



FINANCIAL SYSTEM INQUIRY

CHAPTER ONE

SUPERANNUATION

CHAPTER 1 - SUPERANNUATION

OVERVIEW

Superannuation accounts for a significant proportion of Australia's financial system. Its prominence in the Australian economy has risen considerably since the introduction of compulsory superannuation in 1992.

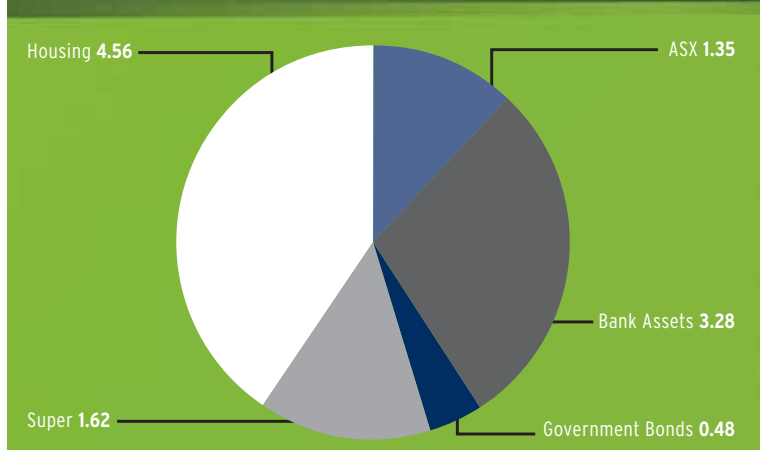
Chapter 1 of FSC's submissions to the Financial System Inquiry will focus on the macroeconomic impact of superannuation, capital flows and asset allocation. We also consider the role of the trustee in allocating capital and the impact of life insurance in superannuation.

Chapter 4: Budget Sustainability addresses the individual retirement income component of the superannuation system and its intersection with public finances. Chapter 4 will also canvass the broader role of the life insurance industry.

APRA advises that, as a pool of capital, superannuation accounts for \$1.62 trillion in funds under management in 30 June 2013 (which rose to \$1.8 trillion in funds under management as at 31 December 2013).

Figure 1.1 compares the size of the superannuation system to other pools of capital in the Australian economy as at 30 June 2013. Superannuation is now clearly a large and structurally significant component of financial system.

Figure 1.1 Size of different pools of assets (\$t, June 2013)



Sources: APRA Superannuation Bulletin June 2013; RBA statistical database

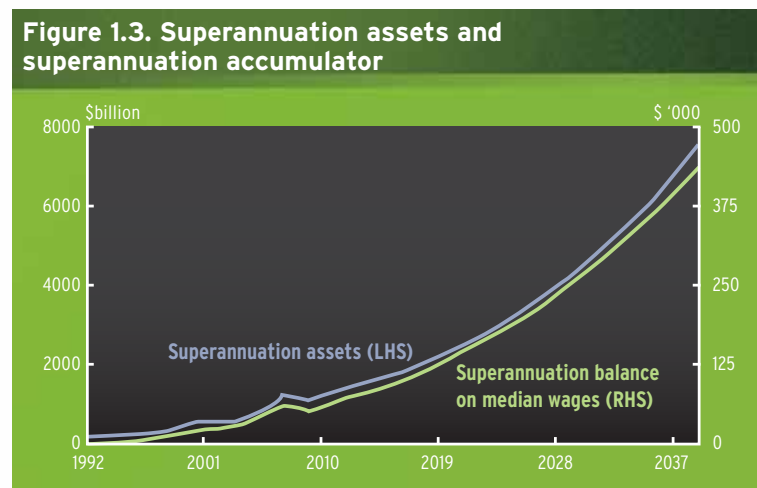
At the time of the final report of the Financial System Inquiry in 1997 (Wallis Inquiry), compulsory superannuation was in its infancy and the contribution rate was only 6%. Significant growth has occurred in the superannuation system following the final report. This is due to both the continued increase in the Superannuation Guarantee rate to 9.25% (currently legislated to increase to 12% by 2019), and a period of significant growth in non-concessional contributions and investment returns.

The future rate of growth of the superannuation system is difficult to predict. It will be influenced by the aging demographics of the Australian workforce, wages and employment growth, and the scheduled increase in the Superannuation Guarantee rate and taxation policy. A range of estimates have been provided into possible growth trajectories of the pool of capital in superannuation, outlined in **Figure 1.2**.

Figure 1.2: Various alternative projections

| | FORECAST DATE | ASSETS (\$) | ASSETS TO GDP |
|-------------------------------|---------------|-------------|---------------|
| DELOITTE | 2033 | \$7.6 | 180% |
| DELOITTE (5YR LONGER WORKING) | 2033 | \$8.6 | 198% |
| COOPER | 2035 | \$6.1 | 130% |
| TREASURY (2008) | 2030 | \$5.1 | 140% |
| RICE WARNER | 2028 | \$3.3 | |

In the 2012-13 Commonwealth Budget the Treasury projection expanded on its earlier forecast for the growth of superannuation as shown in **Figure 1.3**. Treasury forecast the growth of superannuation, as well as average member balances for those on medium wage out to 2037, and similarly concluded to Deloitte that by the late 2030s there would be close to \$7 trillion under management.



Sources: 2012-13 Commonwealth Budget, Statement 4

In 2010, the Super System Review also provided a detailed assessment of the structure of the superannuation industry reproduced in **Figure 1.4** below.

