26 November 2013

Mr Tony Shepherd AO
Chair
National Commission of Audit

Sent via: submissions@ncoa.gov.au

Dear Mr Shepherd

National Commission of Audit

The Friendly Societies of Australia (FSA) appreciates the opportunity to contribute to the National Commission of Audit.

This submission responds to the Commission's requirement to "identify options to address…budget risks in the medium to long term, including by introducing appropriate incentives to encourage self-provision of services by individuals over time."

Friendly Societies and life event products

Through an agreement with the FSA, the Customer Owned Banking Association provides advocacy services for 12 of Australia's 13 APRA-regulated friendly societies.

The friendly societies' vision is to ensure:

- Australians have adequate savings to fund known life events such as the cost of education or a deposit for a first home;
- Australians have adequate savings to help them through difficult times, the cost of health or aged care, or the sudden expense of a funeral; and
- Australians have improved financial and social wellbeing through increased financial literacy and individual self-reliance.

To help achieve this vision, Australian friendly societies commit to:

- providing low-fee products that represent good value, are easily understood, meet an express customer need and are inclusive to all levels of society;
- maintaining exceptionally high standards for customers, centred around honesty, integrity and ease of access;
- educating Australians about the benefits of medium term savings and the means by which they can safeguard their financial and social wellbeing; and
- upholding core friendly society principles of mutual self-help, support and cooperation.

Friendly societies are:

- financial institutions regulated by APRA under the Life Insurance Act 1995; and
- corporations and Australian Financial Services Licensees regulated by ASIC under the Corporations Act 2001.

Friendly societies provide products – insurance bonds - that allow individuals to undertake a discretionary, targeted savings strategy focusing on life events over a range of time horizons.

Insurance bonds primarily take three forms – investment bonds (used for a range of life events such as house deposits, and health and aged-care costs), funeral bonds to cover unexpected funeral expenses and scholarship plans, specifically designed for education savings.

Friendly societies are the main issuer of investment bonds (alongside mainstream life insurance companies) and the sole issuer of scholarship plans and funeral bonds in the Australian market today.

Box 1: Types of Insurance Bond

Investment bonds are multi-purpose life event savings vehicles that are used to prepare for a wide range of life events, such as funding education costs, house deposits, and health and aged-care costs.

They also have a number of strategy-based applications, such as pre-emptive intergenerational wealth transfer and estate planning through the ability to nominate beneficiaries. On death, the balance of the bond is paid tax-free directly to the beneficiary rather than to the estate, avoiding potential disputes and claims from third parties.

Investment bonds are similar in form to a managed fund, except they are 'tax paid', in that earnings within the fund are taxed at the rate of 30 per cent, and non-distributing, with after-tax returns reinvested within the fund.

They can be capital guaranteed (investing in cash and other conservative investments) or unit linked (where investors' funds are pooled together in order to provide individuals with access to investment opportunities that may not otherwise be available to them).

Investment bonds have features that shape their longer-term, savings-based nature, most notably a 10-year holding period, where accumulated capital and earnings are accessible tax-free after ten years. A 125% contribution rule allows for ongoing contributions into the fund over the life of the bond.

Funeral investment bonds are also tax paid, capital guaranteed investment bonds but without specified limits on contribution amounts (other than for means testing for pensions) and holding periods, with the amount of the bond paid only on death of the bond holder.

All funds are paid either to the Estate or a Funeral Director (via assignment) and tax is payable by the recipient on earnings, less a 'termination bonus' that equates to the tax paid by the fund.

Scholarship plans are a variant of an investment bond but with a specific tax treatment under the Income Tax Assessment Act 1997[1] (ITAA). They are specific-purpose life event savings vehicles used to fund the education expenses of children across all levels of schooling – from primary through to secondary - or adults pursuing tertiary or skills based qualifications and carry all of the benefits of investment bonds.

