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Industry Super Australia

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EXECUTIVE SUMMARY

ISA welcomes the opportunity to comment on the Government's Commission of Audit.

Australia's superannuation system, which is a key pillar of our retirement income architecture, serves the dual purpose of improving retirement income adequacy and taking pressure of the age pension expenditures.

At $1.75 trillion in assets, superannuation now represents a significant part of the nation's financial system. Superannuation savings attract tax concessions – consistent with the requirement for long-term preservation of those savings to fund retirement income – and therefore represent a cost to Government. However, by helping to fund retirement incomes superannuation savings reduce the future cost to the budget from the means-tested age pension.

The capacity of the superannuation system to realise its potential is a product of its accumulation settings (net contributions and earnings) and settings for drawdown in retirement (including interaction with the age pension).

Following years of superannuation policy reform, Industry Super Australia (ISA) seeks stable tax and regulatory settings. We therefore welcome the Government's commitment to implement no unexpected, adverse policy change.

We recognise that going forward, particularly in the context of demographic pressures, the retirement income system might need some adjustment. We strongly believe any such changes should be driven by the principles of adequacy, sustainability, equity and efficiency.

We further believe policy change to superannuation should be designed and implemented in consultation with industry and the community – and preferably with bi-partisan support.

We would urge the Commission of Audit to recommend against any short term savings measures which have the potential to undermine the system's long term public policy objectives.

Specifically ISA opposes the repeal of the Low Income Superannuation Contributions (LISC). Equity is an important consideration in the design of tax settings, and Treasury (2008) modelling shows the highest benefits from the retirement income system – combining the age pension, and superannuation – actually accrue to those on the highest incomes. The LISC strengthens the legitimacy of superannuation by addressing the long-standing issue that millions of Australian workers on low incomes currently receive no concession, or are taxed punitively, on their compulsory superannuation contributions. ISA estimates abolishing the LISC will deplete superannuation assets by $13 billion by 2021-22, and result in a diminution of retirement savings for an individual of up to $27,000 in current dollars (a reduction in savings of up to 15%). This outcome will unambiguously increase pressure on future Governments to increase the adequacy of the Age Pension with significant direct cost to the Commonwealth budget.

In addition, a more efficient superannuation system – with lower costs and higher net returns – will have more rapid accumulation, and therefore offset a higher level of pension costs. It is therefore essential that any policy change – such as to recent financial advice, MySuper , product dashboard, or default fund selection reforms – does not allow a reversion to less efficient market conditions.

Superannuation also contributes positively to Government finances through direct financing of private provision of infrastructure. We would encourage consideration of proposals to more fully realise the potential that this offers both Government and superannuation.

Changing demography has led some commentators to call for an increase in the pension eligibility and superannuation preservation ages. ISA notes that Australia's expenditure on public pensions is near the bottom of OECD countries. We further suggest that while increasing senior labour force participation is an important policy goal, less draconian measures to achieve this aim should be explored first. Seniors face age-based discrimination that must be addressed in order to create more opportunities for seniors to access paid work. As well, many seniors face effective marginal tax rates (EMTRs) of between 60 and 80 per cent from the combination of the age pension means-test and the tax system. Finding ways to reduce these to more reasonable levels would remove a fundamental financial obstacle to greater senior participation.

1. Background

The Government budget appears to have entered a period of structural deficit, driven by post-GFC spending and falling tax revenue.

ISA expects that demographic change will soon be a source of additional fiscal pressure as the baby-boomers begin to move into retirement. The number of working age people for every person aged 65 years and over was 6.9 in 1978, 4.6 in June 2013, and is projected to be only 3.2 by 2030. This trend has implications for Government finances generally; but it is of particular importance to managing the net cost of the retirement income system – including both age pension and superannuation.

Under these pressing circumstances, the efficiency of the superannuation system is critical. Policy should ensure each dollar contributed by a worker is boosted by strong net returns to provide the most retirement income possible. Similarly, the contributions of Government through tax concessions need to be equitably distributed and efficiently targeted, to encourage retirement savings that would otherwise not occur.

