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THE FINANCIAL SYSTEM INQUIRY
MERCER RESPONSE

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MARSH & McLENNAN COMPANIES

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Executive summary

Mercer welcomes the opportunity to make a submission to the Financial System Inquiry.

In our response we provide the Inquiry with background, data and evidence in respect of Australia's savings arrangements: financial intermediation within the Australian economy, the retirement system including the role of social security, the role of group insurance and the efficiency and efficacy of the current arrangements including areas for improvement.

There is a focus on superannuation as we recognise the growth of the superannuation system represents one of the major developments within the economy since the previous (Wallis) inquiry. The superannuation system will play an increasingly important role both within Australia's economy and for the Australian community as the assets continue to grow and as an increasing proportion of the assets are held by retirees.

The Inquiry should recognise:

- The Australian financial system operated well during the global financial crisis and there is much merit in the current arrangements
- Australia has an ageing population which will have significant effects within the economy in future years. The potentially adverse impact of this change can be mitigated with better integration between the various pillars of savings together with a clear objective and role for each pillar
- The Australian superannuation system has grown significantly in recent years and is well respected around the world. Its major shortcoming is in respect of the availability of a broad range of post retirement products meets the risks faced by retirees
- There has been a significant increase in compliance and regulation in the superannuation sector which has increased costs to members and limited innovation and efficacy.

We recognise this is the first in a series of papers the Inquiry will seek from the industry over the course of the following months; we are pleased to provide more detail on any of the matters raised in this paper as needed.

Mercer also welcomes the Statement of Shared Intent by Commonwealth, State and Territory Treasurers, to plan to boost Australia's stock of productive infrastructure, released 28 March. Initiatives to foster capital recycling by governments out of existing assets and into new assets deserve detailed consideration. Australian superannuation funds and insurers welcome opportunities to increase their investments in infrastructure assets on commercial terms

acceptable to all stakeholders. Our extensive investor relationships and infrastructure sector expertise make us extremely well placed to make an important contribution to this process.

2

Financial intermediation

The growth of superannuation has significant implications for financial intermediation in Australia; specifically the means by which household savings are channelled into investment and other economically productive uses. An important common theme linking these twin aspects of Australia's superannuation system is diversification.

Viewed from the asset side of the industry's balance sheet, the continuing growth of superannuation could be expected to sustain a higher household savings rate, as well as contributing to further financial disintermediation and the deepening of Australia's capital markets. The latter facet potentially has important macro-economic implications, particularly for a country like Australia in which the banking system dominates the intermediation process and which historically also has a relatively high ratio of investment to GDP.

In terms of the liability side of the industry (i.e. the provision of benefits), superannuation savings are playing an important role in diversifying the wealth of many Australians, in turn improving the security of retirement incomes.

The remainder of this chapter examines the relationship between superannuation savings and the Australian household savings rate and the importance of the superannuation system in shaping the diversification of Australian financial intermediation and household wealth.

A tenuous link between superannuation and Australian household savings rates – until now?

Superannuation savings have increased steadily since the introduction of the Superannuation Guarantee system in 1992. For much of this period, however, the overall propensity to save among Australian households, measured by either the household savings rate or more directly by changes in household net financial position, declined markedly (see Figure 1.1).

As the size of new superannuation contributions steadily increased through the 1990s and the early-middle part of the 2000s, Figure 1.2 shows households reduced other forms of saving (most notably household direct purchases of equities). More importantly, between 1992 and 2007, rapidly rising asset prices were accompanied by significant increases in household borrowings. These factors appeared to have a two-fold effect on Australian savings rates. Firstly, many households tended to regard the increases in asset prices as permanent, and presumably decided to reduce other forms of saving. Secondly, much of the increased

borrowing was used also to fund household consumption expenditure, which at any given level of household income results in a lower household savings rate (the household savings is the residual after consumption is subtracted from disposable income).