Under tax law, scholarship plans can only be established by a friendly society regulated under the Life Insurance Act. As the fund is designed specifically for education, it fulfils the requirements of a 'scholarship plan' under the ITAA. This allows the fund to receive concessional tax treatment, in the form of a rebate on the 30 per cent tax paid at the fund level, which in turns optimises the child's scholarship benefit.

Scholarship plans have a tax treatment more equitable for people on lower incomes and are more popular among this demographic. A 2008 study undertaken by the largest issuer of education savings plans in Australia, Australian Scholarships Group, showed that:

- only 2.3% of new members had a household income of over $100,000; and
- 68.7% of new members had a household income between $52,500 and $78,800.

Recommendations

Unfortunately, the tax attractiveness of these products relative to other savings alternatives, and superannuation in particularly, has been gradually eroded over time, reducing their take up by Australians.

To help address the current lack of neutrality in the tax system between investment bonds and other savings alternatives, FSA recommends:

- a phased reduction in the tax rate applied to friendly society benefit funds from 30 per cent to 20 per cent over five years;
- the introduction of an education savings co-contribution scheme for low and middle income Australian families to help stimulate this form of savings; and
- the immediate restoration of an appropriate tax-free threshold to earnings paid to minors under scholarship plans, which are currently taxed at punitive rates as high as 66 per cent.

Life event savings research

The Australian Centre for Financial Studies (ACFS) is a not-for-profit consortium of Monash University, the University of Melbourne, RMIT University and Finsia, specialising in leading edge finance and investment research.

In August 2011, the ACFS released a research report *Private Saving: The Role of Life Event Products*[2] commissioned on behalf of the FSA. The research showed that individuals face a number of challenges over their lifetime, such as financing education, housing, health and retirement, for which many are unprepared.

The report noted that the financial challenges that these life events create can be met, in part, through an adequate, sustainable savings pool or in other cases, government support. Conversely, a shortfall in these areas will directly impact the range of opportunities available to an individual over their lifetime.

[1] Income Tax Assessment Act 1997 subsection 995-1(1)
[2] Australian Centre for Financial Studies, Private Saving: The Role of Life Event Products

The report concluded that the insurance bond framework, offered by Australian friendly societies, is the best mechanism to prevent medium-term savings shortfalls. However there is a disincentive for low to middle income earners to use these products.

The FSA has developed policy options to address this disincentive, drawing on the report's recommendations alongside the industry's existing policy priorities.

Policy case for insurance bonds in medium-term financial adequacy
In its August 2011 research, the ACFS observed that:

> *Households face a range of possible life events, such as education, health, housing and retirement, which can require significant expenditures for which they are often inadequately prepared by way of saving or insurance.*

The ACFS suggests that government tax policy can also be structured to influence both savings and the design of financial products to assist people in providing for their own pre-retirement welfare.

At a policy level, the ACFS research noted:

> *Insurance bonds are a good example of a 'partnership model' in which individuals accumulate savings to meet expenditures and where some government contribution is involved via the tax concessions provided.*
>
> *It is also possible for that contribution to be achieved by government matching or co-contributions. However, at the current tax rate applied to friendly societies, the attractiveness of these products to low income individuals as a wealth accumulation vehicle is reduced.*

The ACFS research pointed to the insurance bond framework as a long-standing, simple, low-advice mechanism that has the potential to increase household savings and financial wellbeing.

However, the ACFS also made the following observation:

> *The Henry Review (2009) highlighted the lack of neutrality in the tax treatment of various savings products. With the dominance of the superannuation system in public policy, incentives to encourage individuals to be financially self-reliant and plan for the future through non-superannuation vehicles have gradually dissipated.*

The Henry Review, in its report to Government in December 2009 explains the impact of the tax and transfer system in this and other areas, arguing that:

> *"Living standards are also undermined by tax settings that discourage people from making choices that would yield greater lifetime wellbeing"*[3]
>
> "*There* [under the tax and transfer system] *would be clear incentives for people to improve their lifetime opportunities through workforce participation, investing in education or saving".*[4]

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[3] Australia's Future Tax System, Part One, p24
[4] Australia's Future Tax System, Part One, p26

The ACFS research drew a key conclusion:

To enhance the use of this investment vehicle, and also to counterbalance the preferential tax treatment given to a range of other investment strategies, there is merit in considering changes to the current tax and legislative treatment of friendly societies and insurance bonds.

