SuperRatings & Lonsec

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“The Uncertain Path of Superannuation Reform”

Speech by Hon Peter Costello AC

Thirty years of experience

Award superannuation approved by the Australian Conciliation and Arbitration Commission is now 30 years old.

Superannuation implemented by the Commonwealth under its tax power – the Superannuation Guarantee Charge – is now 25 years old.

We have quite a deal of experience to judge how the system is performing. It is no longer in its infancy. It is maturing, if not a fully mature system.

The origin of Award superannuation was the ALP-ACTU Accord Mark II of September 1985. It was agreed there that a 3% wage rise should be paid, not to employees, but into superannuation on their behalf. The then Government also pledged that:

"before the expiration of the current parliament the Government will legislate to:- establish a national safety net superannuation scheme to which employers will be required to contribute where they have failed to provide cover for their employees under an appropriate scheme"

Taken together the proposal was:-

(a) employer/employee schemes would be certified by the Arbitration Commission where there was agreement;

(b) outside that there would be a national safety net superannuation scheme;

(c) a 3% contribution would be a safety net, not to replace the Age Pension but to supplement it.

Neither the contribution into the Fund nor the earnings of the Fund were to be taxable. That was introduced later, in 1988, when the Government needed revenue, so it decided to bring forward taxation receipts otherwise not payable until there were end benefits. With few lonely exceptions, Governments have been hiking superannuation taxes ever since.

There had been various proposals throughout the 20th Century to set up a funded retirement scheme in Australia. The Chifley Government introduced the National Welfare Fund Act of 1945 to impose an additional tax levy which, along with a payroll tax paid by employers, would pay for such benefits. The money was separately accounted for but nonetheless treated the same as consolidated revenue. It was formally abolished in 1985. No individual benefits were ever paid from it. When I became Treasurer in 1996, people were still writing to me asking about their entitlements in the National Welfare Fund! There was nothing to look for.

In 1973 a National Superannuation Committee of Inquiry was established and in 1976 it reported and recommended a partially contributory, universal pension system with an earnings-related supplement. This was rejected by the then Fraser Government.

The first leg of Award superannuation, Consent Schemes were endorsed by the Arbitration Commission to come into operation where there was Employer-Union agreement from 1 July 1987.

The second part – a national safety net scheme was never followed through.

What the Government, in fact, did was to introduce the Super Guarantee System which provides that unless an employer pays a superannuation contribution into an approved Superannuation scheme it is liable to pay an equivalent or greater charge to the Tax Office. No sane employer would give money to the Tax Office when they could use it to benefit employees. As a result money was forced into the superannuation system under the Commonwealth taxation power.

When I became Treasurer (1996), the SG was 5% for small business and 6% for big business. When I left office (2007) it was 9% for both. In 2014 it went to 9.5% where it is today. It will start to increase again in 2021 as the legislated table shows:-

1	Year starting on 1 July 2013	9.25
2	Year starting on 1 July 2014	9.5
3	Year starting on 1 July 2015	9.5
4	Year starting on 1 July 2016	9.5
5	Year starting on 1 July 2017	9.5
6	Year starting on 1 July 2018	9.5
7	Year starting on 1 July 2019	9.5
8	Year starting on 1 July 2020	9.5
9	Year starting on 1 July 2021	10
10	Year starting on 1 July 2022	10.5
11	Year starting on 1 July 2023	11
12	Year starting on 1 July 2024	11.5
13	Year starting on or after 1 July 2025	12

The SG system was superimposed (no pun) on the existing landscape - Industry Funds that had been agreed on and certified by the Arbitration Commission, and private-sector company or public offer plans.

After the idea of a national safety net scheme was dropped, there was little interest in a financial structure that would maximize benefits for those compulsorily enrolled in the scheme under threat of taxation penalties. Yet since this is such a valuable stream of income, mandated by the State, there has always been a very vigorous argument between potential recipients about who should receive it. I will come back to that in a moment.

Australia's retirement system therefore consists of three parts:-

1. The Commonwealth Age Pension currently fixed at 27.7% of Male Total Average Weekly Earnings – maximum rate of $23,254p.a. for an individual and $35,058p.a. for a couple. This is income tested and asset tested. It is totally unfunded. It is paid out of tax revenues received in the year it is paid or (if the Budget is in deficit) paid out of a combination of tax revenue and Government borrowings for that year.

