

# FINANCIAL SYSTEM INQUIRY - PHASE TWO

## CHAPTER ONE

# **SUPERANNUATION, INVESTMENT MANAGEMENT AND RETIREMENT POLICY**

# CHAPTER 1 - SUPERANNUATION, INVESTMENT MANAGEMENT AND RETIREMENT POLICY

## OUTLINE

This chapter widely canvasses the issues raised in the interim report on superannuation, investment management and retirement.

We substantively respond to the interim report's observations on superannuation fees.

We consider the recent reforms and cost components of the \$1.9 trillion superannuation industry and, in doing so, we emphasise the point that a narrow focus on cost without considering returns is inappropriate.

Fees in the superannuation industry have been on a downward trend following the introduction of MySuper in 2013. We believe that fees in superannuation could be further reduced by permitting open competition in the default market, creating a product rationalisation framework and greater transparency generally.

As a heavily intermediated industry, investment returns and costs are central to any analysis of the system. We use a range of data points and new research to highlight the competitiveness of the Australian investment management industry and the returns that superannuation members have been receiving on a comparative basis.

Retirement incomes are equally important - and we welcome the interim report's emphasis on the post-retirement phase. There is further reform

to be undertaken to ensure that Australians and the wider community derive the greatest possible value from the superannuation system.

## 1. SUPERANNUATION

### **Stability in superannuation**

Australians have a consistently favourable view of the superannuation system, with FSC research showing that 86 per cent of Australians 'support' the system.<sup>1</sup> This result is promising, considering the considerable reforms of the industry in recent years and the impact, and recovery from, the financial crisis.

The superannuation system, however, is not immune from disaffection and the FSC supports moves by the industry and stakeholders to promote certainty and avoid short-term decision making.

Funds under management in the system are over \$1.9 trillion and will grow to \$3 trillion by 2020. It should not be expected that such a significant pool of capital will escape the attention of legislators over long periods of time.

There are considerable benefits, however, to be gained from achieving long periods of stability through methodical policy development based on reliable and tested information and industry consultation. Stability around policy settings will generate the dual benefits of:

- ❖ Lower costs arising from compliance with regulatory change, a significant contributor to administration fees; and
- ❖ Greater confidence by fund members that may result in higher contributions and improving adequacy.

Stability and certainty can be promoted through acknowledged benchmarks. In this regard the government's Intergenerational Report is an important measure of the changing demographics of our nation. It creates a suitable framework for measuring the performance of the superannuation system against variables such as projected age pension and aged care expenditure.

It is fundamental to achieving an informed and quality debate, for a baseline of data to be established. The Intergenerational Report will achieve this baseline, and, as the Intergenerational Report is published every five years, this creates a natural hiatus between periods of review in which stability can be achieved.

<sup>1</sup> FSC-ING Direct Superannuation Sentiment Index 2014.

## RECOMMENDATION

The Inquiry recognise that stability in superannuation policy settings is important and that the Intergenerational Report provides an important baseline for any considered changes to the system.

### Trends in the superannuation system

The interim report examines how costs in the superannuation system are driving fees charged by superannuation funds and fund managers. It also examines whether returns are appropriate given the fees charged and whether the degree of servicing adds sufficient value to fund members to warrant the additional cost.

The most important question underpinning these issues is whether the intermediaries in the superannuation system are operating efficiently and are subjected to competitive pressure to ensure that net returns allow the system to achieve its objective of maximising individual's retirement savings.

The FSC submits that the recently implemented MySuper reforms are successfully driving down fees. However the imminent reporting of performance and fees by APRA should engender greater competition to ensure the MySuper regime will achieve its objective. Further reforms in the MySuper market such as allowing all MySuper products to compete for default contributions will further increase competition.

Research by Deloitte Access Economics for the FSC concluded that Australia's system appeared to be "middle of the pack" when compared to overseas systems. Of the twelve jurisdictions considered Deloitte concluded that "Australia has the third highest returns." Chant West similarly found that over the life of the superannuation system net returns have achieved at least CPI + 4 per cent. Further, Deloitte also concluded that MySuper products charge "the fifth highest fees of comparable products."<sup>2</sup>

The combination of relatively low fees in the new MySuper regime and strong returns over the life of superannuation indicates that the superannuation system is meeting its policy objective subject to the performance of MySuper.

The FSC also submits that whilst the Australian superannuation system has a higher cost basis than some comparable overseas jurisdictions, this is the product of:

<sup>2</sup> Deloitte Access Economics, Financial performance of Australia's superannuation products, August 2014

- ❖ The cost of recent regulatory reform, including MySuper, SuperStream and enhanced reporting requirements; and
- ❖ Cost arising from enhanced member servicing, which is either required by legislation or expected by consumers.

The FSC submits that there are policy options open to the Government to drive fees lower in the MySuper market. In particular, the FSC recommends the Inquiry consider:

- ❖ Reforms to allow all MySuper products to compete for default superannuation contributions to drive competitive pressure in the default market; and
- ❖ Regulatory reform to allow superannuation funds, life insurers and Managed Investment Schemes (MIS) to rationalise legacy products.

The FSC also submits that the asset allocation and style of investment management can result in higher net returns and comes at a cost to the Australian superannuation system that is lower than overseas jurisdictions.

### **MySuper fees and performance**

MySuper products are default products that employers must pay their employees' super guarantee contributions (9.5% for 2014-15) if the employee does not nominate a superannuation fund.

The MySuper regime commenced 1 July 2013, with mandatory employer contributions required to be paid into MySuper products for default employees from 1 January 2014. The policy intent of MySuper was to ensure that the majority of employees who are not engaged with their super benefit from lower cost products.

MySuper products have a single investment option - either a single diversified investment strategy (standard mix that will stay the same over the entire period) or a "life cycle product" (where the money will move from growth investments when young to more conservative when older).

Because of common characteristics, they can be compared based on a few key differences - cost, investment performance and level of insurance (these details must be published by every fund on an identical "dashboard"). Comparisons of life cycle MySuper products are more complex because they are multi-staged products which contain differing asset allocation based on age.



MySuper's recent commencement makes it difficult to reach definitive conclusions around its performance. APRA is required to report periodic information around MySuper fees and returns, however at time of writing this information had not yet been published.

Over time APRA's reporting of MySuper performance will become an important benchmark on whether MySuper products are achieving their policy objective.

The introduction of low cost retail products is an important development in the superannuation industry as it reflects a desire by all funds to compete for this key default market. Further consideration is given later in this submission as to how this competition can be enabled through reform.

Table 1 shows that the average asset-based MySuper fee is .73% in 2013. The table highlights the significant reduction in the "retail" sector fees in particular from 1.61% for pre-MySuper default products in 2011 to .82% by 2013.

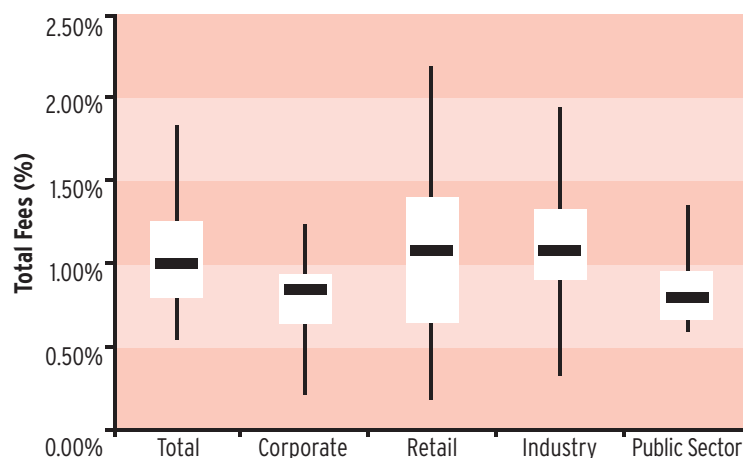
**Table 1.1: Superannuation Fees**

FEES					
Segment	Average \$ per member fee	Average % of assets fee	\$5,000	\$20,000	\$50,000
<b>2011</b>					
Corporate	47	0.62%	77	170	355
Retail	64	1.61%	144	385	867
Industry	68	0.76%	106	220	449
Public Sector	28	0.58%	57	144	317
<b>Total</b>	<b>63</b>	<b>0.92%</b>	<b>1098</b>	<b>248</b>	<b>525</b>
<b>2013</b>					
Corporate	82	0.69%	115	219	426
Retail	72	0.82%	112	235	481
Industry	74	0.72%	110	217	433
Public Sector	29	0.64%	61	156	347
<b>Total</b>	<b>69</b>	<b>0.73%</b>	<b>106</b>	<b>215</b>	<b>433</b>

FSC commissioned fee research in Chart 1 confirms this preliminary data by concluding that fees have fallen significantly amongst the FSC membership since the inception of MySuper.<sup>3</sup>

<sup>3</sup> RiceWarner, Superannuation Fees Research, 2014

Figure 1.1: Distribution of total MySuper fees by segment



It is important that the MySuper regime be afforded time to allow for longitudinal analysis of both fees and returns before conclusions are reached as to the effectiveness of the reforms.