Figure 1.4: The Australian superannuation industry in 2035 (including SMSFs)

| | 1996 | 2009 | 2035 NOMINAL | 2035 CURRENT |
|--|----------|----------|--------------|--------------|
| OVERALL INDUSTRY SCALE | \$245b | \$1100b | \$6100b | \$3200b |
| RATIO OF ACCUMULATION TO POST-RETIREMENT ASSETS | | 4:1 | 3:1 | 3:1 |
| BIGGEST FUND | | \$41b | \$350b | \$187b |
| NUMBER OF APRA LARGE FUNDS | 4734 | 447 | 74 | 74 |
| AVERAGE LARGE APRA FUND SIZE | \$0.04b | \$1.5b | \$53b | \$28b |
| AVERAGE ACCUMULATION MEMBER BALANCE | \$15,000 | \$70,000 | \$335,000 | \$180,000 |
| TOTAL OF SUPER ASSETS - PROPORTION OF GDP | 47% | 90% | 130% | 130% |

Source: Super System Review, Final Report, Part One Overview and Recommendations

AUSTRALIAN SAVING RATES

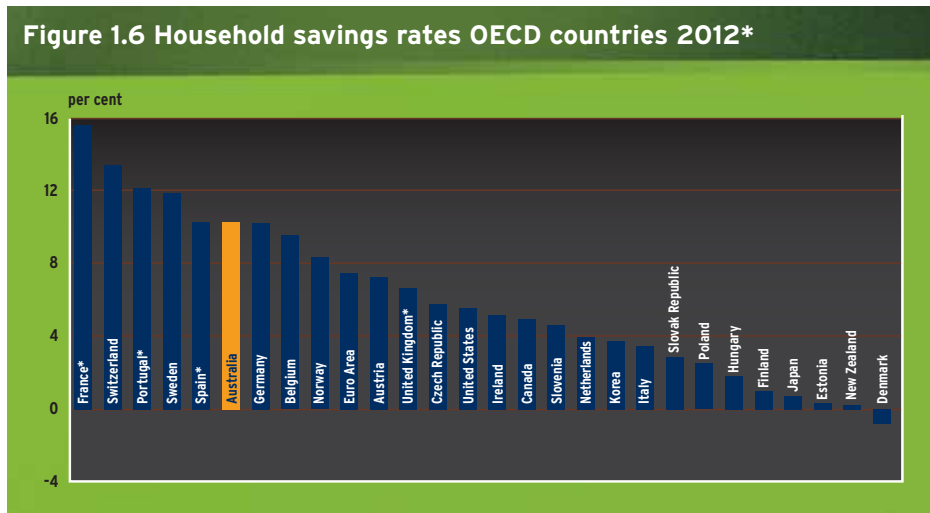
Household saving in Australia has increased (beyond solely superannuation) since the introduction of compulsory superannuation in 1992 relative to OECD trends.

Figure 1.5 demonstrates that Australia's national savings hit historical lows at the start of the 1990s, before the superannuation system was established. Australia's national savings, however, grew steadily following 1991 and was significantly above both the advanced economy average and the world average, which includes high saving East Asian countries, by 2011.



Figure 1.5 demonstrates that Australia’s national savings relative to the rest of the world has consistently trended higher since 1992. Whilst there has also been a recent increase in national savings as a reaction to the financial crisis, this increase is a minor addition to the long term increase in national savings generated by the superannuation system.

Figure 1.6 also shows that Australia’s savings rate is at the top of the spread of OECD countries.



Source: OECD
 *All countries are net savings except for those marked which are gross savings

From a macroeconomic perspective, the benefit to the Australian economy of this stable growth in national savings in a manner that is resilient to international shocks cannot be understated. When compared to the impact on national savings of the 1990-92 recession, the global financial crisis and the Asian financial crisis were relatively modest.

A widely-held myth submits that superannuation has merely substituted for other types of savings rather than grown the total savings pool.

A number of studies show that superannuation has increased savings for individuals and at a macro-level for Australia as a whole.

Research by Treasury in 2011 states:

“The compulsory system appears to have made a significant contribution to national savings - estimated currently at about 1.5 per cent of GDP, and rising to close to 3 per cent over the next few decades.”

The savings ratio in Australia has now increased from 0.3 per cent of income in 2003 to 10.5 per cent in 2013.

RECOMMENDATION

The Inquiry recognises that superannuation has created a significant pool of national savings without a substitution effect.

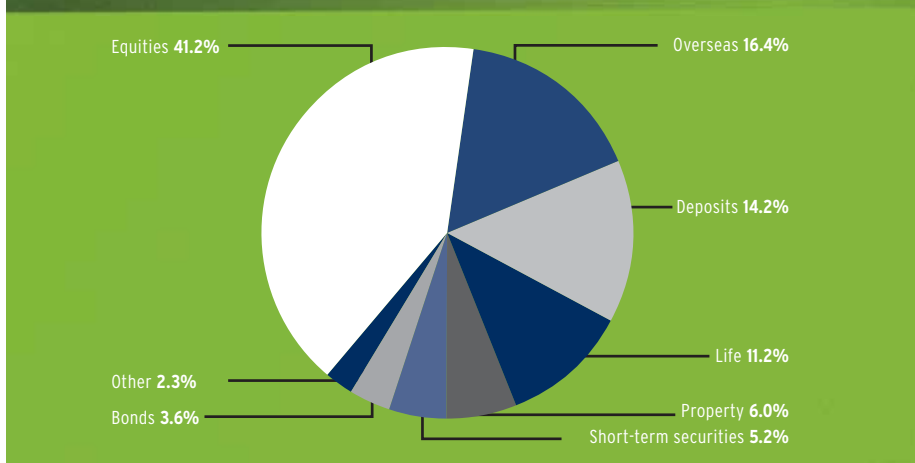
SUPERANNUATION FUNDING THE ECONOMY

Superannuation funds invest in a wide range of asset classes throughout the Australian (and global) economy. **Figure 1.7** outlines the current quantum of capital in superannuation allocated to each asset class, the proportion of that allocation as a percentage of all assets within the system, and the size of the allocation as a proportion of Australia's GDP.