Figure 1.1

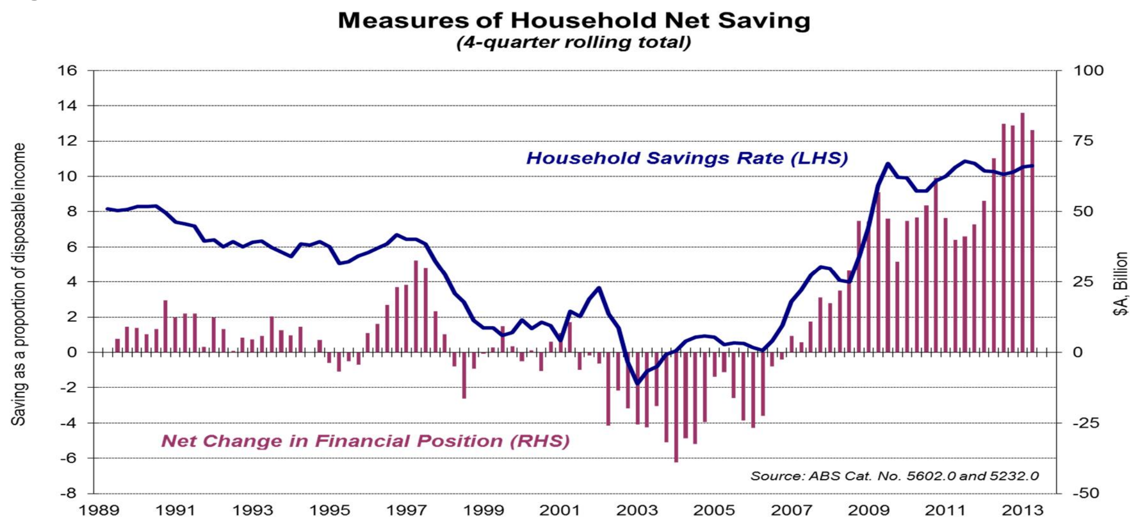
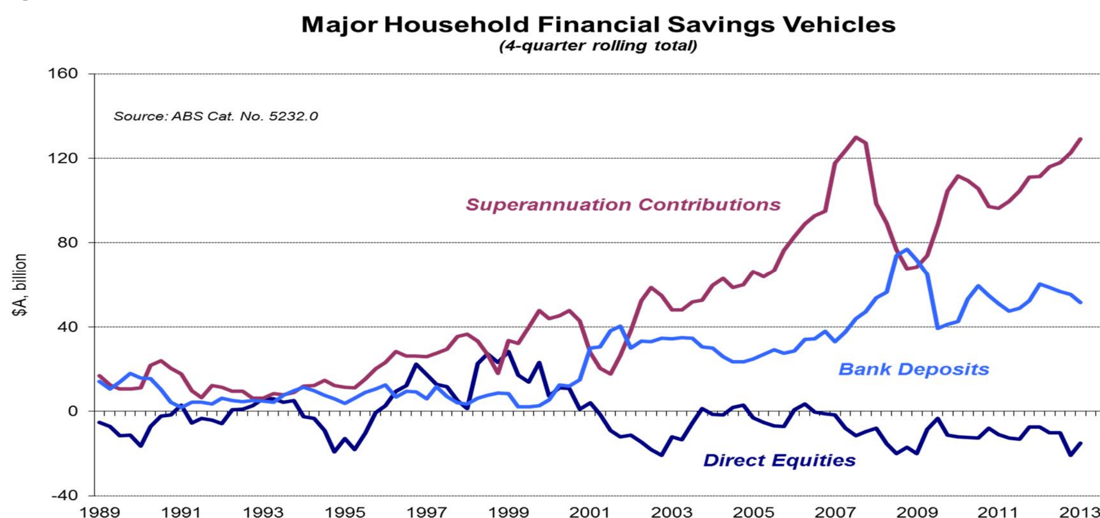


Figure 1.2



Since 2007 (and preceding the global financial crisis), there has been a significant turnaround in the propensity to save among Australian households. Although much of the increase in savings was initially directed into bank deposits, the ensuing recovery in household risk appetite has

been accompanied by an acceleration of flows into superannuation funds. Indeed, with the new 'prudency' among Australian households, and the diminished capacity to take on additional debt, it is generally agreed future asset price increases are likely to be more subdued than in the preceding two decades. Along with broader expectations of continued low real interest rates, and diminished competition more recently among Australian banks for retail funding, there are good reasons to expect a much stronger link in the future between the growth in superannuation funds under management and aggregate measures of Australian household savings.

