, lump sums are highly unlikely to be placed into non-commutable products. Consequently, inability to access allocated income streams means this money stays outside the income stream environment, and in many cases little or no capital is consumed. Were this money allowed into allocated products (allocated pensions and term allocated pensions), the payment factors would assist retirees to use their capital in an orderly way.

While it is impossible for IFSA to calculate the alternative tax revenue on these funds, we do not believe it will be significant. Income generated by conservative investments of lower-income retirees is not likely to produce significant revenue after SATO is applied, and wealthier retirees are likely to use tax-effective investment or asset-holding strategies.

In the long run, this change is likely to produce both economic and fiscal benefits. Economic benefits will arise as more capital is consumed rather than passively held, raising GDP. Capital held is also likely to be invested in more efficient investments, if it is invested in balanced portfolios through allocated income streams. Fiscal benefits will arise as deductible amounts under tax and social security law fall in real terms compared to annual payments, creating higher assessable income for both tax and means tests than would have occurred were investments held passively and capital not drawn down.

IFSA suggests that this objective can be achieved very simply for superannuation funds, without needing to change tax law.

A new SIS regulation could be made, allowing undeducted contributions (ie after tax) to be paid into a superannuation fund after age 65, provide that the contributions were paid to a pension that commences immediately.

Longevity risk in retirement income streams

The issue of longevity risk, and the ability of private pension systems to provide for it, has been a slow-burn issue in retirement income provision.

A key factor affecting the capacity of the private superannuation system to underwrite retirement incomes is the uncertainty of life expectancy of retirees. Future life expectancy is very hard to quantify, particularly because of likely future advances such as in genetic medicine. The longevity of a given age group (whole cohort) could well increase quite significantly, and this is a very different risk than intra-cohort longevity risk.

The challenge in market provision of retirement income stream products such as lifetime annuities is to match the premium charged for the benefit of security to the potential costs and risks the provider must bear. The uncertainty around longevity risk means it is difficult, if not impossible, to reinsure longevity risk[1]. Much of the risk simply cannot be sufficiently quantified or priced. Providers effectively must

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carry this risk on balance sheet – and there are limits on private capacity to do this. The current volume of lifetime annuities is very small, and there is no real capacity for the market to take on more risk should demand increase.

Given the level of uncertainty, answers are not likely to appear quickly. Dialogue about the respective roles of the private market and government in income stream provision could help expose the implicit assumptions in public policy.

Outside the small lifetime annuity market and remaining lifetime defined benefit pensions, longevity risk is ultimately met by the age pension. Given that retirees themselves overwhelmingly prefer account based income streams to lifetime annuities, those who survive longer than their capital will then qualify for age pension. This income trend matches many retirees' expectations that, health and personal care costs aside, their consumption needs will be lower in very old age, and could perhaps be met from the age pension. The treasury Retirement Incomes Modelling group increased its estimate of future pension outlays from 4.6% GDP to 5% GDP in 2003, as a consequence of new longevity estimates.

In the long run, the benefits of increased longevity will flow into national income. As national income rises, government revenues will also rise from both consumption and income taxes. General productivity rises should also flow into equity investments. However, long term fixed interest investments, such as those that fund lifetime annuities, are least likely to benefit.

Thank you for the opportunity to provide these remarks. If you have any questions or would like to discuss these issues, please do not hesitate to contact Bill Stanhope at IFSA on 02 8235 2529.

Yours sincerely

Richard Gilbert
Chief Executive officer

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