Figure 1.7 Current superannuation asset allocation

| | EQUITIES | OVERSEAS | DEPOSITS | LIFE | PROPERTY | SHORT-TERM SECURITIES | BONDS | OTHER |
|------|--|----------|----------|------|----------|-----------------------|-------|-------|
| | Percentage of FUM allocated to each asset class | | | | | | | |
| 2013 | 41.2 | 16.4 | 14.2 | 11.2 | 6.0 | 5.2 | 3.6 | 2.3 |
| | Dollars (t) of FUM allocated to each asset class | | | | | | | |
| 2013 | 0.6 | 0.3 | 0.2 | 0.2 | 0.1 | 0.1 | 0.1 | 0.0 |
| | Percentage of GDP in each asset class | | | | | | | |
| 2013 | 42.0 | 16.7 | 14.5 | 11.4 | 6.1 | 5.3 | 3.7 | 2.3 |

Percentage of FUM allocated to each asset class



Source: ABS Managed Funds 5655.0, Table 4, September 2013.

RECOMMENDATION

The Inquiry finds that superannuation assets are invested widely across the economy.

Variances in asset allocation between different superannuation fund types are demonstrated in **Figure 1.8**.

Figure 1.8: Differences in asset allocation by different fund types 2013 (%)

| | INDUSTRY | RETAIL | CORP. | PUBLIC | APRA FUNDS | SMSFS | SUPER TOTAL |
|---------------------|----------|--------|-------|--------|------------|-------|-------------|
| AUS. SHARES | 29 | 26 | 30 | 22 | 26 | 32 | 29 |
| INT. SHARES | 25 | 22 | 28 | 27 | 25 | 0 | 17 |
| LISTED PROPERTY | 1 | 4 | 1 | 4 | 2 | 4 | 3 |
| UNLISTED PROPERTY | 10 | 2 | 7 | 6 | 7 | 15 | 10 |
| AUS. FIXED INTEREST | 6 | 15 | 14 | 7 | 9 | 1 | 6 |
| INT. FIXED INTEREST | 5 | 7 | 6 | 7 | 6 | 0 | 4 |
| CASH AND TDS | 6 | 14 | 6 | 9 | 8 | 30 | 15 |
| OTHER | 19 | 9 | 8 | 18 | 16 | 16 | 16 |

Sources: APRA Annual Superannuation Bulletin default allocations multiplied up to allow calculation of Total; ATO SMSF database. The numbers are approximate only due to different description of assets. The main issues with SMSFs are allocating unlisted trusts (9%) and managed funds (4%) to 'Other'.

The most notable divergence in allocation occurs between APRA regulated funds and self-managed superannuation funds (SMSFs). Understanding this divergence is important considering that SMSFs now account for over \$500 billion in funds under management. Our research concludes SMSFs:

- ❖ Have a greater home country bias;
- ❖ Avoid currency risk;
- ❖ Hold a greater allocation to cash; and
- ❖ Hold a greater level of unlisted property.

Different behaviours of investors drives the variance in asset allocation between SMSFs and APRA funds. SMSFs traditionally have an older membership focused on more conservative investing and wealth protection, which results in a higher allocation to cash and domestic assets.

Our research concluded that SMSFs have different degrees of professionalism in the management of their investments, resulting in a disproportionately high allocation to accessible and familiar asset classes, such as domestic equities, unlisted property and cash.

There are also notable differences in asset allocation between retail and industry funds, such as:

- ❖ Higher investment in unlisted property and alternatives by industry funds relative to retail funds; and
- ❖ Higher investment in domestic and international fixed interest by retail funds relative to industry funds.

There is, however, greater commonality in the investment strategies between the APRA regulated funds.

PROJECTED FUTURE ASSET ALLOCATION AND TRENDS

1. Superannuation fund asset allocation across all asset classes in Australia and offshore

Figure 1.9 demonstrates that superannuation asset allocations are forecast to remain diversified over the coming decades. FSC research concluded that allocation to international assets will continue to grow, due to both the benefits of diversification and the inability of the domestic economy to provide sufficient assets in which superannuation funds can invest.

Figure 1.9 Current superannuation asset allocation

| | EQUITIES | OVERSEAS | DEPOSITS | LIFE | PROPERTY | SHORT-TERM SECURITIES | BONDS | OTHER |
|---|----------|----------|----------|------|----------|-----------------------|-------|-------|
| Percentage of FUM allocated to each asset class in each pool | | | | | | | | |
| 2013 | 41.2 | 16.4 | 14.2 | 11.2 | 6.0 | 5.2 | 3.6 | 2.3 |
| 2020 | 42.3 | 18.0 | 12.0 | 8.0 | 7.0 | 5.0 | 4.2 | 3.5 |
| 2030 | 42.3 | 20.0 | 10.0 | 5.0 | 7.0 | 5.0 | 6.0 | 4.5 |
| Dollars (t) of FUM allocated to each asset class in each period | | | | | | | | |
| 2013 | 0.6 | 0.3 | 0.2 | 0.2 | 0.1 | 0.1 | 0.1 | 0.0 |
| 2020 | 1.2 | 0.5 | 0.4 | 0.2 | 0.2 | 0.1 | 0.1 | 0.1 |
| 2030 | 2.2 | 1.0 | 0.5 | 0.3 | 0.4 | 0.3 | 0.3 | 0.2 |
| Percentage of FUM allocated to each asset class in each pool | | | | | | | | |
| 2013 | 42.0 | 16.7 | 14.5 | 11.4 | 6.1 | 5.3 | 3.7 | 2.3 |
| 2020 | 54.1 | 23.0 | 15.4 | 10.2 | 9.0 | 6.4 | 5.4 | 4.5 |
| 2030 | 59.2 | 28.0 | 14.0 | 7.0 | 9.8 | 7.0 | 8.4 | 6.3 |

