Financial Review: Banking & Wealth Summit
A World-leading Superannuation System

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The Financial System Inquiry chaired by David Murray was established in 2013 following an election commitment made by the incoming Coalition Government. It was tasked to report on developments in the financial system subsequent to the FSI chaired by Stan Wallis. The Wallis Inquiry reported in 1997. It had examined developments in the period after the 1981 Inquiry into the Australian Financial System chaired by Sir Keith Campbell.

The three reports were done at intervals of roughly 13 years as commissioned by the Fraser, Howard and Abbott Coalition Governments.

The Campbell Report recommended a floating exchange rate and deregulation of interest rate caps. The Wallis Report led to the establishment of our financial architecture- ASIC, APRA and the licensing of financial services providers. You can only float the Dollar once. You should only establish new Regulatory arrangements when the old ones are not up to the job. Ours showed great resilience and success in the financial crisis of 2008.

It was widely expected that the Murray Review would turn its attention to the superannuation system which has assets under management rivalling the assets of the Banks yet operates under a substantially less rigorous regulatory regime. It did make recommendations on superannuation but the part of the Murray report that has garnered the most attention is the increased capital requirements it recommended for Banks- an unexpected recommendation and, from the point of view of the major Banks, an unwelcome one.

Murray's 5 recommendations on Superannuation are:-

1. Enshrine the objective of superannuation in legislation;
2. Introduce a competitive process to allocate members to default funds after 2020;
3. Pre-select an income product for a member's retirement;
4. Provide choice for employees on their Super Guarantee (SG) contributions;
5. Mandate a majority of independent Directors for public offer funds.

Each of these recommendations is worthy. The Industry Funds have indicated that they do not agree with a requirement that there be a majority of independent Directors (5). In the past they have also opposed freedom of choice (4). But it is hard to think these recommendations are controversial in this day and age. I expect the Government will accept and implement them in full.

The allocation of default fund members under a competitive process could well be pulled forward before 2020. This is something that was recommended by the Productivity Commission back in 2012. It was not accepted by the then Government. The Minister for Employment and Workplace Relations, Bill Shorten, announced that default funds would be prescribed under Industrial Awards as determined by Fair Work Australia. The process is designed to advantage, and does advantage, Industry Funds. Those Funds will oppose a new competitive process (2). But over time such a process would make a welcome improvement to getting more competition in the system.

I can therefore answer the two questions that were posed for this talk.

i. What improvement can we expect from the FSI?
   We can expect improvement in superannuation governance and choice.
ii. Will it make any difference to Superannuation?
   Yes it will improve but not radically change it.

Tax Issues

The Murray review also raised a number of tax issues. It suggested they be considered as part of the Tax White Paper which was subsequently released on 30 March. The FSI tax issues so far as they relate to superannuation are:-

1. Ending or reducing dividend imputation;
2. Ending refunds of franking credits for low rate taxpayers like superannuation funds;
3. Review of tax concessions on superannuation;
4. Taxation of superannuation earnings in the retirement phase.

All these proposals would increase tax on superannuation in one way or another.

Over the term of the last Government – in three Budgets and two Mid-year Reviews from 2011 to 2013-there were 33 separate Budget measures affecting superannuation. It is tiring to list them all. As you know they included annual changes to contribution caps and announcements about future caps, some of which were altered before they ever came into effect.

At present the concessional contribution caps are $30,000 generally and $35,000 for over 50s. There is a surcharge for those on incomes over $300,000. This is known as Division 293 tax. It was introduced by Labor from 1 July 2012. It has not yet been in effect for 2 years. Last week Labor announced it wants to increase Division 293 tax by applying the surcharge from a lower threshold of $250,000.

There are also limits on the amount of after-tax money that an individual can put into superannuation. I find that those who complain about large superannuation balances held by others either don't know, or leave out, the fact that to get a large balance like that you have to put in a voluntary contribution which has already been taxed, at current rates up to 49%.

