TOWERS WATSON

The Evolving Australian Retirement System

By Mark J. Warshawsky

Australia's retirement system has three pillars. The government-provided, means-tested age pension establishes a benefit floor for all retirees. Nearly universal superannuation plans (like defined contribution plans in the U.S.), funded by mandatory contributions from employers, and tax-advantaged voluntary savings, including superannuation above mandatory employer contributions, make up the other two pillars.

This basic system has been in place since 1992, although the government has made many modifications over the years. As the system and population continue to mature, emerging issues are prompting new discussions and developments to help Australian workers better prepare for retirement.

Australian age pension

The Australian government funds the public pension program out of general revenues — there is no dedicated payroll tax, as exists for U.S. Social Security. The normal retirement age is 65 for men (64.5 for women, increasing to 65 by 2014). But the normal retirement age for both men and women will rise to 65.5 in 2017, 66 in 2019, 66.5 in 2021 and 67 in 2023.

The pension is a moderate fixed amount that does not relate to the worker's career earnings. Rather, through inflation-related and other adjustments, it replaces roughly 26% of men's average pretax earnings for a single retiree and 40% for a couple; a pension supplement brings these replacement rates up to 30% and 44%, respectively. In the past, workers who didn't claim their benefits at age 65 received a tax-free bonus for every year they continued working, up to five years. The government discontinued that bonus in 2009 for new retirees but now offers a work bonus, whereby it will ignore up to $6,500 of annual employment income in the income test for the age pension (the work bonus is not available to the self-employed).

The age pension is means-tested, so better-off retirees receive smaller benefits, and relatively high-income and high-net-worth retirees do not receive the pension at all. The government raised the assets test threshold a few years ago, so the share of the relevant population receiving some pension benefit has been rising — it was 68% in June 2008. (The other 32% are likely well-to-do workers or those receiving public-sector pensions, disability pensions or veterans benefits.) Fifty-six percent of age pension recipients get the full pension, while 44% receive reduced benefits after means-testing.

Receiving even $1 in age pension, however, qualifies recipients for valuable in-kind benefits, such as health care, drugs and other living expenses. These in-kind benefits are important to many retired Australians, even the relatively well-to-do. Thus, some people may adjust their earning and spending behavior to receive them, such as by reducing income or assets, or retiring early and thereby using up assets.

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Australian superannuation system

The government imposes a superannuation guarantee consisting of mandatory employer contributions to a private retirement plan. The plan may be operated by the employer, industry associations, financial service companies or even individuals themselves. The mandatory contributory rate is currently 9% of employee earnings but is scheduled to jump to 12% by 2019. Employers need not contribute on behalf of very low-wage workers (mainly seasonal and part-time), and contributions are not required on earnings above roughly 2.5 times current average earnings. People earning up to $37,000 now receive a tax refund of up to $500 into their superannuation fund.

Australians may begin receiving superannuation benefits at age 55 — even if they're still working — but only in the form of a non-commutable income stream, and the age requirement will increase to 60 by 2025. Employers must contribute on behalf of eligible employees up to age 70. (The age limit is abolished entirely in 2013.) Employees and the self-employed may also contribute on their own behalf. Although there are a few active defined benefit superannuation plans in the private sector, most are closed, and defined contribution plans now dominate. Participants can withdraw benefits as a lump sum or as some sort of income stream; very few, however, take a life annuity.

As of March 2011, superannuation assets in Australia totaled A$1.23 trillion. In the 2009 – 2010 fiscal year, the program took in A$107 billion in contributions (A$72 billion from employers and the balance from voluntary savings) and paid out A$60 billion in benefits. The tax authority enforces the mandatory contribution requirement. Such enforcement and voluntary compliance seem to be largely successful, as coverage now extends to more than 90% of the workforce; it has increased by almost 20 percentage points since 1992.[1] The average retirement age in Australia is currently in the late 50s.

Emerging issues

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As the superannuation system has matured and become larger and more important to workers, new issues have arisen, one being participants' need for better information. The advantage of providing annual benefit projections to participants seems clear. The projections would likely prompt workers to become more proactive retirement planners, such as by considering whether their retirement savings are adequate, seeking more sophisticated online calculators for more specific information and obtaining personal financial advice.

Some, including Towers Watson and a 2010 advisory panel headed by pension expert Jeremy Cooper, have proposed making the annual benefit projections mandatory; the Australian government has not adopted this recommendation. The government has, however, recently offered plan sponsors some fiduciary relief in exchange for providing benefit projections that meet certain conditions, including projecting a lump sum at age 65 and an annual income stream from the lump sum between ages 65 and 90. These projections are not allowed to include the age pension or any defined benefit, or to project different retirement age or contribution scenarios, and the calculations must be based on government-set actuarial and economic assumptions.[2] It is not yet clear how many employers will provide the government's "safe harbor" projections to workers or take alternative, more comprehensive and integrated approaches without the advantage of fiduciary relief.

A second issue, also placed on the table by the Cooper panel, is what superannuation funds should do for retirees in the postretirement decumulation phase. The panel recommended requiring that funds include one type of income product, offered either through the fund or in conjunction with an external provider. It also recommended requiring that fund trustees devise a separate investment strategy for retirees that considers inflation and longevity risk. The government agreed with the second recommendation but not, at this time, with the first.

Most plans, however, already offer some type of income product, although these products do not necessarily extend for the lifetime of the retired household. Therefore, introducing regard for longevity risk in the second Cooper recommendation is an innovation. As Towers Watson has noted, longevity risk may be addressed by an insurance approach, including the (at least partial) use of life annuities.[3] Again, in the governance of Australian superannuation funds, longevity risk is just beginning to be discussed and addressed as the system matures, with the development of new products and strategies, some of which are based on fundamental research.[4]

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[1] See Australian Bureau of Statistics, *Australian Social Trends,* Issue 4102.0, "Trends in Superannuation Coverage," March 2009.

[2] See John Burnett, "Retirement estimates — ASIC's new guidelines," Towers Watson *View,* February 2012, available at www.towerswatson.com/australia/newsletters/australia-view/6399.

[3] See Nick Callil, "The Post Retirement Challenge: Strategies for Superannuation Fund Trustees," Towers Watson *View,* March 2011, available at www.towerswatson.com/australia/newsletters/australia-view/4066.

[4] See, for example, in the U.S. context, Mark J. Warshawsky, *Retirement Income: Risks and Strategies,* 2012, MIT Press.