Source: Professor Maddock's projections anchored by Treasury projections for totals, see Rothman and Tellis (2008) and initial allocations from Table 3.1. Securitised assets are treated as bonds

The FSC also forecasts that asset classes that have traditionally accounted for a relatively small portion of investments, such as domestic bonds, alternative assets (eg. hedge funds and private equity), direct property and infrastructure will also grow. This growth will be driven by the demand for assets that reward patient capital that can be invested in illiquid assets.

FSC research concluded:

The fundamental logic of long term patient investors like superannuation funds investing a greater proportion of their assets in alternatives, seems inescapable. As (superannuation funds) grow larger they will gain benefits from pooling which will lessen their liquidity risk, and hence be able to direct more of the funds into parts of the market where they can gain the excess returns associated with illiquid assets.¹

¹ Professor Rodney Maddock - Superannuation asset allocations and growth projections

A patient, long term approach to investing is further bolstered by the sole purpose test, which is a requirement that trustees of a superannuation fund ensure that the fund is maintained solely for the provision of benefits after the beneficiary retires, when retirement is after the preservation age².

This requirement has a significant influence on the investment strategies of superannuation funds.

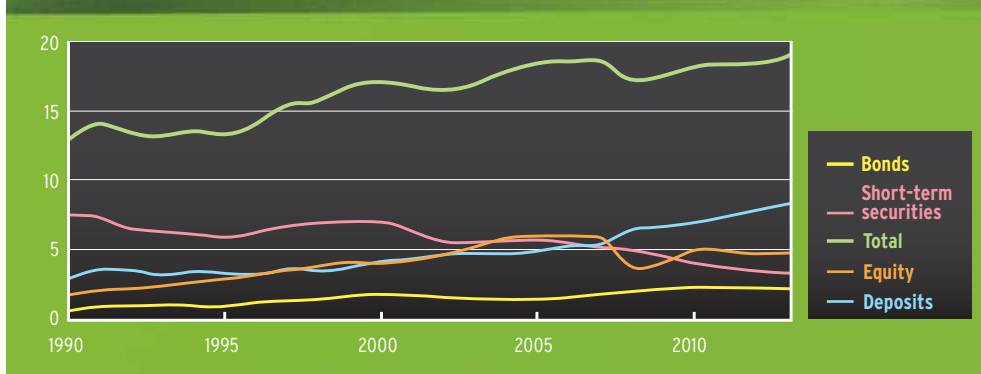
The sole purpose test helps ensure that trustees focus on the long term outcomes of the investment strategy and, where there are benefits to be gained through investing in illiquid assets, they do so to maximise outcomes for members. A natural consequence of this strategy is that a greater proportion of capital is allocated to productive areas of the economy that require patient capital, such as infrastructure projects, bonds and alternative assets.

Some intermediaries do not allocate capital in a manner that is aligned with the long term needs of the beneficiaries of capital. Authorised Deposit-taking Institutions (ADIs), for example, allocate capital to the investment that generates the higher return on capital for shareholders, the natural consequence of which is a greater orientation towards short term investments and less orientation towards often more productive, long term projects.

2. Superannuation funds' call on bank liabilities; cash, bonds and equities

Consumers (businesses and households) in the Australian economy require both patient, long term capital and short term capital. An increasingly symbiotic relationship between banks and superannuation funds is apparent in that the banks now receive large deposits from superannuation funds and ensure that both these forms of capital are available to consumers.

Figure 1.10: Funds' claims on banks - share of unconsolidated bank liabilities



Source: Chart from RBA Financial Stability review, smoothed

² Section 62, Superannuation Industry (Supervision) Act 1993

The superannuation sector had \$215b in deposits at banks by September 2013. That constitutes 14.2 per cent of the funds in the super system.

The availability of bank deposits through the superannuation system has had several consequences. While households can be comfortable leaving “lazy” balances in their bank accounts, professional managers have been far more concerned with the return they get on deposits relative to alternative investments. Like all investors they do certainly want to have ready access to liquidity but recognise it comes at a cost to returns.

The result is that banks have to pay more for deposits, and savers are getting a better return. This is a natural result of the market and an appropriate outcome that delivers improved consumer outcomes.

Banks are not, however, facing a shortfall in capital as a result of the superannuation system. **Figure 1.11** reflects the growth in superannuation funds’ claims on banks over the past decade, demonstrating that banks have ready access, through deposits, equity and bonds, to the capital managed within the superannuation system.

This demonstrates that there is adequate domestic capital for the

Figure 1.11: Superannuation funds’ claims on banks (\$m)

| | DEPOSITS INCLUDING CDS | DEPOSITS AS % OF ALL BANK DEPOSITS | EQUITY | EQUITY AS A % OF ALL BANK EQUITY | BONDS | BONDS AS % OF ALL BANK BONDS |
|----------------|------------------------|------------------------------------|--------|----------------------------------|-------|------------------------------|
| SEPTEMBER 2003 | 39493 | 7.8 | 28044 | 16.6 | 2885 | 2.5 |
| SEPTEMBER 2008 | 121274 | 12.6 | 61719 | 27.0 | 9961 | 2.9 |
| SEPTEMBER 2013 | 266531 | 16.8 | 105209 | 25.1 | 20442 | 5.1 |

Source: ABS Managed Funds 5655.0, Data Table 4 Australian National Accounts Data 5232.0 Table 8

Australian economy and, in particular, the Australian banking system to operate efficiently and effectively, provided consumers of that capital are willing to pay market rates to access that capital.