Last week Labor announced a proposal to tax superannuation earnings in the retirement phase above $75,000 per annum. This was a variation on a previous proposal. In April 2013, while in Government, Bill Shorten announced a tax on superannuation earnings in the pension phase above $100,000. Labor did nothing to legislate this announcement. When the Coalition came to office it dropped it. On 6 November 2013 Joe Hockey and Arthur Sinodinous declared the complexity and compliance costs made it "undeliverable". Most informed observers agreed.

It is worth comparing the two proposals.

In April 2013 Labor said it would tax 16,000 people with superannuation sums above $2 million. In April 2015, it says it would tax 60,000 people on sums above $1.5 million.

Two years ago it was going to index the threshold to CPI. There is no mention of that in last week's Press Release. Two years ago there were transitional provisions to treat existing assets in the system. No mention of that now.

Two years ago the proposal was designed to raise $350 million over 4 years. Now it is designed to raise $9.2 billion over ten years.

The current proposal is to raise ten times (10x) the amount of 2013. Two years ago that was the final proposal. Now "These are the final and only changes". No one has solved the problem of how to legislate it. When it does not raise the money that has been budgeted what do you think the political response will be?

In Australia if you are taxed on contributions and earnings you do not pay tax when the money is paid out. There are people who do not pay tax on contributions and earnings, people like Judges and MPs. Because they are in untaxed funds they have to pay tax when they receive their benefits. But because the overwhelming number of Australians are in accumulation funds which are taxed in the contribution and earning phase they do not pay tax again at the retirement stage.

In Australia before 1988 we did it the other way around. We were taxed at the retirement stage. It was a far more beneficial system for retirees because it was the gross amount that was invested and gross earnings that accumulated in the Fund. Now it is only the net amount (after tax) of contributions and the net (after tax) earnings that accumulate. This diminishes the compounding effect.

When the Government pulled forward the taxation of superannuation from end benefits to contributions and earnings in 1988 it did not do it to help retirees. It figured it could take tax early rather than let it accrue to some future Government. It wanted money. Pulling forward tax was a way of getting an early instalment of future taxation. Other countries have not done it. But once it was done in Australia it became a permanent and irreversible feature of our taxation system. It's a useful point to remember. Increasing taxes on superannuation, which is a long-term savings vehicle, usually involves taking now at a cost to be borne some time in the future.

If taxes on superannuation rise it means people will have lower retirement incomes. Some (especially those who live longer) will fall back on the pension or fall back on a part pension to a larger degree. Just because the cost is in the future doesn't mean the decision is cost-free. Of course Governments interested in the here and now don't worry so much about costs outside the forward estimates. But one thing our Inter-Generational Reports should have taught us is that future generations will have to pay our debts. If we take their taxes as well they will have less to pay them with.

Sovereign Risk

We expect young people to put money aside for their retirement in 40 years' time. Once money is in the Fund you can't get it out. You can't get it out if taxes rise. You can't get it out if end benefits are reduced. It is beyond your control. It is not beyond the reach of Government however. Government can get it out by changing tax rates. It is a big Sovereign risk to lock it up for such a long time. Who knows what the system will look like in 40 years, time? We don't know what it will look like in four years' time.

The thing superannuation needs more than anything else is certainty. Maybe there will be more certainty if the first recommendation of the Murray review is adopted-on a bipartisan basis and the objectives of the superannuation system are enshrined in Statute:

"To provide income in retirement to substitute or supplement the Age Pension"

It might be helpful. It would make it clear that the objective is not to provide a pool of money for the Government to tax when it needs revenue. It would make it clear that superannuation is not an arm of Industrial Relations policy to be arbitrated by Fair Work Australia. It would make it clear that changes should be assessed according to whether they help or hinder the long-term ability to substitute or supplement the pension.

Of course stating an objective is not legally binding. A future Government looking for money is not going to be constrained by any "Declaration of Intent" on Superannuation.

How much is Adequate Superannuation?