2. The Superannuation System. This is a defined contribution scheme. It guarantees no defined benefit. It is fully funded, but subject to investment risk.

3. Income - whether by way of defined benefit or from defined contributions - over and above the SG system. Voluntary contributions are usually the subject of a tax incentive. As we know both sides of politics have recently combined to reduce the tax incentives to discourage larger amounts in private savings.

Average Retirement Benefits

According to APRA's Annual Superannuation Bulletin, the average balance in the Age Bracket 60 to 64 (coming up to retirement) in an APRA regulated entity with more than four members as at 30 June 2016 was:-

Male-$148,257

Female$123,690

These figures would include those who have made voluntary contributions, that is, those under both the second and third stream above.

Those who have only received the SG payments (with no voluntary contributions) would have considerably less.

If you were born in 1956 you could have been in the SG system since age 30- for 30 years. This is not a system still in infancy. We are now starting to get people who have spent nearly their whole working lives in it. On average (male and female) the balance is $137, 144.

That balance is worth less than the value of 6 years of Age Pension.

Yet life expectancy for males at age 60 is 26.4 years and for females 29.1 years.

The SG system will not provide anyone with average life expectancy a retirement income for life, not at a comfortable level and not at all.

What the SG system will do, is supplement a person's Age Pension.

And it is particularly harsh in that respect.

The Age Pension is subject to income and assets test. Roughly, for each $100,000 of assets (after the first), a pensioner will lose $2,000 of pension. They will lose 50 cents in pension for each dollar of income or deemed income over the threshold. It is an extraordinary high effective marginal tax rate.

Superannuation can give a person extra up to the threshold in assets and income, but after that every dollar they get back results in 50 cents being clawed out of their pension.

The Commission of Audit, which reported in February 2014, noted that around 80% of Australians of pension age are reliant on the Age Pension. It then looked at what would happen if contributions were lifted to 12%. It found that with a 12% SG over the next 40 years, the same number – roughly 80% would be still be on the pension.

The difference is that the SG would reduce many of those now on full pension to a part pension (about 20%).

The SG system does not take people off the pension. It supplements it. And as it supplements it, it reduces their pension 50% for each dollar (above the threshold).

In February, APRA reported there were total superannuation industry assets of $2.1 trillion as at 30 June 2016.

“Small funds which include SMSFs, small APRA funds and single member-approved deposit funds accounted for 29.7 per cent of total assets. Retail funds held 26.0 per cent of total assets, industry funds held 22.2 per cent, public sector funds held 17.0 per cent and corporate funds held 2.6 per cent.”

Over the last 10 years the fastest growing sector of the superannuation Industry was the SMSF sector. While total superannuation industry assets increased 132% SMSF assets increased 206%.

This is the truly voluntary sector of superannuation. These are the people aiming to, and the people likely to, fund a retirement that will take themselves off the Age Pension entirely and for life. This works out to be a great saving to the taxpayer.

Of course, this is the sector the Government has targeted with new tax increases, particularly through caps on contributions.

What could be done?

Let us think of how this system of fully funded pension supplement could have been differently structured.

Canada is a country that shares many similarities with us- population 36 million with a similar level of per capita income. Like us it has a three tier retirement income system consisting of:

(a) Old Age Security Pension (lower than ours)income tested and unfunded;
(b) The Canadian Pension Plan (CPP), a defined benefit Plan with compulsory contributions, that is partially funded;
(c) Private savings.

The contributions into CPP are currently 9.9%. The employer and the employee pay half (4.95%) each. It is planned to go to 11.9% soon. The CPP makes pension payments to contributors when they reach 65 equal to 25% of the earnings on which contributions were made over 40 years. At present the average is around C$7,839 and the maximum is C$13,370.

Like our SG scheme it is an occupational scheme. Unlike ours (because it is DB) it is not fully funded. In another respect the CPP is very different. It is managed and invested by a Government body, the Canadian Pension Plan Investment Board (CPPIB). CPPIB currently has C$300B in investments. It has economies of scale. It is extremely active in Australia. It would be one of the most respected investors in the world.

Let me say that I believe that, subject to safeguards, people should be able to choose who should manage their superannuation. But the reality in Australia is there is a very large cohort of people that don't. Their money goes into so-called "default funds" that get allocated to an Industry Fund under an Industrial Award or union agreement, or to a private sector plan by an Employer.