RECOMMENDATION

The Inquiry finds that superannuation funds heavily finance other domestic financial institutions.

3. Lower reliance on foreign capital / higher levels of domestic ownership

The increase to Australian savings through superannuation will, over time, reduce the (net) inflow of capital Australia has experienced for most of its post European settlement history. This is the contribution of a large pool of national savings reinvesting in the domestic economy.

FSC research finds that either foreign inflow will fall or Australian outward investment might rise to achieve this end. It may also reduce foreign ownership of Australian assets, and boost local investment.³

The benefit of Australia relying less on foreign inflows is that it increases domestic resilience. In a time of crisis, this is crucial. The financial crisis demonstrated that a large, nimble and uninhibited pool of capital can deliver for Australia in times where foreign capital is expensive or unobtainable.

This is consistent with analysis by Commonwealth Bank Chief Economist Michael Blythe which predicts that superannuation is one of several factors which will lead to a shift from Australia as a country of persistent current account deficits to one of current accounts surpluses.⁴

It is worth noting that countries with current account surpluses generally have lower interest rates than those with current account deficits as supply of domestic savings exceeds demand for investment.

A large pool of domestic savings also reduces the risk premium foreign investors build in when investing in countries with high current account deficits.

Ultimately, a larger savings pool will reduce Australian reliance on international capital.

RECOMMENDATION

The Inquiry find that Australia will increasingly depend less on foreign capital due to superannuation savings.

³ Maddock ibid

⁴ Australian Financial Review, Wednesday 5 February 2014

4. Equity Investment, Bonds and Securitisation

As superannuation grows larger, its demand for assets will continue to outstrip the supply of assets available in the domestic securities exchange, however home-bias will ensure their appetite for further domestic equity investment will not be diminished. This will create demand for non listed investments, including corporate bonds and securitised assets.

FSC research concluded that allocations to non listed investments, such as bonds, will grow significantly as the superannuation system matures. This diversification of investments will be driven by the needs of beneficiaries, but will also serve to provide a new source of funds for Australia's corporate community and governments.

It is also forecast that intermediaries seeking capital will increasingly use securitisation to enable the sale of on-balance sheet assets to superannuation funds. This will enable banks to focus their capital on providing specialised, high return services. Professor Maddock notes:

Superannuation funds have advantages over banks as repositories of long term assets. They may access the assets through the market, so that they will become important holders of residential mortgage backed securities and other securitised assets, but they may also buy bundles directly from banks reducing intermediation costs. It thus seems very likely that we will see banks and funds developing strong and direct links with each specialising in part of the value chain – banks initiating, credit scoring and managing, with the super funds holding the assets and taking the income risk.⁵

Such arrangements will be mutually beneficial as they will provide superannuation funds with a reliable income stream that matches the needs of beneficiaries and also make available to other intermediaries the capital to fund subsequent transactions.

Professor Maddock notes in his report:

At (securitisation's) heart it involves the conversion of non-traded assets into traded ones. Well-designed securitised assets have an important role to play in that they give investors access to markets in asset classes to which they would not normally be able to get exposure with the added benefit of being relatively liquid.⁶

⁵ Maddock ibid

⁶ Maddock ibid

The reputation of the securitisation market was damaged during the financial crisis due to product design and lax regulation on rating agencies and manufacturers, allowing them to avoid responsibility of the quality of their product. Reforms after the crisis have sought to address such regulatory gaps and it is important these reforms be allowed to be implemented to engender trust and stability in the securitisation market.

The FSC is of the view that the Wallis Inquiry remains correct in predicting that securitisation and non-bank lending in Australia would increase. This prediction held true until the financial crisis, where the subsequent policy responses constrained securitisation. The FSC's research, however, indicates that this disruption is unlikely to be permanent and will not interrupt the long term growth of this market.

RECOMMENDATION

The Inquiry recognises that the exposure of superannuation funds to domestic, non-listed equity investments will increase, partly through securitisation.

5. Home bias of superannuation investment will remain

FSC research concluded that the traditional home bias of superannuation investments will decline to a point, but will remain in an absolute sense. There are strong reasons for investors to retain a home bias, including the reduction of inflation risk and exchange risk through owning Australian domiciled assets. Domestic assets will also remain comparatively cheaper than international assets due to lower transaction costs for the foreseeable future.

The decline in home bias will be driven by a shortage of domestically domiciled assets. Hence, the price of these assets will increase relative to international assets, making international assets more attractive on a risk weighted basis. This will assist in bringing down the cost for beneficiaries of international investments, which, over time, will increase the volume of international investment.

RECOMMENDATION

The Inquiry recognises the home bias of superannuation investment will be sustained.

6. Superannuation as 'patient capital'

Superannuation legislation requires funds to invest with the objective of maximising the retirement income of beneficiaries. This orientation towards retirement ensures that the capital within the superannuation system is 'patient', that is, investment decisions are made in the context of long-term objectives and return targets.

There is a natural fit between patient capital and business or households that require long-term financing for illiquid assets. Where these consumers offer an adequate illiquidity premium the existence of the superannuation system ensures that a large pool of patient capital is available.

The 'patience' of the pool of capital is improved by:

- ❖ The size of funds: larger funds are better able to increase their allocation to illiquid investments without disturbing their liquidity requirements;
- ❖ The size of the illiquid market: connecting patient capital with consumers offering illiquid investments requires a sufficient number of intermediaries or in-house managers with the skills in this form of investing, which becomes viable after the market in illiquid assets achieves sufficient scale;
- ❖ The incentive structure: taxation and remuneration structures should not encourage intermediaries to direct patient capital away from illiquid investments when this is not in the best interests of beneficiaries.