The FSA contends that inadequate discretionary savings among Australians is a major challenge to securing the economic and social wellbeing of individuals and communities.

The FSA believes that the insurance bond framework is a well-developed, mature mechanism that, with only modest changes, will:

1. strengthen the medium term financial adequacy of a wider group of people than the current financial services framework provides for; and
2. increase the range of social and economic opportunities available to Australians through a growing and sustainable savings pool.

Recommendation 1 - a phased reduction in the tax rate applied to friendly society benefit funds from 30 per cent to 20 per cent over five years[5]

A 20 per cent tax rate lies sufficiently below the main marginal tax rate of most Australians (32.5 per cent) and above the superannuation rate of 15 per cent. It will widen the attractiveness of insurance bonds to virtually everyone above a minimum wage.

Investment bonds offer a platform for financial adequacy outside retirement however at the current tax rate of 30 per cent, lack the universal appeal needed to ensure they are a sustainable option.

The timing for such a measure is ideal. In the emerging 'fee for advice' landscape, investment bonds represent a low cost option because they are simple to understand and administer compared to more traditional managed funds.

In today's economic climate, Australians are focused more on saving, creating an opportunity to support products that direct these savings to a medium term strategy-based pathway, rather than riskier wealth-based mechanisms that have performed poorly in recent years.

Recommendation 2 - the introduction of an education savings co-contribution scheme for low and middle income Australian families to help stimulate this form of savings

The FSA sees a strong case for a government co-contribution scheme that stimulates education saving within the community. Despite active marketing of scholarship plans by the friendly society industry, this form of saving remains low.

By illustration, in 2010-11, Australians personally spent around $36 billion on education[6] but only a fraction of that ($270 million[7] or .08 per cent) was met through structured education savings plans.

The objective of this proposal is to both focus public attention on the benefits of education savings and provide a 'stimulus' that increases household savings activity.

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[5] This can be achieved through a simple amendment to the life insurance fund tax rate specified in Section 23A of the Income Tax Rates Act 1986
[6] ABS
[7] Total earnings paid to scholarship plan beneficiaries, 2010

The scheme would be available to all households that make contributions to a scholarship plan[8] issued by a friendly society and would adopt the basic characteristics of a contribution amount, a cap and eligibility rules.

A much larger pool of 'public-private' education funding could emerge within a relatively short period of time. This will help address lower education participation rates, particularly among low and middle income households, and widen the range of education pathways available to a young adult when their plan matures.

A scholarship plan owner (usually a parent, grandparent or another sponsor) could participate in the scheme on a child-by-child basis over a fixed, five year period that commences within the first two years after the birth of a child, with government matching, dollar-for-dollar, annual contributions up to a maximum of $500 per year.

The scheme should specifically target post-secondary education, be that tertiary study, TAFE or other forms of skills and vocational training. This can be achieved by preserving the co-contribution made by government (both the capital and income component) until the time the student beneficiary reaches a minimum school leaving age of 17.

There should be no restrictions on withdrawing personal contributions made by the plan owner earlier. Scholarship plans are designed to fund education expenses across all levels of schooling and this flexibility must be maintained.

However, creating a 'lock-in' period of a proportion of these savings over a child's entire schooling life will allow sufficient time for the amount of the co-contribution to generate a sufficient amount of earnings.

The integrity of the scheme would be maintained via the existing ATO-defined 'sole purpose test', which removes the existing concessional tax treatment on earnings if they are not used for legitimate education expenditure.[9]

There are other considerations that would need to be discussed with industry as part of a consultation process, such as entry and exit rules (particularly around any unused contribution amounts), timing and eligibility.