Superannuation diversifies financial intermediation and can help reduce Australia's long-term financing gap

Financial intermediation in Australia is still dominated by the banking system despite the rapid growth in Australian superannuation funds under management, and the favourable international comparisons.[1] OECD data confirms Australian pension fund assets, relative to GDP, are already among the highest in the world, and the highest of any major developed economy outside Europe.[2] At 92.8% as at June 2011, Australia trailed only Netherlands (135.5%), Iceland (128.7%), Switzerland (110.7%) and the United Kingdom (95.8%), and compared favourably with the United States (70.6%). Using more recent data, this ratio had subsequently increased to around 100% as at December 2013.[3]

In comparison, assets of Australian Authorised Deposit Taking Institutions were equal to 213% of GDP at the end of 2013. In the United States, in contrast, total financial assets of Private Depository Institutions were equal to just 92% of GDP at the end of 2103.[4] Relative to Australia, off-balance sheet activities, wholesale funding and securities markets (with an accompanying wide range of participants beyond depository institutions and pension funds) all play a much more significant role in financial intermediation in the US.

This submission offers no comment on the relative merits of bank-based or market-based financial systems. Nevertheless, the serious shortcomings of evolving bank business models in many developed economies were laid bare with the global financial crisis, and will take many

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[1] For a (slightly dated) international comparison of domestic financial systems, see Demirguc-Kunt, A. and Levine, R., "Bank-based and market-based financial systems: cross-country comparisons." World Bank Policy Research Paper No. WPS 2143. July 1999. World Bank. Washington, D.C.

[2] OECD. "The role of banks, equity markets and institutional investors in long-term financing for growth and development." February 2013. Paris.

[3] Reserve Bank of Australia. Statistical Table B1.

Accessed from www.rba.gov.au/statistics/tables/index.html#assets_liabilities on 20 March 2014.

[4] Board of Governors of the Federal Reserve System. Financial Accounts of the United States. Table L 109. Accessed from www.federalreserve.gov/releases/z1/Current/ on 20 March 2014.

years to fully address. Moreover, the OECD believes persistent ‘blockages’ in banking systems, which in turn are causing a growing mismatch between the amount and time horizon of available capital and the demand for long-term finance, remain the major constraint on a stronger recovery in long-term business and infrastructure investment in the developed countries.[5]

Although such blockages are less apparent among Australian banks, it is unclear the domestic banking sector is especially well positioned to meet Australia’s growing long-term financing gap. In contrast, superannaution funds and other institutional investors appear much better suited. Volatile equity markets and expectations of a prolonged period of low real interest rates are increasingly pushing institutions to identify alternative sources of long-term, inflation protected returns, among which infrastructure appears particularly attractive. The long-term horizon of the same funds is also conducive to investment in start-ups and venture capital vehicles, and which ultimately could also lead to lower concentration risks in the Australian equity market (which currently is dominated by a small number of large mining companies and banks).

Other implications

All other things being equal, a sustained lift in the Australian household savings rate could be expected to reduce the size of Australia’s current account deficit. Indeed, since peaking most recently at 6.7% of GDP in 2007, Australia’s current account deficit narrowed to 2.9% in 2013. In the simple national accounting framework, the rise in the household savings rate (or the increase in household net lending to other sectors) has more than offset net borrowing by the government sector (i.e. rising budget deficits) and net borrowing by the non-financial business sector (more than all of which appears to be among mining companies).

In terms of current transactions, the narrowing of Australia’s external deficit in the past few years largely reflects relatively weak import growth, surging mineral resource exports, and a decline in the primary income deficit (the difference between servicing obligations on the stock of Australia’s foreign liabilities and the returns earned from Australia’s investments abroad). While much of the decline in the net income deficit is attributable to lower interest payments on Australia’s foreign debt, income credits have also increased moderately in the past three years. However, the relatively small increase in income credits masks a significant surge in the stock of foreign assets owned by Australians in the same period; to the point now Australia has a positive net foreign equity position (i.e. the stock of foreign equity assets owned by Australians exceeds the value of Australian equity assets owned by foreigners). Exchange rate and market movements account for some of the turnaround, but the next section will also highlight the important contribution from rising investment in foreign assets by Australian superannuation funds.