APRA and various private sector ratings agencies will continue to provide robust sources of data over coming years which will allow a more comprehensive analysis. It is expected that the public scrutiny of MySuper products and greater transparency will help foster competitive dynamics in the industry.

Scrutiny of the performance of MySuper products will assist in developing genuine competition in the default market. FSC research recently found that 27 per cent of fund members felt they would likely change their fund provider in the future based on available fund information.

The two dominant reasons consumers cited for potentially changing their funds were:

- ❖ Lower fees from another provider (53 per cent); and
- ❖ Better performance and returns from another provider (52 per cent).<sup>4</sup>

The advent of MySuper has therefore had the desired impact of reducing fees in the superannuation industry, which can be supported by engendering greater competition in the default market.

## RECOMMENDATION

The Inquiry recognise that the implementation of MySuper has reduced fees in the default market.

<sup>4</sup> FSC-ING Direct Superannuation Sentiment Index 2014.

## Fees in superannuation

Deloitte Access Economics research has demonstrated that fee drivers in pension systems across the world are diverse, making simple international comparisons difficult. Their research, however, concluded that significant drivers broadly fall under administration or investment management costs.<sup>5</sup>

Analysis of the distribution of fees in the wider superannuation system (including all APRA funds and SMSFs) has concluded that approximately 50 per cent of total costs are attributable to administration and trustee costs, and 50 per cent to investment management.<sup>6</sup>

Under the MySuper reforms, trustees now need to break down fees into investment and administration components. These fee components will be disclosed in APRA's forthcoming MySuper comparative tables.

To better understand the factors influencing investment management and administration fees, this chapter considers the cost drivers that underpin each of these, as well as the capacity for further changes to attempt to reduce costs.

## Administration fees

Administration fees are based on costs the trustee incurs when operating a superannuation fund, which itself is a factor of operating expense and cost of compliance with regulatory requirements.

Examination of the costs that underpin administration fees is appropriate, however it is important to distinguish between costs that are derived from different sources, such as compliance with recent regulatory change or member servicing.

## Regulatory changes

Costs in the superannuation system have been increased by recent regulatory reform in the industry, including:

- ❖ MySuper and accompanying Stronger Super prudential requirements;
- ❖ SuperStream;
- ❖ Enhanced APRA reporting requirements; and
- ❖ The Fair Work Commission's (FWC) review of default superannuation funds.

The implementation and ongoing cost of each of these areas of reform for FSC members is outlined in Table 2. This does not include the costs



of all reforms as a result of Stronger Super, including policies currently subject to consultation, such as portfolio holdings disclosure.

**Table 1.2: Cost of Reforms**

Reform	Implementation Cost	Ongoing Cost (pa)
<b>MySuper</b>	\$295 million	\$17 million
<b>SuperStream</b>	\$315 million	\$20 million
<b>Enhanced APRA Reporting</b>	\$29.8 million	\$4.9 million
<b>FWC Default Super Review</b>	\$25.5 million	\$25.5 million (every four years)
<b>Total</b>	<b>\$665 million</b>	<b>\$67 million</b>

The total cost of these reforms over the several years that they have been implemented is estimated to be \$665 million for FSC members, and incurring an additional \$67 million in annual ongoing costs for relevant years.

Whilst some of these reforms, such as MySuper and SuperStream, will certainly generate benefits for consumers over time, the cost of these reforms are being felt immediately.

Whilst the cost would be amortised over a number of years the reforms remain a major contributor to cost in the system.

The FSC is also concerned that some reforms are generating immediate costs without any consumer benefits. FWC review of default superannuation arrangements, which duplicates APRA's role authorising all MySuper products, creates over \$25.5 million in cost for FSC members without any consumer benefit. The FSC supports observations by the Inquiry that there is no competition in this sector and submits that the costs associated with the FWC process are unnecessary.

## RECOMMENDATION

The Inquiry recognise that costs in the superannuation system may currently be higher than they would otherwise be as a result of system complexity and MySuper and SuperStream.

## Member servicing

FSC consumer research reflects the degree to which members expect more expensive tailored and personalised forms of servicing from their superannuation funds.

27 per cent of all fund members make direct personal contact with their fund each time they interact with the superannuation system, comprised of:

- ❖ 59 per cent of that contact being made by phone;
- ❖ 32 per cent by email; and
- ❖ 13 per cent in person.

Each of these forms of contact requires personalised servicing, contributing to administration costs in the system.

In comparison, cheaper technology based servicing is relatively uncommon, with only 30 per cent of contact being made online, such as through the fund's website. Only 4 per cent of fund members contact their fund through a mobile app.<sup>7</sup>

Members of Australian superannuation funds receive additional and embedded product features, for example:

- ❖ The ability to build your own investment options;
- ❖ Life insurance;
- ❖ Intra fund advice (personal and general);
- ❖ Account consolidation;
- ❖ Comprehensive disclosure about the fund; and
- ❖ Automatic contributions and rollovers.

### RECOMMENDATION

The Inquiry recognise that many legislated and expected member services contribute to fund costs and that these services have genuine value to members.

## Returns

The Inquiry has asked how cheap or expensive the Australian superannuation system is when compared globally.

To answer this question, we need to look at the cost and value of the superannuation system and the funds management industry.

The returns that members receive from their superannuation funds over the long term are the most important factor.

<sup>7</sup> FSC-ING Direct Superannuation Sentiment Index 2014.

Chant West has concluded on this point:

“... the typical return objective for a growth fund is to beat inflation over rolling five year periods by between 3% and 4% per annum. When we look back over the 22 year period, we find that the annualised return is 8%, the annual CPI increase is 2.6%, so the real return above inflation has averaged 5.4% per annum. So the return objective has been well and truly met.”<sup>8</sup>

On any measure this is definitive evidence that Australia's superannuation system is working.

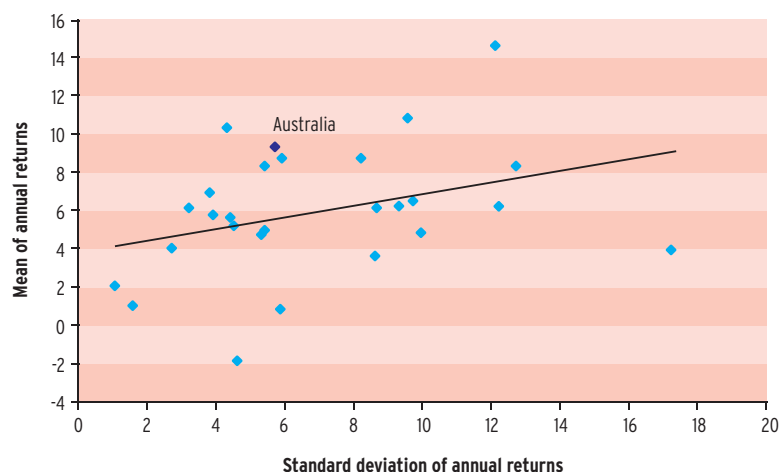
To supplement findings by private sector ratings agencies, the FSC commissioned Deloitte Access Economics to benchmark fees and returns to Australian superannuation funds against comparable OECD countries.

There are a variety of factors that drive differences in both gross returns and in the volatility of returns between retirement income systems in different countries:

- ❖ The larger the retirement income system, the higher gross real rates of return tend to be;
- ❖ Retirement income systems with greater competition also tend to experience lower volatility of returns; and
- ❖ Higher returns are associated with occupational (as opposed to personal) retirement income systems, closed systems and retirement income systems with multiple funds.

Australia ticks all of these boxes so it might be expected to have relatively higher returns and lower volatility than the average.

Figure 1.2: Mean of real returns against standard deviation of returns (all years)<sup>9</sup>



<sup>8</sup> Chant West, 22 July 2014, <https://www.chantwest.com.au/PDFFiles/Chant%20West%20Media%20Release%2022Jul14.pdf>

<sup>9</sup> Deloitte Access Economics, Financial performance of Australia's superannuation products, August 2014

Chant West research into the characteristics of new MySuper products demonstrates a mix between actively and passively invested products.<sup>10</sup>

Over time the benefit or detriment of increased passive investment will emerge and it is expected the significant public focus on fees and returns will allow the market to drive members to the funds generating the highest net returns. This assumes the market operates as intended – with competition and transparency at its heart.