The primary difference as a result of the advent of the superannuation system is that capital in the system has an investment horizon based on the investment needs of the beneficiaries. Alternative savings vehicles have their investment horizon set based on the return expectations of the intermediary, with little regard for the needs of the beneficiary or the consumer of the capital.

The benefit of intermediation though is apparent:

1. Superannuation savers benefit from professional management of their money;
2. Large superannuation funds will, over time, create demand for non-listed equity investment.

ASSET ALLOCATION OF PENSION FUNDS GLOBALLY

A common view is that superannuation is “overweight” in equities, in particular in Australian equities, when compared to similar pension systems around the world.

RECOMMENDATION

The Inquiry recognises superannuation funds will continue exercising their role as investors of patient capital in unlisted assets such as infrastructure.

There is also a view that superannuation asset allocation distorts the savings structure of the economy to the detriment of some financial institutions and businesses.

Despite the frequency of these comments, they have not been based on substantive research.

FSC commissioned research by Mercer Consulting for this inquiry: “Asset allocation of pension funds around the world.”

The research compares Australia's asset allocation in superannuation to that of 11 other private pension schemes around the world.

Its findings were:

1. Four of the five largest pension systems in the world - of which Australia is the fourth largest - have an allocation to equities of between 35 and 50 per cent
2. The report also finds that there are a number of reasons why Australia should be expected to have a high allocation of pension funds to equities
3. Defined Contribution (DC) systems such as Australian superannuation remain less common relative to Defined Benefit (DB) systems
4. DC pension systems are fully-funded and non-guaranteed. Accordingly, DC systems will have a higher allocation to growth assets than DB funds. “DB members now represent less than 11% of all superannuation assets.”

5. Australia has a strong home bias and a high allocation to domestic equity - not all countries share a high allocation to domestic equities. For example, the majority of European pension systems surveyed allocate a higher proportion of fund assets investments to non-domestic equity markets relative to their home country allocation
6. Jurisdictions including the USA, Hong Kong, Chile and the UK have a similar allocation towards equities as can be found in Australia
7. Australia has a higher allocation towards property and other (including infrastructure and alternatives) but a lower relative allocation towards fixed interest investments
8. Australia also has the second highest allocation to
 - a. cash / deposits; and
 - b. land and buildings
9. The major difference between the Australian superannuation system and comparative pension systems is Australia's lower allocation towards fixed interest
10. The report finds that the narrow corporate bond market limits the ability of superannuation funds from obtaining domestic fixed interest investments as there is a tax incentive (imputation) in the system which drives both supply and demand of equity over debt (This finding is reinforced by further research conducted by Capital Markets Consulting which features in the Financial System Users chapter of FSC's submissions)
11. A number of countries have their plans heavily allocated towards defensive assets; this will "limit the return achieved by the pension plans over the longer term..."

RECOMMENDATION

The Inquiry recognises the asset allocation of Australian superannuation is consistent with other major pension systems.

Although pension systems are difficult to compare due to differences in regulation, management styles, domestic economic conditions and culture, the report has demonstrated that Australian asset allocation is not unusual. It further shows Australia has one of the most diverse allocations.

PRIMACY OF TRUSTEESHIP

The superannuation system must continue to be structured for the primary benefit of members. A glance at Hansard in the early 1990s shows that superannuation was always intended to perform two tasks - improve incomes in retirement and grows the savings of Australia as a nation.

The allocation of those savings was intended to be determined by the market since it brings these two goals together.

By maximising returns to superannuation fund members as required by legislation trustees of superannuation funds are also maximising returns to the Australian economy.

Every transaction that seeks to increase returns for a superannuation fund member is a de-facto cost-benefit analysis for investment in the economy as well. If it is not a good investment for an individual - it is not a good investment for the Australian economy.

As the Maddock and Mercer research shows, trustees currently allocate superannuation capital widely across varying asset classes such as cash, fixed income, property, equity and infrastructure.

Trustees allocate the capital for the benefit of members except where members exercise choice of fund or investment strategy.

Member choice

Superannuation members are empowered to select their own chosen fund and the nature of the investment within that fund. Choice of fund and investment laws provides the superannuation system with the flexibility to meet the preferences of most Australians.

Despite its preserved status (where many Australians will be unable to access their benefits until they are 60 years old) superannuation has become the savings vehicle of choice. For example, discretionary member contributions were \$36.5 billion in 2012-13.⁷

Member investment choice permits superannuants to select assets which match individual risk profile and diversification needs.

Self managed and retail superannuation funds primarily provide this service where members can create their own investment portfolio.

⁷ APRA Annual Superannuation Statistics June 2013

Most members (measured by assets) in retail funds create their own investment portfolio in superannuation. **Figure 1.12** below highlights that only 23 per cent of retail superannuation fund assets are held in the default investment strategy. This differs considerably to other fund types such as industry with 71 per cent investment in the default option set by the trustee.

Figure 1.12 Assets in the default investment strategy⁸

| Australian Superannuation Industry - Default Investment Option at June 2013 (\$billion) | | | | | |
|---|--------------------|---------------|---------------|--------|-------|
| ASSETS | CORPORATE IN-HOUSE | INDUSTRY FUND | PUBLIC SECTOR | RETAIL | TOTAL |
| FUND NET ASSETS | 53 | 316 | 148 | 413 | 929 |
| DEFAULT OPTION ASSETS | 25 | 218 | 92 | 77 | 411 |
| % OF NET ASSETS IN DEFAULT | 47% | 71% | 73% | 23% | 45% |

This divergence in member investment choice does not diminish the superannuation fund’s ability to allocate capital as described above.