The FSA reiterates that the existing tax regime specifically established for scholarship plans back in 2003 is well-placed to address any major tax integrity concerns and facilitate a relatively easy design and implementation phase of the scheme.

There are several compelling reasons to introduce incentive-based measures that encourage education saving. A family that builds a sustainable pool of education funds can increase their financial adequacy and in turn:

- provide a family member with a higher level of education, such as a tertiary degree, that may otherwise have been unaffordable;
- unlock new education pathways, such as TAFE study or vocational education and training;
- increase a family member's level of education support, such as tutoring and coaching or exam preparation; and

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[8] As defined under the *Income Tax Assessment Act* 1997 subsection 995-1(1)

[9] Under tax law, if the earnings under these plans are not used for legitimate education expenses, then the 30 per cent tax paid at a fund level applies to these earnings and is assessed in the hands of the parent investor, not the child. Where the investor is on a higher tax bracket than 30 per cent, further tax is payable.

- relieve financial pressure by using savings to cover ancillary education costs (such as uniforms, travel or textbooks) or smoothing the impact of education costs over time.

These are significant benefits at an individual level, with flow on collective benefits for Australian society. A large pool of national education savings could potentially:
- boost Australia's long-term education capacity;
- increase workplace productivity and participation rates; and
- widen employment opportunities and subsequent earnings capacity.

The FSA believes that participation rates are a function of access, which is driven by affordability and means. A national program of education savings could mitigate, or even overcome affordability problems and make a wide range of education pathways available to more people, regardless of their socioeconomic backgrounds and beyond what government welfare support can currently sustain.

Illustrating the size of this challenge, 2011 ABS Census data reveals that half the Australian population had not yet achieved education qualifications beyond high school and 17% held a bachelor qualification.

Currently, the friendly society industry manages over $1.6 billion in education savings on behalf of 190,000 students up to tertiary age. Depending on the level of schooling, students can have, on average, $9,000-$14,000 in funds to put towards their education.

These are healthy numbers in real terms however when viewed against the wider population, the current pool of funds equates to around $230 for every child and young adult in Australia between the age of 0-24 years, providing an insight into how small Australia's education savings rate is in relative terms.

In the latest AMP.NATSEM Income and Wealth Report: *Smarter Australians*, which explores education and innovation in Australia, education was found to be among the top 15 expenditure items for Australian families and in the last six years, average family spending on preschool and primary school education had risen by 79 per cent and spending on secondary education increased even more at 101 per cent.

The same report showed that the ratio of government to private expenditure on education had increased substantially between 1984 and 2011. In 1991, Australians spent the same amount on their education as government; now, government expenditure is 65 per cent higher than private expenditure (2011) and rising each year.

If incentive-based reforms are successful in encouraging a higher rate of private, discretionary savings to fund education expenses, it is reasonable to expect a commensurate easing in household financial pressure and a gradual fall in reliance on government support for education.

Government co-contribution schemes are driven by these principles and have been used as a 'stimulus' in a number of areas of national concern, including health, retirement and housing, however one is yet to be considered for education.

The success of the superannuation co-contribution scheme indicates that Australians may respond to similar scheme for education. Over the three years from 2008-2011, 1.35 million Australians on low to middle incomes utilised the super co-contribution scheme, a significant reaction given the long-term nature of retirement savings.

Education savings are medium-term, discretionary savings vehicles. This means that people using these vehicles realise the benefits of their investment earlier than superannuation, have active control over their savings and therefore have a greater level of personal involvement.

The FSA believes this will have a significant influence on the success of an education co-contribution scheme, perhaps even greater than that seen with superannuation (in relative terms).