## Data

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The FSC disputes the premise of various submissions that claim to demonstrate that fees in the Australian system are unjustifiably high.

Data on which some participants sought to draw conclusions does not support those conclusions. In particular, OECD data is inconsistent as different international pension systems report fees differently, preventing direct comparisons from being established. This critical point was neglected by those organisations that sought to make such comparison.

Further, OECD data does not take into account the different degrees to which legislation or community expectations result in different degrees of member servicing. Member servicing is a significant contributor to the cost basis for a superannuation fund and, in many instances, should not be discounted where it is important to an effectively functioning system.

For example, government run pension funds, such as the two Norwegian funds, 'Government Pension Fund - Norway' and the 'Government Pension Fund - Global', do not provide any degree of member servicing. Those funds are administered through an arm of Norway's Central Bank and are not required to have any notable interaction with the public that it is ultimately intended to provide for.

The FSC notes the Inquiry's comparison of the Australian system to the auction model for default contributions in Chile.

The rationale for a major change to the default superannuation system provided by both the Grattan Institute report and the interim report, is that there is little competition in the Australian system and fees are high.

However, there is vigorous competition in the Australian superannuation industry, especially in the default MySuper space. In this segment, there

<sup>10</sup> Chant West presentation to FSC Conference, 7 August 2014

are 120 MySuper products and fees are a major area of competition. The Grattan Institute report found Chile's fees were about one-third of Australia's default MySuper fees, but the report wrongly compared Chilean administration fees with the total of administration and investment fees for MySuper options. The following compares Chile's fees with the fees of MySuper products on a like-with-like basis.

### **Chilean system**

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The rationale for a major change to the default superannuation system provided by both the Grattan Institute report and canvassed in the interim report is that fees in Australia are too high because members are disengaged and do not put pressure on funds to reduce fees.

Both Grattan and the interim report cite Chile as a system worthy of comparison.

Accordingly, the FSC engaged Chant West to examine the Chilean system in detail.

The Grattan report claims Chile's default fees are less than one-third of MySuper fees. This is not correct.

The problem is the Grattan report compares only Chilean administration fees with total MySuper fees (administration plus investment fees).

Chant West shows that Chilean default and MySuper administration fees are at similar levels.

The biggest difference is with investment fees. Chile's fees are much lower because it invests in a very different way to MySuper funds.

Essentially, funds in Chile (including its default fund) manage about 57% of assets in-house at very low cost. Most of this is domestic and most of it is in fixed income securities. Overall, about 60% of Chilean assets are invested in fixed income assets. By contrast, less than 5% of MySuper assets are managed in-house and only about 20% of assets are invested in fixed interest securities. Given these differences, you would expect MySuper investment fees to be higher.



## Overview of Chilean system

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Chile's pension system comprises three pillars: a poverty prevention pillar, a mandatory contribution pillar, and a voluntary savings pillar. Under the mandatory pillar, employees are required to contribute 10% of their wage or salary to an individual account and choose a private sector Pension Fund Administrator (AFP) to manage the account. Currently, there are six AFPs operating in Chile.

Assets in the mandatory system are currently (June 2014) about US\$170 billion. The number of members is about 9.7 million, of which, about 5 million (52%) are making contributions (contributors). The four largest AFPs have combined assets of about US\$163 billion (96%).

AFPs are free to set the administration fees they charge members, but the fee must be the same percentage of salary for all their members. Only contributors pay this fee, which are about half the number of members. No fixed dollar or asset-based fees are allowed.

In 2008, the Government introduced a public tender system designed to increase competition between AFPs and so reduce administration fees. The tender occurs every two years and the default fund status is awarded to the AFP with the lowest fee. The winning fee must be offered to existing members and new entrants.

Modelo, a new AFP, won the first tender in 2010 with a bid of 1.14% (of salary), and the second tender in 2012 with a bid of 0.77%. PlanVital won the third tender in 2014 with a bid of 0.47%.

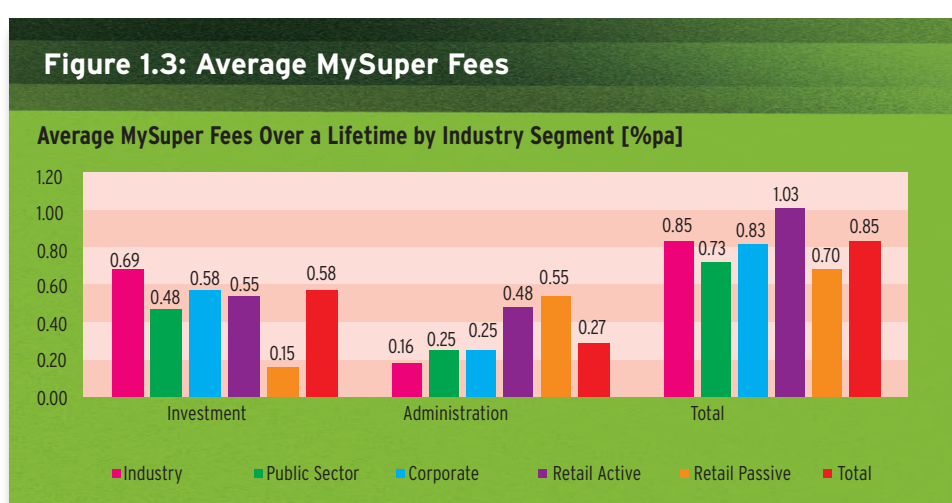
There are questions about the sustainability of PlanVital's new administration fee. Its new fee of 0.47% represents an 80% reduction in its pre-bid fee of 2.36%. This means its revenue in August 2014 will be only 20% of its revenue in July. Based on estimated new entrants into the pension system, it is likely to take PlanVital four years to return to pre-bid revenue levels.

AFPs are allowed to offer up to five investment funds, called Funds A to E, which have different proportions of their portfolios invested in equities. There are regulated investment limits for each Fund. AFPs must meet a minimum level of return for each Fund based on the average return for all AFPs. To meet the guarantee obligation, an AFP must hold a reserve equal to 1% of the value of each Fund and meet any shortfall out of this reserve.

## Administration & investment fees

The report from Chant West shows that the fees of MySuper products compare favourably with the Chilean AFPs.

Figure 1.3 shows the average MySuper fees paid over a member's lifetime for different segments of the market (weighted by assets under management). Chant West has used the same OECD methodology to calculate the average fees as the Grattan Institute uses in its report. The average MySuper fee is made up of an administration fee of 0.27% and an investment fee of 0.58% for an average total fee of 0.85%.



The published MySuper administration fee for retail active products is the maximum fee paid by members. Many medium to large employers, however, because of their scale, are able to negotiate a lower administration fee for their employees. Chant West has sourced information from the five largest corporate master trust providers on the average administration fees paid in their MySuper products. Based on this information, Chant West has reduced the weighted-average administration fee of retail active funds from 0.65% to 0.48%.

Table 1.3 shows the average administration fees of MySuper products and Chilean AFPs. It shows that the average MySuper fee of 0.27% is lower than the Chilean default fee of 0.33% that applied for the two years to July 2014. Chile's new default administration fee of 0.20% is lower than the average MySuper fee, but it is slightly higher than the average non-profit MySuper fee of 0.19%. Clearly, MySuper administration fees compare favourably with those in Chile.

**TABLE 1.3: Average Administration Fees (using OECD methodology)**

Segment	Average Fee (% pa)
<b>MySuper</b>	
Industry	0.16
Public Sector	0.25
Corporate In-House	0.25
Average Non-Profit	0.19
Retail active - average	0.48
Retail passive	0.55
<b>Average MySuper</b>	<b>0.27</b>
<b>Chile AFPs</b>	
Capital	0.65
Cuprum	0.67
Habitat	0.57
Modelo	0.33 (default until July 2014)
PlanVital	0.20 (new default from August 2014)
Provida	0.70
<b>Average AFP</b>	<b>0.66</b>

Table 1.4 compares the investment fees of MySuper products with investment fees of Chilean AFPs. Note that the investment fees for retail active funds are lower than those of non-profit funds. This partly offsets their higher administration fees.

**TABLE 1.4: Average Investment Fees**

Segment	Average Fee (% pa)
<b>MySuper</b>	
Industry	0.69
Public Sector	0.48
Corporate In-House	0.58
Average Non-Profit	0.63
Retail active - average	<u>0.55</u>
Retail passive	<u>0.15</u>
<b>Average MySuper</b>	<b>0.88</b>
<b>Chile AFPs</b>	
Capital	0.27
Cuprum	0.26
Habitat	0.24
Modelo	0.29
PlanVital	0.27
Provida	0.26
<b>Average AFP</b>	<b>0.26</b>

Clearly, Chilean investment fees are lower than those of MySuper funds. This is because Chilean AFPs and MySuper products are invested quite differently. The main differences are that Chilean AFPs invest more in fixed interest securities, have more in-house management and have minimal investment in unlisted assets. All of these strategies lead to lower costs. Table 1.5 shows a high level comparison of Chilean AFP and MySuper investments.