With default funds we are dealing with the money of people who make no active choice about where they want their money to go or how it should be invested.

Instead of the Government arbitrating between Industry Funds and private funds, there is a fair argument that this compulsory payment should be allocated to a national safety net administrator - let us call it the Super Guarantee Agency – a not for profit agency, which could then either set up its own CPPIB-like Investment Board – the SGIA-or contract it out – the Future Fund Management Agency could do it. There would be huge economies of scale. It would end the fight between the Industry and the profit sector over who gets the benefit of the default funds. Neither sector has been able to attract the money voluntarily. It exists by reason of Government fiat. The Government has decided it should go into the Super system. It could show some interest in managing it in a cost-efficient way.

Default contributions are now spread between many Funds. They allocate them to equity products, fixed income products etc. Sometimes the different superannuation funds use the same managers each paying the fee to do so. Those fees would be reduced if the money were pooled together, if there were one default fund making larger allocations, if market power were used to reduce costs.

It is the other side of the investment equation that particularly interests me. One side is how it comes in, the other side is how it is invested out. You all know that the biggest variable in the benefit that a retiree will receive from Super is the investment return. A bigger pool with economies of scale and access to the best Managers would likely drive down costs and drive up returns. It would be in the interest of all, except of course the mangers, and those interested in using administration fees for other purposes.

CPPIB is an example of how a long term Sovereign Fund investing defined contributions can get global reach, and valuable diversification in asset class and geography.

It also adds to the National skill base that Canada has:- a Sovereign Institution of sophisticated investors operating in global markets. The feedback and expertise developed is very valuable to national decision-makers.

The Concentration in Australian Equity Markets

Now I know that Super Ratings is releasing or has just released its ratings on performance of various funds.

The year ended 30 June 2017 was a good year for superannuation returns. I congratulate those of you who have done well.

For Balanced Funds (growth assets ratio between 60% and 76%), the top quartile return was 11.15% and the bottom quartile was 8.28%. It would be wrong to conclude this means there is a 3% return for skill. Inside this category – Balanced Funds – there is a large variation for growth assets – 15%. We would expect allocation further up the risk curve to do better – and in fact that was the case.

What made returns good this last year was the bounce on global equity markets. You know and I know that the most important factor in return is the overall market movement – Beta.

And what worries me is that the Australian Market is overwhelmingly influenced by Bank Stocks. Bank Stocks make up 25% of the ASX 200. They are either the four largest companies on the Australian Stock Exchange or 4 out of the top 5 – depending on the price of BHP.

There would not be another Western Country where the Stock Exchange is so dominated by financials and in particular by the main banks – the quadropoly as I have previously described them.

We therefore have a situation where superannuation returns are unduly influenced by the returns of the big four Australian Banks. I do not think it is healthy to have retirement incomes so significantly concentrated in this way.

I have no doubt it is an enormous advantage for the Banks. It means that every Australian in a super scheme that holds growth assets (and every working Australian is in a super scheme by virtue of Government legislation, and every person short of nearing retirement will be in growth assets), is invested in Banks.

Banks never have to fear a flight of Australian investors. By reason of their size and by reason of compulsory pool of savings, Australian superannuation funds with their compulsory rivers of gold have to hold them.

The four big banks are privileged. They are immune from takeover. They cannot merge. They have an ever ready supply of superannuation money flowing into their stocks. You can see why an air of impregnability and complacency has seeped into the management in Australian banks. Market discipline is negligible. And the returns on equity are hardly matched anywhere else in the world.

Again judging from the experience of CPPIB, the ability to accumulate and diversify with economies of scale might be good for superannuation members and it might also be good for the banking system – not so much in price – but in introducing a little more competition and market discipline.

The big mistake in developing our pension supplement (the occupational contributory superannuation system), is that all the focus was on getting money into it, with not enough thought about the optimal way of managing it. I do not say it has caused it, but it has contributed to concentration of financials in the Australian Stock Market.

The interaction of the tax and welfare system (particularly very high withdrawal rates) means compared to reliance on the Age Pension alone, the system does not bring anything like the benefits touted. To really calculate the benefit of SG, you need to deduct foregone age pension it will trigger.

The system has created an industry. It has certainly delivered benefits for those working in it. But it does not exist for them. It exists for those who are forfeiting wages month in month out in the expectation that in 10, 20, 30 or 40 years they will get to enjoy the fruits of their labour.