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[5] OECD, op cit, p. 4.

These developments have led some to speculate Australia could move into a current account surplus by as early as 2018/19.[6] Again, we offer no judgement as to whether a current account surplus is 'good' or 'bad', particularly for a country with relatively large investment needs. As the Commonwealth Bank notes, however, one important implication could be lower interest rates than otherwise, while the implied domestic savings surplus could also be expected to lower Australia's vulnerability to swings in global investor sentiment and volatile capital flows.

More diversified household wealth

Corresponding with the increase in superannuation savings has been a rise in the share of financial assets as a proportion of total household assets (from which is deducted household liabilities to obtain a measure of total household net worth). According to the Australian Bureau of Statistics[7], financial assets comprised approximately 40% of total household assets as at 30 September 2013, compared with a little over 30% around the time of the commencement of the quarterly data series in 1988. Perhaps surprisingly, residential land and dwellings have remained relatively steady at around 50% of total assets throughout the entire period. Financial assets have gained ground at the expense of other produced assets (primarily physical productive assets owned by unincorporated enterprises).

Superannuation now comprises the most significant share of the *stock* of household financial assets (Figure 1.2 shows the *flows* of net new savings into each major savings vehicle). At almost 48%, the share of superannuation assets is up from just 30% in 1988. Directly purchased equities comprise 17%, not a lot different since 1988, although the share has fluctuated widely over the period. Bank deposits comprised 21%, down from 27% around the commencement of the series, with the proportion also showing significant swings in the past 25 years.

Within superannuation fund assets, however, there has also been a long term shift in the mix of assets, largely reflecting the growing dominance of defined contribution schemes (including SMSFs) and the reduction of defined benefit schemes. ABS data shows the largest shift has been in the allocation to equities, which has increased from 31% to 46% since 1988[8]. Correspondingly, holdings of cash and bonds have fallen from 42% to 27%. Importantly, the allocation to overseas assets has increased from 14% to 19% in the past 25 years. Indeed, other ABS data[9] suggests a slightly higher re-allocation between domestic and overseas assets within the equities portfolios of Australian superannuation funds, from approximately 20/80

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[6] See Commonwealth Bank of Australia. "Current account surplus – or banana republic no more?". Economics: Issues. 4 February 2014.

[7] Australian Bureau of Statistics. Catalogue No. 5232.0, September Quarter 2013. Table 43.

[8] Australian Bureau of Statistics. Catalogue No. 5655.0. December Quarter 2014. Table 4.

[9] Australian Bureau of Statistics. Catalogue No. 5232.0, September Quarter 2013. Table 10.

(foreign/domestic) in 1988 to 30/70 in 2013. The potential for further diversification offshore should again help Australian savers avoid the relatively high concentration risks in the Australian equity market.

The continued growth and strength of Australia's superannuation system is crucial in facilitating higher national savings, a more diversified financial system with broader and deeper capital markets, and a more diversified mix of household wealth and retirement income streams.

3

Australia's retirement system

The multi-pillar approach

In its influential report "Averting the Old Age Crisis", the World Bank (1994) recommended a multi-pillar system for the provision of old-age income security comprising:

Pillar 1	A mandatory publicly managed tax-financed public pension
Pillar 2	Mandatory privately managed, fully funded benefits
Pillar 3	Voluntary privately managed fully funded personal savings

Subsequently, Holzmann and Hinz (2005) of the World Bank extended this three-pillar system to the following five-pillar approach:

Pillar 0	A basic pension from public finances may be universal or means-tested
Pillar 1	A mandated public pension plan is publicly managed with contributions and, in some cases, financial reserves
Pillar 2	Mandated and fully funded occupational or personal pension plans with financial assets
Pillar 3	Voluntary and fully funded occupational or personal pension plans with financial assets
Pillar 4	A voluntary system outside the pension system with access to a range of financial and non-financial assets and support

In effect, they split the original first pillar into two and also divided the third pillar by adding a new fourth pillar which includes personal savings, home ownership and other assets held outside the pension system. The recognition of Pillar 4 highlights the important role these assets play in providing financial support to individuals or households during retirement.