**TABLE 1.5: Asset allocation**

Criteria	Chile	MySuper
Management by internal team	57%	<5%
Equities	40%	56%
Bonds	60%	20%
Unlisted Assets	Nil	24%

By way of summary, Table 6 compares the total fees of MySuper products and Chilean AFPs.

The average MySuper total fee is 0.85%, which is higher than PlanVital's fee (Chile's new default fund) of 0.47%. It is also higher than Modelo's fee (Chile's default fund between 2010 and 2014) of 0.62%. MySuper retail active funds have the highest total fee at 1.03%.

Clearly, the component parts of the total fee tell a different story. The average MySuper administration fee of 0.27% compares favourably with PlanVital and Modelo - 0.20% and 0.33%, respectively. The average MySuper investment fee of 0.58%, however, is much higher than PlanVital and Modelo - 0.27% and 0.29%, respectively. This, of course reflects the very different nature of how investments are made in each country.

We believe this analysis shows that MySuper fees compare favourably with default fees in Chile when you take into account the clear differences in the approach to investment management.

**Table 1.6: Average Total Fees (% pa)**

Segment	Administration	Investment	Total
<b>MySuper</b>			
Industry	0.16	0.69	0.85
Public Sector	0.25	0.48	0.73
Corporate In-House	0.25	0.58	0.83
Average Non-Profit	0.19	0.63	0.82
Retail active - average	0.48	0.55	1.03
Retail passive	0.55	0.15	0.70
<b>Average MySuper</b>	<b>0.27</b>	<b>0.58</b>	<b>0.85</b>
<b>Chile AFPs</b>			
Capital	0.65	0.27	0.92
Cuprum	0.67	0.26	0.93
Habitat	0.57	0.24	0.81
Modelo	0.33	0.29	0.62
PlanVital	0.20	0.27	0.47
Provida	0.70	0.26	0.96
<b>Average AFP</b>	<b>0.66</b>	<b>0.26</b>	<b>0.92</b>



## 2. INVESTMENT MANAGEMENT

### Relative performance

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FSC engaged Chant West to examine the impact of asset allocation and management style on historical member returns.

In assessing the effectiveness of the superannuation system, we know that average returns have been in excess of 8% over twenty years, but it is not clear whether these are strong relative returns.

The relativity of the superannuation returns against a representative passive benchmark (the benchmark) is an important consideration when evaluating the effectiveness of the system.

In making this assessment, Chant West considered a variety of scenarios covering both multi-sector and single asset sector investment options.

### Multi-sector portfolios

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Chant West examined the ten largest default-like MySuper products over the past 15 years to determine performance against the benchmark.

Judged against the benchmark, the largest superannuation funds have shown strong outperformance over the past 15 years. Chant West research shows that they outperformed the benchmark by 80 basis points per annum over that period.

The ten largest funds comprise about 30% of APRA regulated AUM and 40% of members.

The default investment option offered by each fund has been used for the purposes of assessing its performance as most assets are in this option.

Prior to MySuper, superannuation trustees were permitted to have any number of default investment options. The trustee would typically agree a suitable option with the employer.

With the advent of MySuper, trustees are now only permitted one "generic" MySuper product per Registrable Superannuation Entity (RSE).

The following table shows the performance of the default options offered by the ten largest funds over five, seven, ten and 15 years to June 2014.

**Table 1.7:**

Performance of the Ten Largest MySuper Products (% pa)				
	5 years	7 years	10 years	15 years
<b>Median</b>	<b>9.8</b>	<b>4.2</b>	<b>7.5</b>	<b>7.2</b>
Highest	10.7	5.6	8.0	8.0
Upper Quartile	10.1	4.6	7.6	7.3
Lower Quartile	9.7	4.1	7.2	7.0
Lowest	9.2	4.0	7.0	6.8
Number of Options	10	10	10	9
<b>Passive Benchmark</b>	<b>10.0</b>	<b>3.8</b>	<b>6.9</b>	<b>6.4</b>
<b>Median Outperformance</b>	<b>-0.2</b>	<b>0.4</b>	<b>0.6</b>	<b>0.8</b>

Source: Chant West

The FSC agrees with the conventional dictum that past performance is not a good indicator of future returns and we remain agnostic about asset allocation.

However, it does show that many superannuation funds have used a combination of asset allocation and management style which has been able to beat the benchmark.

It demonstrates that the ten largest MySuper default-like products, have delivered strong returns relative to the benchmark. This does not mean that every superannuation fund or default investment option has beaten the benchmark.

This performance may not be replicated over the next 15 years, which is why it is essential that trustees retain sovereignty over asset allocation (sole purpose test).

### **Single asset sector portfolios**

Another element of Chant West's research was to examine the performance of multi-manager, single asset sector portfolios where a reasonable benchmark could be established.

Australian shares and international equities are typically the largest component of a balanced superannuation default investment option.

**TABLE 1.8: Current superannuation asset allocation**

	Equities	Overseas	Deposits	Life	Property	Short-term Securities	Bonds	Other
2013	Percentage of FUM allocated to each asset class							
	41.2	16.4	14.2	11.2	6.0	5.2	3.6	2.3
2013	Dollars (t) of FUM allocated to each asset class							
	0.6	0.3	0.2	0.2	0.1	0.1	0.1	0.0
2013	Percentage of GDP in each asset class							
	42.0	16.7	14.5	11.4	6.1	5.3	3.7	2.3

At almost 50 per cent of the average allocation, performance of both Australian and international equity sectors is incredibly important.

Chant West considered whether investment managers operating such portfolios would beat the index on a an historical basis - also over the past 5, 7, 10 and 15 years.

Over every time period in the past 15 years, Australian share managers have, on average, outperformed the S&P ASX 300 (before fees).<sup>13</sup>

**TABLE 1.9: Australian shares**

	5 Years	7 Years	10 Years	15 Years
Median	11.4	3.1	9.6	9.3
Highest	13.8	4.2	10.2	9.9
Upper Quartile	11.9	3.3	9.9	9.4
Lower Quartile	11.0	2.6	9.0	8.8
Lowest	10.6	1.1	8.9	8.8
<b>Number of funds</b>	25	25	19	9
<b>S&amp;P ASX 300 Accumulation</b>	11.0	2.1	18.9	8.4
<b>Outperformance</b>	0.4	1.0	0.7	0.9

<sup>13</sup> Source: ABS Managed Funds 5655.0, Table 4, September 2013.

Over 15 years, international share managers also beat the MSCI World Ex Australia Index by 0.6 per cent (before fees) but the outperformance does not occur in every time period.

**Table 1.10: Performance of active international share portfolios**

Performance of Active International Share Portfolios (% pa) - To June 2014				
	5 Years	7 Years	10 Years	15 Years
Median	11.9	1.7	4.3	2.2
Highest	13.6	2.7	5.2	3.4
Upper Quartile	12.1	2.3	4.7	2.4
Lower Quartile	11.5	0.5	3.8	2.1
Lowest	8.7	-0.3	3.0	1.3
<b>Number of funds</b>	20	20	13	8
<b>MSCI World Ex Australia</b>	11.5	1.8	3.9	1.6
<b>Outperformance</b>	0.4	-0.1	0.4	0.6

Chant West estimates there is a premium for active management (added cost) which for an Australian equities product is up to 0.30 per cent and up to 0.45 per cent for international shares.

In both asset sectors, over the past 15 years, the average return above the index outstrips the premium paid. However, this is not true for international shares over shorter periods.

The benefits of compounding are well-known. On a 40 year investment like superannuation, the value of compounding through a higher return, net of fees, is significant.

This research shows that, on average, the ten largest MySuper-like products have outperformed the benchmark over the past 15 years. It also shows that outperformance in both equities asset classes can be achieved.

The research does not provide a prediction on the performance of assets in the future. Nor does it suggest that outperformance will always occur in any particular asset class or management style.

It merely provides an evidence base that trustees, engaging investment managers in a competitive marketplace, can and do beat the market.

In making these decisions, trustees must be conscious of cost. Active management can be expensive and so it is important that the public at large is aware of the costs of managing the superannuation system.

The impending release of the APRA league tables for MySuper products will break down the fees and costs associated with the different components of managing the superannuation fund. The tables will specifically break down investment management costs, investment return targets and actual returns.