The superannuation system has provided good jobs for people who administer it and good income for the Fund Managers who invest it. How has it performed for the person who puts their money in and hopes to live off the proceeds in retirement? Their benefit will depend on amounts paid in, costs taken out, tax taken out and, probably the biggest variable, investment income. In our accumulation system all the investment risk is carried by the contributor-not by the Trustees, or the administrators, or the Fund Managers or any of the professionals who work in the industry. The biggest risk- the investment risk-is carried by the least financially sophisticated person in the whole process, the punter.

If it all falls apart they fall back on the taxpayer. But the purpose of the system is to try to help them to save enough to live independently of the taxpayer. The system of SG alone will not do that. In reality what it will do is provide a supplement to the pension.

I was interested to read Jeremy Cooper, author of the "MySuper" system write last week that you would need a Lump sum of more than $1million to produce an income stream equivalent to the pension today. That assumes preservation of capital. I think the value of today's Age Pension, is closer to a lump sum of $400,000 to $500,000 (for a single). This is roughly calculated as 20 years (an average for 65 year olds) @ $22,400 which, of course, is indexed to wages rising at say 3% less the discount rate at around the same levels. So when you see those Advertisements promising superannuation balances of $300,000 remember they are promising an income less than the Age Pension.

You will not be worse off if you get Super plus the Pension. However subject to thresholds and deeming rates you do not get full Super plus full Pension. You lose 50 cents of pension for every $1 in superannuation. Half of the value of a person's Superannuation will be clawed back out of the Pension. It is an extremely high Effective Marginal Tax rate. The Government will claw back 50% of Pension for each dollar of deemed earning out of Superannuation. You can see why it is in Government interest to give a tax break now if it can claw back at that rate in the future.

Superannuation Asset Allocation

There has been some effort in recent years to protect disengaged people from expensive or risky investment options in superannuation. Where a person does not exercise an investment choice, they are placed into the "MySuper" product of their Superannuation Fund. As of March 2014, 120 Superannuation entities had registered a MySuper product. These products show broad similarities.

Research by the Centre for International Finance and Regulation[1] (CIFR) shows on average these funds have a weighting of 72% to growth assets of which 52% was in Equities, 6% in property and the remainder mostly in infrastructure (5%) and private equity(3.4). The deviation from the average is quite small. Most of the industry funds (which are taking the lion's share of default assets) rebranded an existing single strategy, the balanced fund, as their MySuper offering. They are not lifestyle strategies, that is, the allocation does not vary as the member approaches retirement.

The CIFR research shows that allocation to equities was split roughly equally between Australian and International which means mostly the U. S. market. In exposure to International equities the Members would be carrying a good deal of exchange rate risk. Both Australian Equities and the exchange rate (falling Australian dollar against the USD) are playing well into returns at present. Super Ratings report Year-to-Date returns of 10.8% for the median Balanced Option. It was not the case five years ago.

Back then people were compelled to put wages into Superannuation Funds that were investing it into falling markets. They were losing money. By law they had no right to cease contributions until they could preserve capital rather than lose it. The fortunes of Australian superannuation returns are highly correlated to the Stock market- at home and abroad. The superannuation system takes a chunk of Australian's wages and invests them in the Stock

[1] Centre for International Finance and Regulation, MySuper: A New Landscape for Default Superannuation Funds, April 2014

Market. Most Australians probably think a rising dollar is making them richer. In fact a falling dollar will boost their retirement balances.

I don’t think anyone in Government (I include myself) realised the extent that Australia’s retirement pool would eventually be hitched to the ride of the stock market. Some funds perform better than others but the real determinant of whether a person’s SG contributions are growing or falling (in balanced and default Super funds) is whether the share market is going up or down.

This is why the Dividend franking system is of enormous interest to every citizen in this country. Every citizen who has ever held a job has been levered into the Stock Market. If dividend imputation changes they will pay higher tax on their Superannuation earnings. Also there will be less reason to keep that equity investment in Australian Shares as opposed to International Shares.

No one is suggesting that changes to the dividend imputation system will make retirement income policy better. But then again very few changes to superannuation are directed to promoting retirement income. When the hunt for revenue is on, good policy is usually a casualty. The Murray Review might have had something when it reminded us what superannuation is really there to do.