2. A principles-based approach to superannuation policy

ISA considers that there is broad industry consensus that superannuation policy be developed using a principles based approach, with bi-partisan support, and progressed outside an election context. Policy settings should not be adjusted on a regular basis under the guise of budgetary pressures, and should become entrenched in our culture, akin to the GST or the PAYE system.

Our approach suggests policy should be based on the following principles:

> **Adequacy** – people should be able to achieve a sufficient standard of living in retirement relative to either the standard they enjoyed while working or as compared to an objective budget standard for retirees. In this context, longevity, inflationary and investment risk need to be managed to avoid erosion the individual's benefits.
>
> **Sustainability** – The cost of the retirement income system needs to be managed over time, recognising the interactions between superannuation and age pension costs.
>
> **Certainty** – individuals should be able to understand the superannuation environment and entrust the system with their private savings.
>
> **Equity** – the age pension is the retirement income safety net and superannuation tax concessions compensate workers for preservation of savings until retirement. It is important that the benefits of the retirement income system are distributed fairly, and that all taxpayers have access to concessional contributions.
>
> **Flexibility** – While the system should promote take-up of income streams to fund retirement income over the long term, it is reasonable for members to retain the option to use deferred wages to fund significant contingent expenditures.

This submission focuses on application of the principles of adequacy, sustainability and equity.

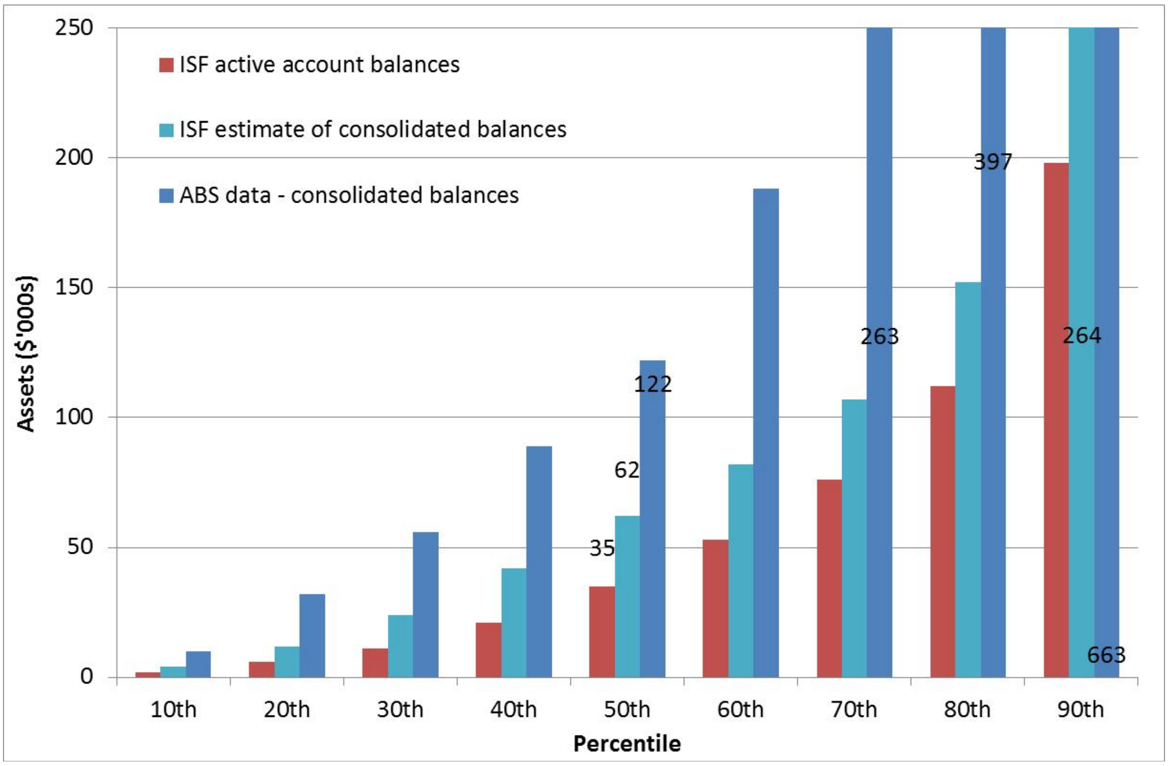
2.1 Adequacy

A continuing policy challenge for Australia remains securing the adequacy of retirement income, including through boosting superannuation members' balances at retirement.