This transparency will provide research houses and commentators with vastly more information than has been possible in the past.

We believe the release of this information will engender stronger competitive tensions in the marketplace than has previously been possible.

### **Infrastructure investment**

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The interim report asks whether there is the possibility of greater superannuation investment in infrastructure projects.

Australia has been a pioneer in investing in infrastructure and alternatives. Active management of these assets has delivered performance that would not have been possible elsewhere.

Both the interim report and the government want to find ways to increase the level of superannuation investment in infrastructure. There is already \$45 billion of superannuation funds invested in direct and indirect infrastructure. This is projected to rise to \$100 billion in the near term as state governments' commitments to privatisation and new infrastructure increase.

There are a number of aspects of the financial services industry and Australia's regulatory environment more generally that impact on superannuation's capacity to invest in infrastructure.

The growth in the size of Australian superannuation funds is driving



capacity of funds to invest in infrastructure. The rationalisation of the industry has been considerable, with the number of funds decreasing from over 4700 in 1996 to 352 in 2012.

Larger funds are able to invest in large infrastructure assets without creating liquidity risk. As total superannuation FUM grows and the size of individual funds grow with it, the liquidity constraint on investment in infrastructure diminishes.

Further, the growing scale of superannuation funds has increased the number of funds with the critical mass to consider developing in-house infrastructure investment skills. Some FSC members additionally have noted that investment managers were developing additional indirect infrastructure investment vehicles aimed at medium sized funds that could not justify the expense to create an in-house infrastructure team.

There are however, a number of areas in which government action could assist in removing barriers to superannuation funds investing in infrastructure.

Investment in infrastructure could increase to \$225 billion<sup>14</sup> if policy settings between the Commonwealth and states undertook a number of reforms:

- ❖ Encourage asset recycling;
- ❖ Establish a pipeline of brownfield projects; and
- ❖ Maintain policy stability.

Superannuation funds are strongly in favour of the capital recycling model as a method of delivering proven infrastructure assets to market for sale, which in turn frees up capital for governments to invest in essential infrastructure projects.

Ownership is viewed by credit rating agencies as adding to balance sheet risk and often requires longer-term capital spending requirement putting pressure on the maintenance of government credit ratings.

There are significant benefits to governments and funds should a “virtuous circle” of capital recycling be achieved:

- ❖ superannuation investors would purchase brownfield assets at yields consistent with their established operating profile;
- ❖ governments could invest the proceeds in new ‘greenfield’ projects, avoiding the need to involve early expensive private funding; and

<sup>14</sup> EY FSC Superannuation Investment in infrastructure: Steps to further efficiency

- ❖ governments could eventually sell the greenfield infrastructure as a brownfield asset when the cash flow profile is stable.

Superannuation funds will continue to be a reliable source of capital for infrastructure financing provided the investment environment is stable. Research by the FSC shows that funds and investment managers consistently hold the view that further regulatory and tax changes would be counter-productive as it risks causing uncertainty in an asset class that requires stability to underpin long-term investment decisions.<sup>15</sup>

The often cited view “there is insufficient investment by superannuation in infrastructure” should be rephrased, “there is insufficient infrastructure for superannuation to invest in”. A consistent theme in research undertaken into superannuation’s role in infrastructure is that there is not a long-term pipeline of assets being prepared for sale or construction available for superannuation funds to invest in.

This view is supported by research conducted by EY for the FSC in 2011 and 2013. As demand by superannuation funds for this type of asset are expected to increase with the search for long-term stable returns for the retirement phase, the lack of investment ready projects actually becomes a risk for superannuation as funds compete for a small number of assets coming up for sale and possibly driving up the prices of assets.

These issues and others affecting superannuation investment in infrastructure were considered in the Productivity Commission’s inquiry into Public Infrastructure.

The Productivity Commission review brought to light two options for financing public private partnerships which should be considered further. These models unbundle the financing and construction parts of the PPP process to varying degrees.

The first option is to allow bidders to be appointed before they have financing and allow the winning bidder to seek financing later. This allows the bidder to seek out the broadest possible financing source.

A second option is the “inverted bid” model. Through this model, a fund manager is appointed, then a tender is undertaken for the long-term equity partner. Once appointed, the long-term equity partner conducts a second round of tenders for construction, operation and maintenance.

<sup>15</sup> Ibid

While the FSC sees some potential in these models, at the same time, the FSC does not believe the process should be changed to favour one type of financing source over another.

These options need further investigation and trialing before they can be implemented on a broad scale and an incremental approach is preferred.

#### RECOMMENDATION

The Inquiry recommend that the Government adopt the recommendations of the Productivity Commission's inquiry into Public Infrastructure. Specific recommendations in that report of direct relevance to superannuation's role are:

State and Territory Governments should privatise their government-owned:

- electricity generation, network and retail businesses; and
- major ports.

#### RECOMMENDATION

The Australian Government should conduct scoping studies to investigate the efficiency gains and other merits of privatising some or all of the business activities of the Australian Track Corporation. Airservices Australia should include a review of the efficiency of its capital expenditure program, as recommended by the National Commission of Audit.

The Australian, New South Wales and Victorian Governments should similarly investigate the sale of the Snowy Hydro. Sale of shares of one of these governments should not depend on the decisions made by the other governments.

#### RECOMMENDATION

Governments should undertake pilot procurement programs without the requirement for bids to be fully financed at the time of tendering.

The FSC agrees with the Productivity Commission that this model should be tested before the inverted bid model is considered further.

As infrastructure investments are typically active in nature, this asset allocation may not be desirable if seen through a “cost only” looking glass.

### **Global perspective on investment management**

As a significant proportion of the expenses incurred by superannuation funds, it is also important to consider the funds management industry's competitive position relative to other markets.

Despite views to the contrary, the primary reason that funds management fees are competitive in Australia is that superannuation trustees use their scale and experience to achieve lower costs.

This MySuper data is supported by the global research house Morningstar which says in its 2013 Global Fund Investor Experience Report:

“Australia fares very well with respect to fees and expenses. Australian equity, allocation and fixed income funds are some of the least expensive globally, with only the much larger United States charging consistently lower total expense ratios.”

In order to determine whether or not Australian superannuation funds are paying high fees to fund managers, we decided to undertake research into investment fees.

We conducted research to ascertain the relative level of fees in Australia compared to other parts of the world. Specifically, we conducted a survey of several large global fund managers on their fees charged for the same products in Australia and other jurisdictions. Collectively, the surveyed managers' funds under management (FUM) in Australia total around \$110 billion and \$7.1 trillion globally.

The methodology was as follows. In order to gain an accurate comparison we collected the actual fees charged (and not the published rates) on products that are sold in multiple jurisdictions. This means we compared the same product sold around the world. The products used were: global equities, global property securities, emerging markets and global bonds. The jurisdictions compared were Australia, US, Europe ex UK, UK, Asia ex Japan, and Japan. As fees can be charged based on the

size of the investment, the fee rates collected were based on a \$100 million mandate.

The results showed:

- ❖ Global equities rates are almost 11 bps lower on average in Australia than the other jurisdictions;
- ❖ Global property securities are 6 bps lower on average in Australia than the other jurisdictions;.
- ❖ Emerging markets are 13 bps lower on average in Australia than the other jurisdictions;and
- ❖ Global bonds are marginally more expensive in Australia (less than .1%) on average.

These results, comprising data from some of the world's largest fund managers show that Australia has very competitive fees on investment products. Anecdotally, the FSC heard from several fund managers that on most occasions, approval had to be sought on a regular basis from head office to lower the fees used in Australia in order to win business. The FSC submits based on this data that fund managers' fees in Australia are competitive and often the lowest globally. The primary reason that funds management fees are competitive in Australia is that superannuation trustees use their scale and experience to achieve lower costs.

While reaffirming Morningstar's results, our survey shows Australia has lower fees than even the United States on average based on a \$100m mandate. Fees in the US can be lower due to the large mandate sizes but on the same product at the same mandate, Australian fees are lower on average.

The survey shows that the 400 plus fund managers operating in this country are competing strongly for business of the 100 MySuper providers by driving down fees in this market.

#### RECOMMENDATION

That the Government recognise competition between superannuation funds and investment managers has driven comparatively low investment management expense rates in superannuation.



### 3. OPPORTUNITIES TO REDUCE COSTS AND FEES IN SUPERANNUATION

#### **Competition and scale**

MySuper was intended to keep fees low whilst maximising returns. The introduction of MySuper has seen competitively priced products come to market, however the ultimate policy objective will not be realised until the MySuper market is opened to competition. It is the movement of fund members from less competitive to more competitive products that generates the consumer benefits.