Members investing through a retail fund benefit from economies of scale and the professional management of a collective investment scheme.

The trustees of a retail fund assemble a menu of investment options, typically several hundred. The investors then access those options at “wholesale” prices due to the trustee’s ability to invest on behalf of other superannuants. A superannuation trustee can typically negotiate a lower fee when engaging an asset manager relative to an individual investor.

In this way, member investment choice and trusteeship are complementary. That is, widespread member investment choice does not diminish the ability of superannuation funds to leverage their scale and remain a source of patient capital.

⁸ Chant West Financial Services - Submission to APRA

Directed investment

Directed investment has been attempted in Australia prior to financial deregulation (such as the 30/20 rule) which required life offices and superannuation funds to invest a fixed proportion of their assets in government bonds.

The 30/20 rule was abolished in 1984 after the Campbell Inquiry of 1981 recommended it as part of a wide sweeping package of financial deregulation in Australia. This included the entry of foreign banks, floating the dollar and removal of controls on banks.

The 30/20 rule commenced in 1961. At least 30 per cent of life and superannuation assets were required to be invested in Commonwealth securities. Failing to do so resulted in significant taxation disincentives.

Campbell found that the rule was ineffective, inefficient and damaged the financial system.⁹

Directed investment had distorted financial markets and the allocation of capital within the economy. It also has the clear risk that superannuation fund investors will suffer relative to other financial institution such as banks. This is because trustees would be automatically compelled to invest in particular asset classes without considering their attractiveness or appropriateness in meeting the existing “sole purpose test”.

Dr Vince FitzGerald commenced in 1991 on directed investment proposals for superannuation that:

end result would probably be a similar balance between Australian and overseas investment, but a different pattern of holding of investments within Australia. Superannuation funds would tend to hold more of the ‘socially valuable’ investments and others, such as banks and other financial institutions, individuals and so on would hold less of these. Whether there would be a significant net additional supply of capital to the areas concerned [is] questionable, but [the clear] result would be distortion of the investment patterns of both superannuation funds and other investors.¹⁰

⁹ Campbell Inquiry 1981

¹⁰ Vince FitzGerald cited in Chalmers - pp41

As stated by Chalmers in his 1995 Parliamentary report on the subject, the government is not better suited or skills to guide investment than superannuation trustees. He notes: "it is therefore difficult to escape the conclusion that directed investment must involve reduced returns, with the inevitable consequences for the standard of living in retirement of superannuants."

This perspective is again supported by Dr Vince FitzGerald who estimated that the 30/20 rule reduced superannuation returns by 2-3 per cent annually.¹¹

Governments in Australia do not have a great record of "picking winners". For instance HomeFund and Tricontinental in NSW and Victoria are examples where the government has directed investment into venture capital and low cost housing projects.

RECOMMENDATION

The inquiry finds directed investment of superannuation would reduce returns to members and distort the financial system and the economy

Picking winners in terms of particular projects or asset classes is fraught with danger. Amongst other things, it would be likely to:

1. Lower returns
2. Reduce confidence in super
3. Distort the financial sector and economy
4. Increase regulatory cost

LIFE INSURANCE

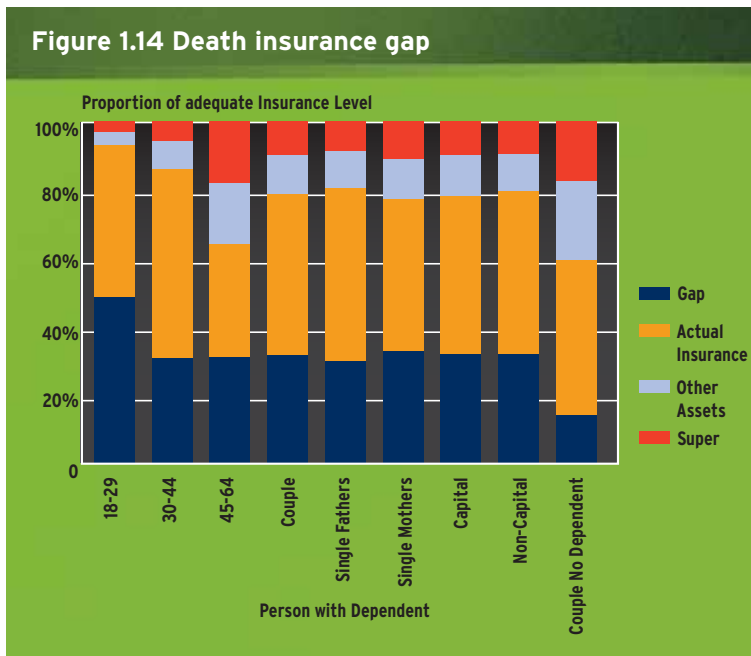
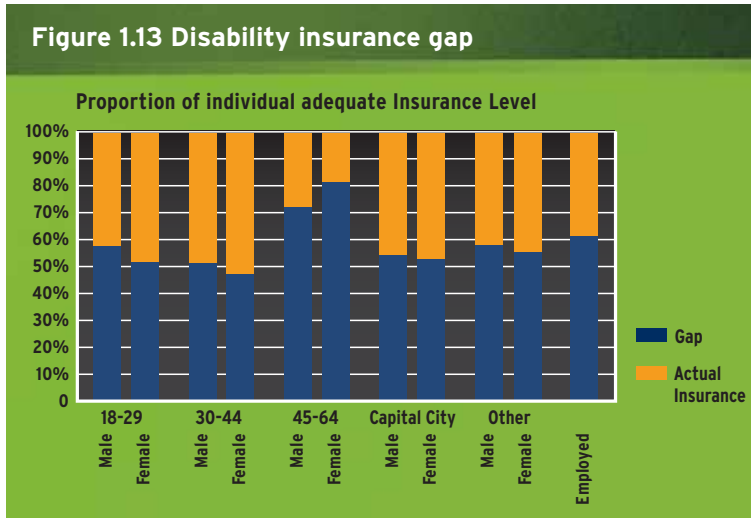
Life insurance within superannuation is a critical component of the system. Life insurance is a complementary feature of the superannuation system as it protects retirement savings and quality of lives.