Data from large Industry SuperFunds (ISFs) shows the median balance for active accounts for members aged 60-65 is only approximately $35,000,[1] including both accumulation and pension accounts.

Allowing for multiple accounts, our estimate of median superannuation holdings for ISF members is approximately $62,000 per person. ABS data for the wider population shows estimates of $122,000 per person (Figure 1). While balances are improving for retirees, these levels are still well below adequate.

Figure 1 - Member balances for 60-65 year old, December 2012 (Industry SuperFunds & whole population)



Source: ISA analysis based on data from SuperPartners (2013) and ABS (HILDA microdata, 2012)

Using the ASFA comfortable budget standard as a guide, retirees should be aiming for annual after-tax income of around $41,200 for singles or $56,400 for couples.

Assuming receipt of a full age pension, including allowances of $21,500 for singles or $32,400 for couples, this leaves a shortfall to be made up by super of $19,700 per year for singles or $24,000 per year for couples. Even without any allowance for contingency or bequest, that translates into required accumulation of around $226,000 for singles or $275,000 for couples.[2] The current holdings of working Australians of median wealth are still well below these targets.

The Government has announced it will repeal the Low Income Superannuation Contributions (LISC) and delay the increase in the SG by two years. ISA estimates that the delay in the SG increase could result in a

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[1] December 2012.

[2] The level of assets required for singles takes them above the age pension assets test, resulting in reduced pension income, therefore requiring even further super assets to reach the ASFA comfortable level. Based on the assets test alone, singles would need $255,000 in assets. The required drawdown to reach the comfortable level would then be above the minimum drawdown level, potentially also triggering the income test on the pension, resulting in further loss of age pension. This model assumes 20 year life expectancy, 6% pa net returns and full drawdown (with no provision for bequest, contingency or longevity.

cumulative impact of around $40 billion less in super savings in the system over the next seven years – an amount that could fund several major infrastructure projects.[3] The Government's decision to remove the Low Income Superannuation Contribution (LISC) will also adversely affect the balances of low income Australians, reducing aggregate retirement savings by an additional $13 billion by 2020. These changes will leave the nation significantly less prepared for the known demographics changes ahead, as well as increasing demands on the public purse.

2.2 Sustainability

2.2.1 **Superannuation tax concessions**

Constant tinkering with the tax treatment of superannuation undermines confidence in the system and can discourage voluntary contributions. We reiterate the importance of broad consultation and bi-partisan support in relation to any further policy changes.

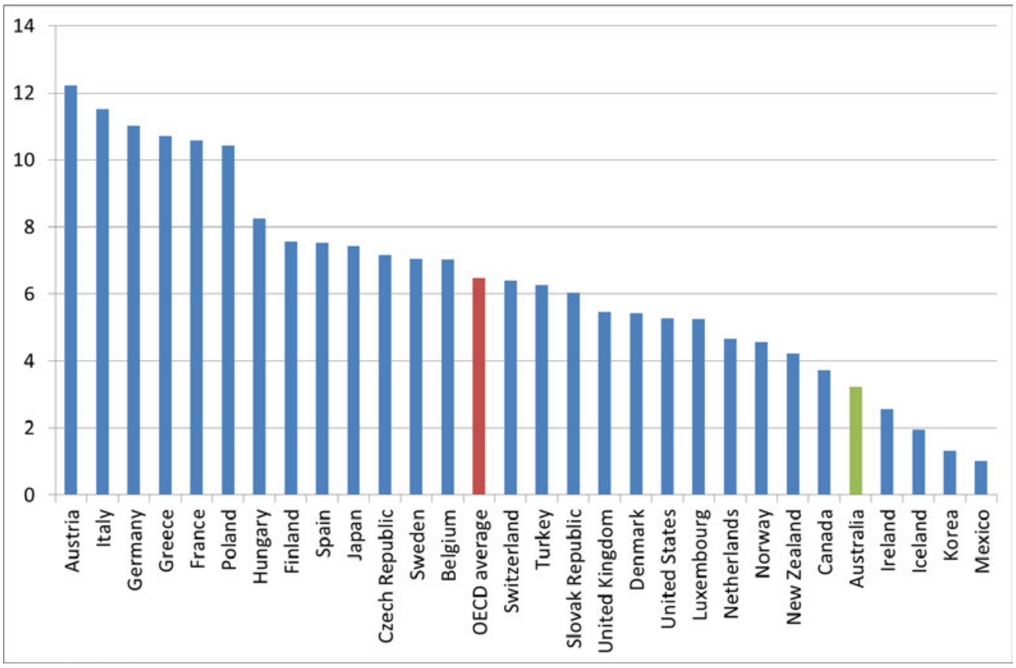
ISA recognises, however, that superannuation tax concessions are a large and increasing cost to Government, and the benefit of these concessions are skewed towards those on high incomes with larger balances.