The interim report noted that “the selection of default funds in awards largely reflects precedent and is not subject to a competitive process.” The FSC agrees that the current FWC process for selecting default funds in modern awards is not a competitive process.

The FWC process also brings with it \$25.5 million in additional costs for superannuation funds.<sup>16</sup> It unnecessarily duplicates the APRA approval process required to secure a MySuper authorisation and ignores the consumer protections built into MySuper products through legislation.

Research by Rafe Consulting has concluded that 2.25 million fund members could also have their future superannuation contributions moved to a new fund should the FWC review process be allowed to be completed. This would result in duplication of accounts, multiple fees and insurance premiums, and increases in ‘lost’ super.<sup>17</sup>

Rafe Consulting estimates that the total cost to superannuation funds, fund members, employers and the Government could exceed \$400 million should the FWC default superannuation review be allowed to conclude.

The FSC supports introducing competition in the default superannuation market by allowing any MySuper product to compete to be the default superannuation fund of any employer. This would avoid any cost as an employer could remain with their current MySuper indefinitely.

<sup>16</sup> FSC Submission to the Treasury superannuation discussion paper

<sup>17</sup> Rafe Consulting, Impact of the Changes to the Fair Work Act on the Australia superannuation sector, employers and their employees, June 2014

FSC fees research and APRA data both demonstrate that the advent of MySuper has resulted in lower fees amongst default products. Lower fees may not be retained or improved upon unless those products are able to compete for new members. Funds that offer a MySuper product but are locked out of the default market lose the incentive to offer a low cost default product, reducing competition.

The stifling of competition in the default superannuation market is a critical economic and public policy issue as the default market directs the flows of “potentially more than \$9 billion” annually in contributions,<sup>18</sup> or at least 12.5% of total compulsory contributions.<sup>19</sup>

The current default process severely limits competition between funds and:

- ❖ Creates unnecessary duplication by requiring MySuper products to be approved by APRA, then accepted for default listing by the FWC Expert Panel, and then chosen from the list by the FWC Full Bench; and
- ❖ Favours incumbent award default funds by restricting the right to make submissions in the second stage of the FWC review, which decides which fund is listed in each award, to only registered organisations (unions and employer organisations) that own industry funds.

The duplication of process and incapacity of some funds to make applications during the second stage test is a major barrier to competition in the default market.

## RECOMMENDATION

To deliver the benefits of competition to over two million Australians covered by modern awards the current process for selecting default funds in modern awards be abolished to allow any MySuper product to be an eligible default fund.

Opening the default market to competition would also drive further industry consolidation that would improve fund scale.

The current default arrangements shelter funds that are sub-scale and high cost from competition. These funds are able to rely on modern award listing as a guaranteed source of new, disengaged members and their contributions, providing those funds with liquidity and removing the incentive to compete.

<sup>18</sup> [http://www.pc.gov.au/\\_data/assets/pdf\\_file/0011/119981/default-super.pdf](http://www.pc.gov.au/_data/assets/pdf_file/0011/119981/default-super.pdf) at 8

<sup>19</sup> [http://www.apra.gov.au/MediaReleases/Pages/11\\_01.aspx](http://www.apra.gov.au/MediaReleases/Pages/11_01.aspx)

In spite of widespread recognition that further industry consolidation would improve fund scale, the sheltering of sub-scale funds from market competition through the modern award system counteracts this objective. This is apparent in the relatively slow consolidation of the industry between 2004 and 2013, where the number of public offer funds only reduced from 296 to 161.<sup>20</sup>

APRA's most recent data shows that of the 120 approved MySuper licenses, 91 are 'not-for-profit' industry, corporate or public sector funds. The FSC submits that subjecting these funds to market competition will drive further consolidation and improve economies of scale.

It would be in the interest of members of those 'non-for-profit' sub-scale funds that are reliant on their modern award listing to have their fund be subjected to competition. Those funds would be compelled to either reduce their cost base or face losing members to lower cost competitors. It would also create pressure on the trustees of those sub-scale funds to consider merging with other, more efficient funds.

A model where any MySuper product is entitled to compete for default contributions will allow this process to occur incrementally without generating systemic risk as trustees are subjected to the pressure of competition.

Driving industry consolidation through competition in the default market compliments the Inquiry's focus on realising the benefits that can be achieved through economies of scale.

### RECOMMENDATION

The Government support an open and competitive default superannuation market to support industry consolidation and improvements in economies of scale.

### Product rationalisation

The FSC submits that the inquiry also recommend to the government that it reform how the rationalisation of legacy products is regulated. A comprehensive system to allow rationalisation of legacy products would significantly reduce cost in the financial services industry, placing downward pressure on fees and improve consumer outcomes.

A comprehensive product rationalisation regime would extend a simpler rationalisation process to managed investment schemes, superannuation and life insurance products.

<sup>20</sup> APRA Superannuation Bulletin 2014

The FSC notes that an effective system to rationalise superannuation products exists, however insurance products and MISs, including those within superannuation, cannot be rationalised. The mechanism for doing so is too difficult and expensive. As a result consumers remain in financial products that suffer from a higher cost basis and carry operational risk from outdated technology that is difficult to support.

The current rationalisation has resulted in the creation of over 600 legacy structures amongst FSC members, which may contain multiple products each, affecting an estimated 2.44 million consumers. The FSC does not expect, however, that all legacy arrangements would be rationalised in the near term. The FSC understands that, should rationalisation be allowed to occur, there would be a methodical process of rationalisation, starting with smaller and more costly legacy systems.

The FSC surveyed members to develop conservative estimate of the benefits that an effective product rationalisation regime would deliver in the near term:

- 38 individual IT systems could be closed, of 79 legacy IT systems across the sector;
- ❖ 286 life products and 77 managed investment schemes could be closed; and
- ❖ \$22.6 billion in funds under management could be transferred to contemporary products.

FSC members forecast that through these changes they could achieve \$94 million in cost reductions over the near term through a staged rationalisation program.

The size of legacy systems has been exacerbated by the advent of MySuper due to the large number of members that now sit in pre-MySuper products. The FSC has not incorporated these products in our calculations as the transfer of Accrued Default Amounts (ADA) is a partial solution. It is clear, however, that where the invested money does not fall within the definition of an ADA, legacy default superannuation products will create their own legacy issues.

Product rationalisation would allow consumers to be transferred from out-of-date products to comparable contemporary products without financial detriment to the consumer. Product rationalisation also allows the financial services industry to more easily update technology infrastructure underpinning financial products to improve efficiency and usability for consumers.

Treasury recognised the need for product rationalisation in a December 2009 Discussion Paper. In spite of broad industry support for the establishment of a product rationalisation regime, however, there continues to be inaction on this matter.

The FSC (then IFSA) detailed a framework in our 2010 submission that we continue to consider appropriate to addressing these issues. This submission is attached for your reference. The proposed framework is focused on fund member and policy holder protection and on industry efficiency.

The proposal outlined in the attached submission ensures that:

- ❖ A financial product to be rationalised meets the criteria of being either subscale and, therefore, uneconomic, or being a legacy product;
- ❖ Consumer rights are protected; and
- ❖ To the extent that a consumer suffers a detriment as a result of rationalisation, there is an entitlement to compensation on just terms.

An effective product rationalisation framework would result in improved disclosure, lower operational risk and access to new investment opportunities for consumers. It would also promote competition and productivity within the industry and reduce costs for industry participants.

## RECOMMENDATION

The Inquiry support the Government establishing a comprehensive and unified framework to facilitate the rationalisation of legacy products issued by superannuation funds, life insurers and managed investment schemes.

## Choice, portability and the three day rule

Choice of fund is an important feature of the superannuation system. It supports efforts to generate competition between funds, and also achieves better member outcomes when an investment strategy can be suited to an individual investor's financial arrangements.

The Australian system provides participants more choice than is present in most other jurisdictions. The availability of choice is valuable; in a mandatory system the capacity for individuals to exercise choice is important.

The FSC notes that the interim report discussed potential changes



to portability rules to address the some industry participants' views around liquidity. The FSC does not support changes to the current portability rules for liquidity management purposes.

Scale in the superannuation industry will be the biggest factor that allows funds to invest in more illiquid assets. Scale will be achieved through natural growth in a mandatory system. Policies that will drive industry consolidation, including APRA's scale test and opening up the default system to competition, would also drive scale and allow illiquid assets to be readily accommodated.

Suggestions that changes to the three day rule can have a significant impact on liquidity are unsupported by evidence. Portability would need to be curbed to a significant degree, such as staged draw downs over many months, to have any tangible impact on a fund's liquidity. The FSC submits that the loss of value would more than offset any marginal gains.