Life insurance products play an important role in the community as they protect the insured and their dependents against the financial risks associated with premature death, permanent and temporary disability, as well as various specified critical medical conditions.

Additionally, annuity products designed to meet retirement and other long-range goals also provide the insured with periodic payments after a specified date. However, Australians remain chronically underinsured against these risks.

According to research undertaken by KPMG for the FSC, 35% of employed people in Australia have no private disability insurance at all and 19% of families do not have any life insurance.

¹¹ Ian Chalmers Yours, mine or ours?: Is there a case for directed superannuation investment? Parliamentary Research Service No.32 1994/1995 pp42



On aggregate, the level of disability underinsurance is estimated to be \$304 billion per annum while the level of underinsurance of the lives of employed people against premature death in Australian families is estimated to be \$800 billion.¹² **Figure 1.13** shows the proportion of adequate insurance levels held by individuals for disability and **Figure 1.14** shows the same for premature death.

Insurance coverage held through superannuation represents more than half of all life insurances held by Australians. According to KPMG’s analysis, approximately 67% of life insurance and approximately 56% of disability insurance in Australia is held through superannuation.

RECOMMENDATION

The Inquiry finds life insurance through superannuation provides significant coverage to Australians which would not otherwise be available

¹² KPMG, Death and Disability Protection Gap in Australia, 2014

Figure 1.15 shows a breakdown of the \$5.5 billion premium value of insurance held through superannuation by market segment. Given the superannuation system manages around \$1.6 trillion worth of assets, insurance premium costs equate to approximately 35 basis points (bps) of assets under management per annum.

Figure 1.15 Insurance premiums in superannuation¹³

| MARKET SEGMENT | TERM (\$MILLION) | TPD (\$MILLION) | INCOME PROTECTION (\$MILLION) | TOTAL (\$MILLION) |
|------------------------|------------------|-----------------|-------------------------------|-------------------|
| WHOLESALE | | | | |
| CORPORATE FUNDS | 51 | 45 | 50 | 146 |
| INDUSTRY FUNDS | 895 | 565 | 570 | 2,030 |
| PUBLIC SECTOR FUNDS | 296 | 187 | 179 | 662 |
| EMPLOYER MASTER TRUSTS | 333 | 291 | 174 | 798 |
| TOTAL WHOLESALE | 1,575 | 1,088 | 973 | 3,636 |
| RETAIL | | | | |
| ADVISER SUPERANNUATION | 1,310 | 435 | 184 | 1,930 |
| TOTAL MARKET | 2,885 | 1,523 | 1,157 | 5,566 |

RECOMMENDATION

The Inquiry find life insurance coverage is provided at a reasonable cost to members which does not drain retirement savings.

The ability to access insurance affordably through superannuation is relatively unique to the Australian retirement savings system and is well supported by consumers. Recent consumer research undertaken by GfK for the FSC demonstrates this in that 42% of Australians without existing disability coverage selected the ability to purchase insurance through superannuation as being one of the top motivators that would persuade them to take out cover.¹⁴

Superannuation has proved to be an important vehicle through which the majority of employed Australians have been able to access life and disability insurance regardless of their personal circumstances.

Group insurance offered through superannuation generally does not require an individual to complete comprehensive underwriting in relation to their individual circumstances, unless voluntary top-up cover is obtained. This feature of group insurance, available through superannuation, has been particularly beneficial in ensuring access to insurance at a comparatively affordable rate for workers employed in higher risk occupations.

¹³ Rice Warner Actuaries & FSC Savings and Longevity Report 2014

¹⁴ MetLife/FSC research, Apathy to Action: Understanding consumer barriers to adequacy in life insurance, GfK, 2014 p.21

By enabling affordable access to insurance that protects an individual against the economic risks of injury, illness or disability individuals are more likely to be able to continue to save for their retirement through ongoing income replacement benefits rather than accessing retirement savings earlier than they would have otherwise due to loss of income as a result of disability.

The FSC strongly supports the continued accessibility of life and disability insurance through group insurance arrangements offered by superannuation funds to improve the adequacy of life and disability insurance held by Australians.

CHAPTER 1 RECOMMENDATIONS:

The Inquiry recognise that

1. Superannuation has created a significant pool of national savings without a substitution effect.
2. Superannuation assets are invested widely across the economy
3. Superannuation funds heavily finance other domestic financial institutions
4. Australia will increasingly depend less on foreign capital due to superannuation savings
5. Exposure of superannuation funds to domestic, non-listed equity investments will increase, partly through securitisation
6. The home bias of superannuation investment will be sustained
7. Superannuation funds will continue exercising their role as investors of patient capital in unlisted assets such as infrastructure
8. Professional investment management has delivered higher returns to superannuants than would otherwise be possible
9. Asset allocation of Australian superannuation is consistent with other major pension systems
10. Directed investment of superannuation would reduce returns to members and distort the financial system and the economy
11. Life insurance through superannuation provides significant coverage to Australians which would not otherwise be available
12. Life insurance coverage is provided at a reasonable cost to members which does not drain retirement savings.