Given that tax expenditures, as with other expenditures, must be paid for elsewhere in the tax system, ISA considers it is important that superannuation tax concessions are targeted effectively towards achieving the retirement income objectives of super and not any other purpose.

2.2.2 **Demographic change, retirement age and the Age Pension**

As the population ages, the Government will need to consider the sustainability of the current retirement income system, including both the Age Pension and superannuation system. It is important, in this context, to recognise that the Australian means-tested Age Pension is among the most affordable public pension arrangements among OECD countries (Figure 2).

Figure 2: OECD public pension expenditure as a percentage of GDP, 2005

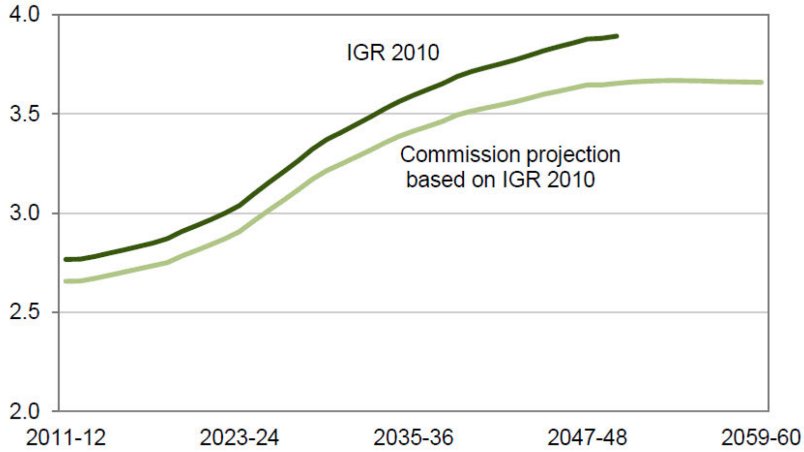


Source: OECD (2010) *OECD Factbook 2010: Economic, Environmental and Social Statistics*

[3] For example, the WestConnex project in Western Sydney linking the M4 to the M5 and city is estimated to cost $10 billion.

Modelling described in the Intergenerational Report 2010 and the recent Productivity Review (2013) report takes population ageing into account. It projects cost will plateau at about 3.7% of GDP around 2050 (Figure 2).

Figure 3 Projected age pension outlays (per cent of GDP) – Productivity Commission (2013)



Data source: IGR 2010 and Commission estimates.

The main connection between ageing and fiscal pressure is that labour force participation is much lower among seniors than it is for younger groups. As people move into retirement, their income and income tax paid decreases, and they become eligible for benefits, including the age pension.

In recent weeks, commentators have suggested that growing fiscal pressure linked to demographic change will require further increases in the pension eligibility age (beyond the scheduled increase from 65 to 67 that will occur over the next 10 years). The evidence from the increase in the female pension eligibility age between 1994 and 2013 is that this change will increase labour force participation.[4]

However, we would suggest that any such change be subject to extensive analysis and consultation. Increasing the pension age dramatically reduces the generosity of the pension when considered on a whole of life basis, because, for any given life expectancy, it reduces the period for which the pension is paid and increases the period for which contributions (in this case from income tax) are paid.