Further, proposals that such rules could be applied to particular age cohorts are deeply concerning. If there was significant loss in value in a particular asset class this would allow older fund members to leave the asset class, depressing prices at the expense of younger people who would be unable to exercise choice.

The FSC notes that some funds have concerns that in practice, the three day rule is difficult to implement. Within technical and rigid provisions for the process of responding to a request to transfer or rollover is the existing capacity for trustees to adopt a longer time frame than is standard for 'illiquid investments' where members actively choose and agree to those options.

There is room for technical improvements with this provision to enhance member outcomes without undermining the fundamental concepts of portability. In this regard the FSC would not oppose relaxing of the three day rule in a minor manner, such as an extension by a matter of days. The somewhat arbitrary time limit of three days was introduced to address complaints that some superannuation funds were deliberately delaying the portability process and making it so onerous that members invariably gave up and did not complete the transfer.

The three day limit has a number of consequences which are causing issues for some trustees including unnecessary and costly breach reporting to the regulator for events which lead to processing delays including reasonably common scenarios such as:

- ❖ trustees using forward pricing;
- ❖ high volume periods;
- ❖ end of financial year protocols (unit pricing particularly);
- ❖ State based holidays;
- ❖ distribution periods where prices are simply not always readily available; and
- ❖ in some cases market corrections.

“Forward pricing” means that a member application or withdrawal will be priced based on the valuation of assets of the fund at a point in the future from the time a valid instruction is received. A significant advantage of forward pricing over historical pricing is that the forward price is not known at the time of the application or withdrawal, which makes them less susceptible to price arbitrage.

The FSC does not subscribe to the view that portability is, of itself, creating major distortions or under-exposure to infrastructure investment or other less liquid assets simply due to liquidity requirements. The FSC therefore does not see merit in any major revision to the portability framework.

#### RECOMMENDATION

The Government recognise portability is not a significant issue when considering liquidity management for superannuation funds.

## 5. RETIREMENT

The superannuation system has the dual purpose of providing retirement incomes for Australians to improve quality of life in retirement and reducing the public's reliance on the age pension and other age related payments and services to minimise the fiscal impact of retirement.

The current system, however, does not adequately address the needs of Australians at retirement. The default arrangement is for a retiree to remain in accumulation phase for an unnecessarily long period of time until they decide how to structure their retirement. A large number of retirees do not receive advice at retirement and are at risk of making poor financial decisions.

The ramifications of a poor decision at retirement can significantly undermine the quality of an individual's retirement and undermine the effectiveness of the significant tax concessions afforded superannuation.

The FSC supports allowing funds to project retirement incomes on member statements. This relatively simple reform would shift perceptions of the system towards the adequacy of the income they will receive and away from lump sums.

The retirement phase is a complex interaction between the superannuation, taxation and social security systems. The FSC is concerned that the FSI's terms of reference do not allow for a holistic review of the retirement phase, and that should any recommendations be made in this area, the recommendations should be later subject to additional analysis.

We are concerned that retirement public policy development is siloed between:

- ❖ Superannuation and retirement incomes;
- ❖ Taxation;
- ❖ Social security;
- ❖ Health care;
- ❖ Disability care; and
- ❖ Aged care.

The FSC appreciates that a review of retirement incomes through the FSI would therefore need to also be considered in a holistic review of all the policy levers that are available to the Government.

## RECOMMENDATION

The Inquiry establish a framework for integrating the superannuation and social security system which will require additional input from the Tax White Paper.

### Current trends in retirement phase

The FSC agrees with the interim report that the retirement phase has not been subject to the same level of analysis as the accumulation phase. As a result the policy framework is less sophisticated.

This may be generating less optimal outcomes for retirees, however hard evidence of this is limited and it is certainly the case that fears of financial mismanagement in retirement are overblown.

For example, even without policy directing retirees to take their savings as income streams, it is increasingly less common for retirees to opt for a lump sum payment and prematurely consume their retirement savings.

In its Superannuation Bulletin APRA concluded:

“The changes in benefit payment options chosen by members is evident in a comparison between pension payments and lump sum benefit payments... the value of lump sum benefit payments increased by 39 per cent from 2005 to 2012 (from \$17.8 billion to \$24.7 billion) and that the value of pension payments increased by 155 per cent over the same period (from \$6.0 billion to \$15.5 billion). At the same time, retirement-age vested benefits increased by 120 per cent. This means that the proportion of retirement age vested benefits paid as pensions increased (from 4.3 per cent to 5.0 per cent) while the proportion of retirement-age vested benefits paid as a lump sum decreased (from 12.7 per cent to 8.0 per cent).”<sup>21</sup>

There is therefore no imminent risk of the retirement system failing. With the weight of superannuation savings soon moving into the retirement phase, however, it is prudent for the FSI to consider how the financial system can evolve to accommodate the needs of this cohort.

### Improving retirement policy

The FSC suggests that the FSI consider recommending principles to the Government to assist and inform more detailed government policy development.

<sup>21</sup> APRA Superannuation Bulletin, June 2012 (revised 5 February 2014) - <http://www.apra.gov.au/Super/Publications/Documents/Revised%202012%20Annual%20Superannuation%20Bulletin%202005-02-14.pdf>

The FSC recommends that the FSI consider a framework based on the following principles:

- ❖ Trustees be afforded the option of building into MySuper products a seamless transition into retirement phase where members who do not exercise choice at retirement are moved into a retirement product with a simple direction from the member;
- ❖ That retirement product may include an income stream, such as a (lifetime or deferred) annuity, including an annuity premiums paid in instalments in lieu of life insurance, an allocated pension, or a combination of an annuity or allocated pension;
- ❖ Trustees offering Choice products would have the capacity to choose whether to have the retirement phase 'built in' to their Choice products, or require members to seek advice from their advisor or fund (or not) at retirement;
- ❖ A broad degree of flexibility be afforded the retirement market so that a range of products become available to accommodate different retirement needs (with members protected by a trustees' duty to move the members into a product that is in their best interest).

The FSC also supports government moves to reform the retirement system to allow a more diverse income stream market to develop.

These parameters would allow a well functioning retirement system to develop quickly, but still allow individuals to tailor their financial arrangements to suit their personal needs. The point at which an individual contacts the fund to notify the fund of their retirement allows a point of engagement where the fund, or a financial adviser, can allow the individual to make improved retirement decisions for their situation.

The proposed framework would also allow the annuity market to achieve scale in Australia through group purchasing of annuities. Group annuitisation is important to minimise risk associated with selection bias from differing life expectancies.

The FSC refers to the FSI to our submission to the Treasury's current consultation on income streams and the minimum draw down requirements for a more technical analysis of the barriers to income streams. In the context of that submission the FSC supports competitive neutrality across the broad eight categories of income stream products that cover the range of allocation of longevity risk:



1. ILA (immediate lifetime annuity);
2. DLA (deferred lifetime annuity);
3. RCLA Type A (ruin contingent lifetime annuity);
4. RCLA Type B 'also known as Variable Annuity;
5. GSA (group self annuitisation);
6. FTA (fixed term annuity);
7. TAP (term allocated pension);and
8. ABP (account based pension)

Affording trustees flexibility to develop and offer retirement products across those eight categories would allow products to be tailored to the needs of a fund's members. It would also engender innovation and competition to the benefit of fund members.

The FSC notes, however, where particular products are purely conceptual in nature, such as GSAs, further consideration would necessarily need to be given to what degree of prudential oversight would be necessary to address any systemic risk that may arise from those products should they come to market.

The FSC also stresses that the FSI consider the social security and tax implications of its recommendations. In particular, any recommendations that reduce choice in retirement may encourage retirees to withdraw their savings to take advantage of the tax preferred and flexible Senior Australians and Pensioners Tax Offset (SAPTO).

Such an outcome would be inconsistent with the objectives of our retirement system as these retirees would be more likely to hold their savings substantially in cash, and therefore earn a lower rate of return and expend their retirement savings sooner.

The negative effects of behavioural change on the integrity of the system cannot simply be overcome by mandating particular investment decisions due to the significant damage this may cause the reputation and trust in the system.

## RECOMMENDATION

The Inquiry endorse the framework for more effectively managing the transition from accumulation to retirement phase as outlined above, but with regard to the need for further analysis of the social security and tax implications of this transition.

## Preservation age

The FSC submits that the preservation age be increased from 60 to 65 years and thereafter linked to life expectancy.

Life expectancy in Australia has continued to increase strongly. For Australians born today, the average male is now expected to live to 83 years and the average female to 87 years.<sup>22</sup> This is a significant increase from 80 years and 85 years respectively only ten years ago.<sup>23</sup>

Over the same period superannuation and age pension policy settings have failed to be adequately adjusted to accommodate not only improved longevity, but also the ageing of the 'baby boomer' cohort.