Recommendation 3 - the immediate restoration of an appropriate tax-free threshold to earnings paid to minors under scholarship plans, which are currently taxed at punitive rates as high as 66 per cent

The lack of any meaningful tax-free threshold and the high rate of tax on income earned by minors from scholarship plans is an unintended consequence that stemmed from the removal of the low income tax offset from non-work income earned by minors in 2001.

While the original policy behind this measure was sound (it would prevent high income earners from accessing the tax offset via the transfer of income to a child), it triggered a major jump in a minor's tax rate on any income[10] they withdrew from a scholarship plan.

On 1 July 2011, the tax rate increased from 0 per cent to 66 per cent for earnings between $416 and $1,307, and from 0 per cent to 45 per cent for earnings above that. This was due to a decrease in a child's notional tax-free threshold from $3,333 to $416.

This has a significant impact on existing beneficiaries. At the time of the change, nearly 60,000 Australian children under the age of 18 had in place a family-sponsored scholarship plan accumulating education savings on their behalf.

These plans were established by families on the understanding that the government's concessional tax treatment would remain, only to later find that the final earnings payment would be much lower should they decide to withdraw.

Industry evidence over 1 July 2011-30 June 2012 points to a concerning combination of a spike in plan closures and substantially slower product take up. One fund of around 6,500 members saw 600 investors withdraw completely in the first 12 months after the changes and 33 per cent less in new members over the same period.

There are only two friendly societies that offer scholarship plans in Australia. A third had just commenced offering these plans three months prior to the changes but has now closed this product line.

The FSA believes that the future of scholarship plans in the under 18 year old market is under a cloud – the specific tax benefits introduced by government years ago have been all but reversed.

This is a very unfortunate outcome for thousands of Australian families. Scholarship plans are unique – they are the only dedicated education savings vehicle in the market today and by law[11], can only be offered by a friendly society. Their tax integrity is upheld through a sole purpose test that removes any taxation concessions if earnings are not used for their intended education purposes.

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[10] Where assessable in the hands of a student who is a minor (under Division 6AA rules) and not in the hands of a sponsoring adult - *Tax Laws Amendments (2011 Measures No $) Bill 2011*, Explanatory Memorandum, ch2.

[11] Section 995.1 of the *Income Tax Assessment Act 1997* defines a scholarship plan as a life insurance policy issued by a friendly society for the sole purpose of providing benefits to help in the education of nominated beneficiaries.

With the low income tax offset all but removed, government should announce a new tax-free threshold for these vehicles as a priority, set at $3,333 (the same as originally applied) and indexed annually in line with the CPI for education.

We believe the cost to revenue from this change would be negligible. The flow on impact of the low income tax offset changes on education earnings was never foreseen and it is unlikely that the small revenue gain from an increased tax rate applicable to these plans was measured.

Therefore, the FSA believes there are no further revenue implications under this proposal.

Conclusion
This paper presents a number of targeted policy measures that if adopted, will improve the financial and social wellbeing of individual Australians.

The FSA believes government should recognise the benefits an increase in medium-term savings could deliver to society and introduce measures that encourage people to utilise specific mechanisms best-suited to the task.

We believe the insurance bond framework is such a mechanism and can deliver significant benefits across a number of levels.

Financially, insurance bonds can:
- help increase overall national savings by encouraging a savings culture;
- boost private household wealth through a reduction in debt reliance and the smoothing expenditure on key life events over time; and
- increase financial literacy levels across a wide age group due to the planned, intergenerational, discretionary nature of the product.

Socially, insurance bonds can:
- increase the employment opportunities available to Australians by facilitating access to a higher standard of education; and
- reduce reliance on government and social welfare by encouraging personal responsibility.

The FSA hopes the Commission will agree that our recommendations address long-term budget risks and respond to the need to introduce appropriate incentives to encourage self-provision of services by individuals over time.

Please contact me on [redacted] or [redacted] Senior Policy Adviser, on [redacted] or [redacted] to discuss any aspect of this submission.

Yours sincerely

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[redacted]
A/Head of Public Affairs