Such a change would also have different impacts across the income distribution, as workers on lower incomes may have fewer options to incorporate part-time work in the transition to retirement, may have a physical aspect to work which becomes dangerous with age and will also have significantly lower life expectancies.[5]

Alternative policy measures to improve senior workplace participation – including removing obstacles to those who would like to work – should be explored. Seniors face age-based discrimination that reduces work opportunities.[6] They also face high effective marginal tax rates from the interaction of the pension means-test and the tax system, that remove much of the financial incentive to take on paid work for those of pension eligible age.

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[4] ISA (2013) *Retirement and labour force participation*

[5] NSW Health Statistics (Accessed 2013). Between 1995 and 2007, the difference in life expectancy at 65 between the poorest and wealthiest quintiles increased from 1.2 years to 2.1 years. During this period the life expectancy of the poorest increased by around 2 years to 84.1 while that of the wealthiest increase by around 3 years to 87.2.

[6] National Seniors (2013) *Age Discrimination in the Labour Market: Experiences and Perceptions of Mature Age Australians*

2.3 Equity

The benefit of taxation concessions afforded to superannuation contributions and earnings are skewed towards those with higher marginal tax rates. Individuals taxed at the top marginal rate (46.5 including Medicare levy), receive a benefit of 31.5 per cent on their concessional superannuation contributions if their annual income is less than $300,000. Individuals with a tax rate of greater than 15 per cent, receive some taxation benefit for concessional contributions and earnings, however significantly less relative to their higher income counterparts. Individuals with a tax rate below 15 per cent are effectively penalised through the superannuation system as their contributions and earnings tax rate is greater than their personal marginal tax rate.

For those earning under $37,000 per annum, whose marginal tax rates are equal to or less than the 15 per cent contribution tax rate, to only concession to compensate them for deferred consumption is the Low Income Super Contribution (LISC) - a rebate of up to $500. This payment affects 3.6 million Australians, of which over 2 million are women. ISA notes the Government has proposed to abolish this tax benefit. ISA submits there are alternatives that must be explored, including revisiting the original Henry Tax Review proposal for a flat 20 per cent tax offset on contributions which would be broadly revenue neutral.

Further, ISA is concerned that the decision not to legislate the 15 per cent on pension earnings in excess of $100,000 simply defers an issue which will need to be addressed in the future. While contribution caps limit concessions provided to taxpayers in the accumulation phase, there is no limit in the earnings sphere, either in the accumulation or decumulation phase. Despite the obvious volatility in returns, earnings tax concessions have a significant fiscal impact, with concession in 2012-13 costing the taxpayer $17.1 billion. The earnings tax concession is the fastest growing superannuation tax expenditure, growing at a compound rate of 17 per cent per annum over the 5 years from 2010-11 to 2014-15, compared to Age Pension growth of 8 per cent per annum. The proposed policy introducing taxation on earnings over $100,000 in the pension phase was estimated to generate $313 million over the forwards.

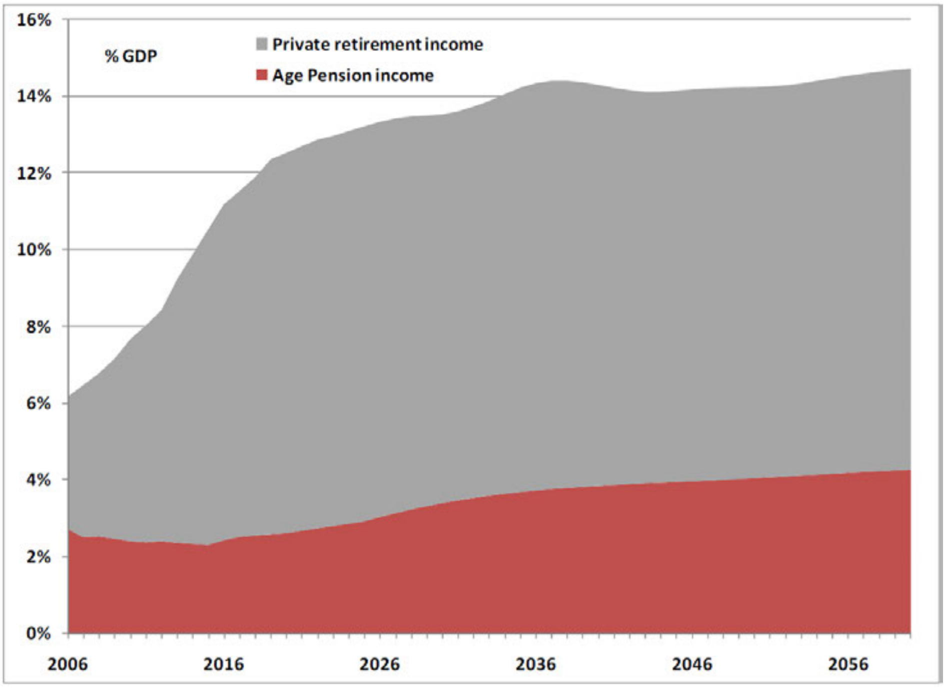
The Commission of Audit may ask whether having an uncapped earnings tax concession in the drawdown phase is sustainable and whether there is a risk it may distort behaviour and erode other revenue bases. The Henry Review considered how earnings tax could be applied in the drawdown phase. The Review suggested reducing the tax to 7.5 per cent in the accumulation phase, and increasing it to 7.5 per cent in the decumulation phase.