Increasing the preservation age is a serious reform to enable the retirement system to more effectively address the challenge that an ageing population presents to government finances and to bolster individual savings and quality of life in retirement.

The preservation age is currently transitioning from 55-60 years based on an individual's date of birth as outlined in Table 1.11.

**Table 1.11: Transitional arrangements for preservation age**

Date of birth	Preservation age (years)
Before 1 July 1960	55
1 July 1960 – 30 June 1961	56
1 July 1961 – 30 June 1962	57
1 July 1962 – 30 June 1963	58
1 July 1963 – 30 June 1964	59
1 July 1964 – 30 June 1965	60

<http://www.ato.gov.au/Super/Self-managed-super-funds/Accessing-your-super/Preservation-age/>

The FSC recommends that the superannuation preservation age be increased. Research by Rice Warner Actuaries shown in Table 1.12 indicates that for every year the Government increases the preservation age, national private retirement savings would be increased by \$200 billion.

<sup>22</sup> 3302.0.55.001 - Life Tables, States, Territories and Australia, 2010-2012

<sup>23</sup> 3302.0.55.001 - Life Tables, Australia, 2003

<sup>24</sup> <http://www.ato.gov.au/Super/Self-managed-super-funds/Accessing-your-super/Preservation-age/>

**Table 1.12: Total retirement savings gap****Total Retirement Savings Gap – delaying retirement age (\$billion)**

As at 30 June 2011	Males	Females	Total
<b>Retire at age 60</b>	1,333	933	2,326
<b>Retire at age 61</b>	1,248	889	2,137
<b>Retire at age 62</b>	1,111	794	1,905
<b>Retire at age 63</b>	1,000	722	1,722
<b>Retire at age 64</b>	878	641	1,519
<b>Retire at age 65</b>	701	588	1,289
<b>Retire at age 66</b>	573	494	1,067
<b>Retire at age 67</b>	453	383	836

FSC &amp; Rice Warner Actuaries, Longevity Savings Gap Report, 2012

This is measured by determining the shortfall in retirement savings needed to provide an adequate retirement income and the extent to which each one year increase in the preservation age increases retirement savings and decreases the shortfall.

There would also be a significant positive Budget outcome from increasing the preservation age which has been supported by the Productivity Commission.<sup>26</sup>

The Grattan Institute modelled increasing both the preservation age and the Age Pension eligibility to 70 years by 2035. The estimated saving would be \$12 billion by 2023 and \$15 billion in 2035 (today's dollars).<sup>27</sup>

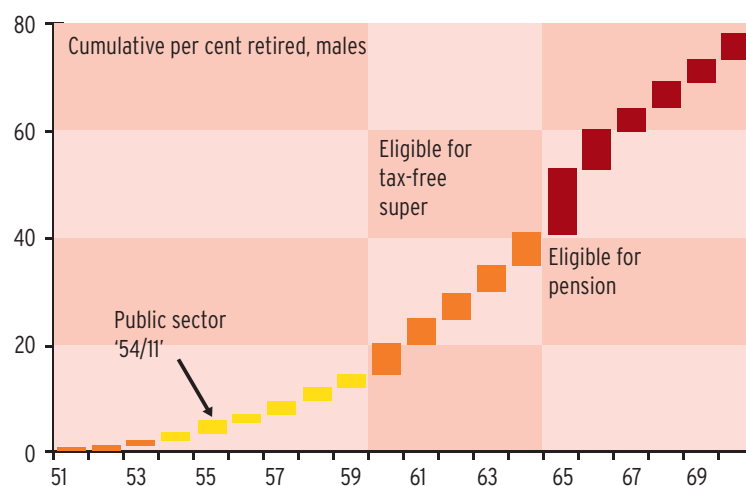
As the increase in the preservation age and the Age Pension age interact significantly, it is difficult to disaggregate their respective impact on labour force participation; however Figure 1.4 demonstrates how significantly retirement rates accelerate as individuals become eligible to receive tax free superannuation savings.

<sup>25</sup> FSC & Rice Warner Actuaries, Longevity Savings Gap Report, 2012

<sup>26</sup> Productivity Commission, An Aging Australia: Preparing for the Future, November 2013 at 201 [http://www.pc.gov.au/\\_data/assets/pdf\\_file/0003/129747/ageing-australia-overview.pdf](http://www.pc.gov.au/_data/assets/pdf_file/0003/129747/ageing-australia-overview.pdf)

<sup>27</sup> Grattan Institute, Balancing Budgets: Tough Choices We Need, November 2013 at 30 [http://grattan.edu.au/static/files/assets/ceacf10a/801\\_Balancing\\_Budgets.pdf](http://grattan.edu.au/static/files/assets/ceacf10a/801_Balancing_Budgets.pdf)

Figure 1.4 Age of eligibility for superannuation and age pension affects retirement decisions



Source: Grattan analysis of ABS (2011a) Note: Assumes that differences in labour force participation rates between cohorts one year apart in age reflect retirement rates.

Up to age 60, only 2 per cent of people in the labour force retire each year. However this number jumps up to 5 per cent at 60 years until 65 years. The FSC understands that those who retire at the preservation age, rather than the age pension eligibility age, are overwhelmingly higher income earners with larger superannuation balances as it is those who feel they have adequate savings to retire early.

Increasing the preservation age should therefore be considered a targeted policy that would improve the Government's fiscal position whilst also addressing the equity of the allocation of tax concessions in the superannuation system.

Increasing the preservation age would improve the equity in the system by:

- ❖ Retaining higher income workers in the workforce longer, increasing tax receipts from income tax, earnings tax and contributions tax;
- ❖ Reducing age pension outlays for those who outlive their retirement savings as a result of retiring prematurely;
- ❖ Increasing the savings of those who would otherwise have retired by adding an additional five years of earnings on their entire accumulated superannuation savings.

The rate of retirement jumps again at age 65 as individuals become eligible for the Age Pension, due to both the ability to substitute their income with the Age Pension and a significant increase in the effective marginal tax rate.

The Productivity Commission similarly concluded that the preservation age has an important effect on labour supply. The Productivity Commission concluded that the preservation age was the most significant trigger for premature retirement, and recommended increasing the preservation age to improve the efficacy of the superannuation system.

The Productivity Commission reported:

In principle, the preservation age should consider life expectancy and the Age Pension eligibility age as relevant factors. A preservation age linked to life expectancy would provide a financial incentive to stay in work for longer, and as noted earlier for the Age Pension, provide a shift in expectations about the age to retire.<sup>28</sup>

In reaching this conclusion, the Productivity Commission also noted the recommendation of the retirement paper attached to the Henry Tax Review that supported the preservation age being gradually increased to align with the Age Pension eligibility age.<sup>29</sup> This recommendation bolsters support for linking both the Age Pension eligibility age and the preservation age to life expectancy.

The Commission of Audit (CoA) also recommended an increase in the preservation age. The CoA argued that the preservation age should continue increasing in parallel with Age Pension eligibility and maintain a five year link between both ages.

### **Balancing the impact of a higher preservation age**

The possible burden for some mature workers of a higher preservation age is reduced by the availability of transition to retirement arrangements, which allow mature workers to reduce the number of hours they work whilst continuing to make superannuation contributions.

There remain, however, some cohorts of the Australian public who may be unable to work later in life due to the nature of their work, or as a result of lower life expectancy or poorer health than the broader public. The FSC would support appropriate amendments to the early release scheme that allow individuals who are unable to continue work to the preservation age to access their superannuation at an earlier stage when medical evidence can establish their inability to work.

<sup>28</sup> [http://www.pc.gov.au/\\_data/assets/pdf\\_file/0005/129749/ageing-australia.pdf](http://www.pc.gov.au/_data/assets/pdf_file/0005/129749/ageing-australia.pdf) at 201

<sup>29</sup> Treasury 2009, p. 16



The FSC proposes a Centrelink assessment that, subject to medical evidence, allows the Government to direct a superannuation fund to commute an individual's superannuation savings to an allocated pension, without a tax penalty, in the event they are unable to continue to work before the preservation age is reached. The FSC is also of the view that it would be necessary to grandfather current arrangements. Individuals who have commenced planning for their retirement should not have those plans interrupted as a result of retirement policy changes. The previous transitional arrangement provided for past increases in the preservation age could be suitably adapted for this purpose.

#### RECOMMENDATION

The Inquiry support the preservation age increasing to age 65 and thereafter be linked to average life expectancy with adequate transitional arrangements and protections for those unable to work to retirement age