Further, it is likely that the contributions caps will increase in the future as the adequacy debate continues. While we support the ability for individuals to provide for their retirement through the superannuation system, we consider that tax concessions for low income earners need to be improved prior to any general cap increases.

3. Optimising superannuation outcomes

While most current retirees are entirely dependent on the age pension, the importance of superannuation and other private sources of retirement income will grow rapidly in coming years (Figure 4).

Figure 4 Sources of retiree income



Source: Access Economics (2009) modelling for ISA Henry AFTS submission

In addition to the level of net flows (contributions minus benefits), the rate of accumulation of superannuation assets is driven by the rate of net returns. Over time, seemingly small differences in returns have a significant impact. Access Economics modelling commissioned by ISA during the AFTS inquiry found that a 0.75% p.a. increase in net returns had a similar impact on assets over a 30 year modelling period as an increase in the rate of SG contributions from 9% to 12%.[7]

The modelling also found that long term offsets to the age pension from this scenario were estimated to be 0.3% of GDP. These offsets could clearly be lost with sub-optimal policy settings.

It is consequently of vital importance for long term budget sustainability that further superannuation reform does not undermine system efficiency.

3.1 Future of Financial Advice

The FoFA reforms were made in response to a series of financial advice scandals, as well as global advances in financial advice regulation in the wake of the GFC. The FoFA reforms were strongly influenced by better understanding of behavioural economics in the financial advice market and a view that disclosure alone is an insufficient mechanism to protect consumer interests.

Following a number of financial collapses and devastating consumer losses, the Financial Services Regulation (FSR) regime which was premised on disclosure of conflicts of interest, was found to be inadequate and had not prevented product providers improperly influencing financial advice recommendations through the payment of financial incentives such as commissions, volume rebates, and other financial and non-financial incentives. Unfortunately the failures of the FSR framework will continue

[7] Allowance in this projection was made for offsetting of voluntary savings due to behavioural change.

to be felt for many years. While ASIC has identified improvements to their processes in dealing with enforcement issues in recent years, it must also be recognised that the pre-Future of Financial Advice (FoFA) regulatory framework was primarily to blame for permitting conflicted remuneration structures and inadequate protection of consumers.

The benefits from the FoFA reforms were unambiguous. According to a report by Rice Warner:

- The FoFA reforms will boost Australians' private savings under advice by $144 billion by 2027.
- The average cost of advice will reduce from $2,046 before the reforms to $1,163 after the reforms by 2026/27 (in 2012 dollars).
- A doubling in the provision of financial advice to Australians – by 2026 there will be 1.88 million pieces of advice provided compared to 893,000 pieces under a no reform scenario.

ISA believes that the FoFA legislation should not be watered down and that any dilution of the best interests duty or conflicted remuneration provisions will seriously compromise consumer protections, eroding individual and aggregate superannuation balances.

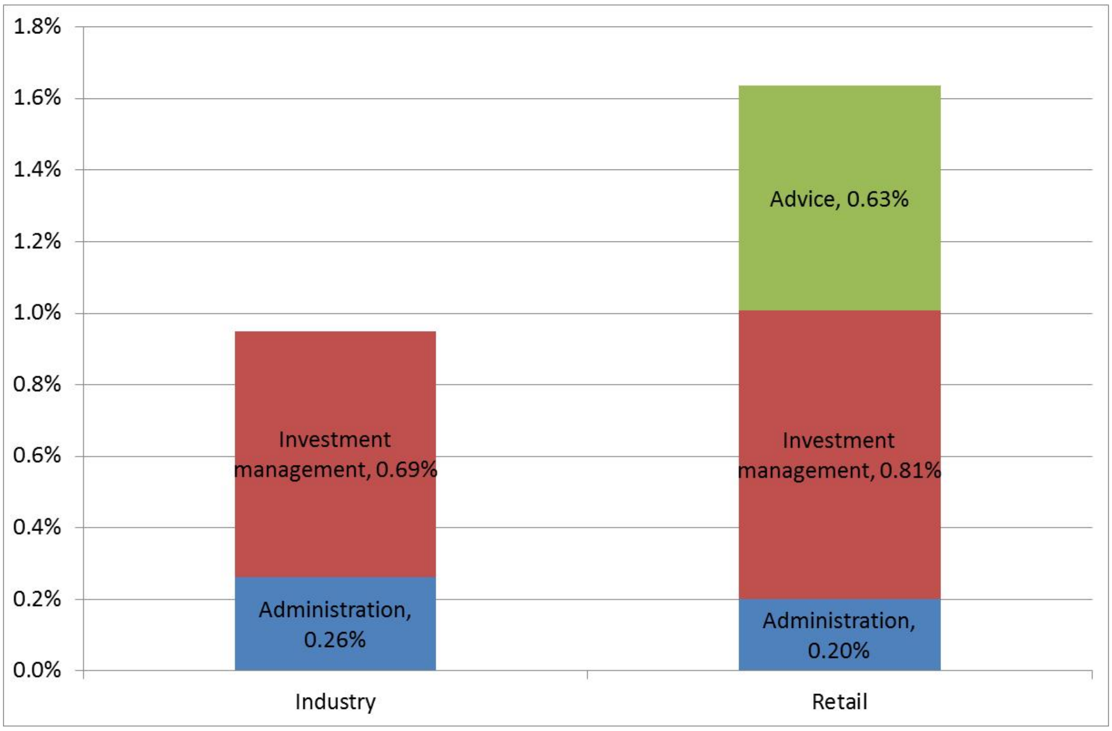
3.1.1 **Conflicted Remuneration / Commissions**

Re-permitting the payment of asset based advice fees (essentially commissions) on superannuation through the removal of opt-in will have a profound impact on net returns.

The following figure provides an average fee comparison between industry and retail funds. The costs associated with advice are significant and reduce individual and aggregate superannuation balances. It is the absence of fees that has enabled industry funds to achieve superior returns over retail funds over 5, 7, and 10 year of returns (Table 1).

The indirect costs associated with advice can clearly be seen comparing the difference in crediting rates between retail and industry funds, to the cost of advice. Average retail fund advice costs are 0.63 per cent, which is significantly less than the difference between industry and retail fund crediting rates, for 10 years, of 1.75 per cent. Either there are significant hidden costs in retail funds, or they are investing in underperforming products.

Figure 5: Fee comparison, Industry and Retail funds, 2013



Source: ISA modelling based on Superratings data (2013)

Table 1: SuperRatings Fund Crediting Rate Survey – SR50 Balanced Option – Median Returns

	5	7	10
Industry	7.49	4.54	7.32
Retail	7.36	2.75	5.57
Difference	0.13	1.80	1.75

Source: SuperRatings Fund Credit Rate Survey (Oct 2013)

The impact of net returns can have a significant impact on an individual's retirement balance. Access Economics shows that a 0.75 per cent improvement in net returns is similar to an increase in SG from 9 to 12 per cent.[8] This modelling shows the importance of low fee products and the ability of information for consumers to make informed decisions about where their superannuation savings are held.

Further, Access Economics modelling showed that an improvement in net returns of 0.75 per cent per annum increased superannuation assets by 19.1 per cent of GDP, compared to 20.6 per cent based on an SG increase from 9 to 12 per cent. This also had a significant impact on replacement rates.

The Government, (again, while in opposition), further indicated that no changes be made to the existing remuneration structures regarding risk insurance and that the ban of commissions on these products be limited to automatic insurance cover within superannuation funds where individuals have not received specific advice.

This will mean that commissions would be payable on group insurance products within Choice and MySuper products. Implementing such a recommendation would be in conflict with recommendations 1.14

[8] Access Economics (2009) *Retirement Incomes Policy: Simulations Paper*
Modelling conducted over a 30 year period.

and 1.26 of the Cooper Review, which recommended against commissions on risk insurance being allowed inside either MySuper or Choice products.

ISA believes that the proposed amendments to the FoFA legislation represent very significant weakening of the regulatory framework. Banks and bank owned super funds have sought to characterise changes as "dealing with unintended consequences" or "reducing red tape". However, the reforms could result in a weaker regulatory environment than that which existed prior to the FoFA reforms, in circumstances in which consumers have been led to believe that commissions have been abolished and that advice must be provided in their best interests. We submit that to the extent that a further review of the regulation of advice is required, it should take place as part of the Government's proposed Financial System Inquiry.

3.1.2 **Best Interests**

The FoFA reforms introduced the 'any other step' clause to ensure that product recommendations are justified by a strategy, that the limits of advice recommended are explained, and that the reviews of the strategy are prompted. These are all reasonable requirements which do not impede the delivery of scaled advice.

ISA considers that removing this 'any other step' requirement, a move suggested by the Coalition, makes the best interest test a tick-a-box checklist.

Further, the Coalition has indicated that the best interests legislation should be amended to permit clients and advisers to agree to limit the subject matter of advice provided in order to facilitate the provision of financial advice.

ISA considers that this effectively contracts out the best interest duty and diminishes consumer protections provided by the best interest duties, particularly given the information asymmetry between planners and clients.

Any dilution of the best interests duty provisions will seriously compromise consumer protections put in place to prevent further instances such as that which triggered the Inquiry into the Performance of ASIC.

3.2 Default fund selection

Australia's system of compulsory retirement savings system is working towards, but has not yet delivered, a system that will ensure most Australians can look forward to a dignified retirement.

The system has generated in excess of $1.7 trillion in retirement savings and has widespread support, due in part to the recognition that the system is good public policy and the system's concessional tax treatment. Despite, and perhaps partly due to the level of support for the system, more than three quarters of superannuation fund members do not exercise choice of fund.

There is clear evidence of market failure in the industry with too many fund members being placed in underperforming and in some instances inappropriate funds. The process for selection of default funds must have, at its core, the best interests of employees. The lack of active engagement with the system requires default fund arrangements which ensure superannuation contributions are made on behalf of an employee into an approved fund.

The new MySuper product rules provide additional protections to employees and certainty to employers. Compulsory superannuation contributions have the character of deferred wages and the selection of workplace default funds has been part of the industrial relations system and it is appropriate that it remains so.

To date, the system has worked well as default funds named in awards have outperformed.

Any change that allows underperforming funds to receive Superannuation Guarantee contributions by default is an unsustainable and inefficient use of superannuation tax concessions and will result in lower retirement account balances and place untenable pressure on future tax-payers. Not all MySuper funds are the same. The selection of a default fund that is cost effective and is a product that is designed to meet the needs of the industry it seeks to serve is required to ensure the system operates efficiently.

3.3 Product dashboard

APRA has finalised Reporting Standards which establishes a set of standards for the reporting of prescribed information in a common form for superannuation funds, commencing with MySuper funds and eventually all APRA-regulated funds.

The intention is to allow consumers to readily compare costs, historic returns, risk and investment targets. The standard specifies the methodology to be used. To ensure a level of comparability in the system the SIS Act further specifies that public information provided by the fund in relation to these matters must be based on a consistent methodology.

Changes to this approach would potentially undermine the objective for consumers and employers to be able to compare different products on a consistent basis.