The Australian system

The Australian system has four of the five pillars as follows:

Pillar 0	The age pension, funded on a pay-as-you-go basis from general taxation, subject to means tests
Pillar 1	*Australia does not have a public pension funded by contributions from employers and/or employees*
Pillar 2	The Superannuation Guarantee (SG) system requires contributions from employers for the majority of their employees, but does not cover the self-employed. With the exception of some public sector defined benefit funds, it is a fully funded system.
Pillar 3	This is an extension of Pillar 2 where individuals make voluntary contributions through salary sacrifice arrangements or from after tax income. Some employers also make contributions above the SG requirements. As is common practice around the world, Pillars 2 and 3 are combined and represents our superannuation system.
Pillar 4	The treatment of the family home within both the taxation and social security systems represents one example of how Australia supports this pillar and thereby encourages the relatively high level of home ownership which can be important in providing financial security in retirement.

It is important to recognise each pillar has different but complementary objectives. For example, the primary purpose of the age pension is poverty alleviation and to ensure all older Australians, whatever their background and personal circumstances, are able to live with dignity and enjoy a reasonable standard of living.

On the other hand, Pillars 2 and 3 are more focused on the individual's circumstances throughout their income-earning years. The SG ensures a minimum amount is set aside for their retirement every quarter whilst Pillar 3 provides the opportunity for individuals to adjust their savings as circumstances change. The broad objectives of these two pillars are:

- To enable individuals and households to maintain their standard of living in retirement, up to an appropriate level
- To reduce future government expenditure on the age pension.

It is critical the objectives of Australia's retirement system are clear so the complementary roles of the pillars are appreciated by all. This would assist the related debates concerning the taxation of superannuation, the level of taxation concessions, the form of superannuation benefits and the required relationships, if any, between superannuation assets and the funding of Australia's future development.

The impact of social security

Australians finance their retirement years from the following sources:

- Pillar 0 - The means tested age pension
- Pillars 2 and 3 - Superannuation
- Pillar 4 - Personal non-superannuation savings.

The age pension is subject to both an income test and an assets test. In broad terms, deemed income is used in relation to financial assets. From 1 January 2015, this will also apply to account based pensions (with some grandfathering provisions).

For a single homeowner, the full age pension applies where:

- Income is less than $156 a fortnight; and
- Assets are less than $196,750.

The age pension is reduced by 50 cents a fortnight for each additional dollar of income and by $1.50 a fortnight for each additional $1,000 of assets over the above thresholds. These tests are applied independently with the test producing the largest reduction in the age pension being applied.

These social security rules create many anomalies and lead to some inappropriate behaviour and misallocation of resources in relation to superannuation and other investments. Two examples are set out below.

1. Superannuation

Existing means testing of the age pension encourages some retirees to spend their super before the pension eligibility age or during the early years in retirement.

Fred is a single (home-owner) retiree with a $500,000 account based pension. He is drawing down the minimum 5% of the account each year.

By spending $100,000 of his superannuation account on an overseas trip, Fred increases his age pension by $150 a fortnight ($3,900 a year).

If he continues to draw down the minimum allowed from his account based pension, his withdrawals reduce by $5,000 a year meaning he is only $1,100 a year (or $21 per week) worse off after his $100,000 overseas trip.

This issue particularly relates to those with modest levels of superannuation, which include many Australians who have not had superannuation throughout their career.

This example raises questions about the current integration of superannuation and the age pension and whether a more appropriate integration model should be developed. For example, reducing the amount by which the age pension is reduced from the current amount of $1.50 a fortnight for each $1,000 of assets over the asset test free amount could reduce the incentive to consume superannuation savings early in retirement.

2. Principal residence

The exclusion of the principal residence from the assets test encourages over investment in the home and discourages retirees and older workers from downsizing their primary residence.

Therefore consideration should be given to the treatment of the principal residence and/or the treatment of any capital generated from downsizing in the assets test.

The difference in the asset test free limits between homeowners and non-homeowners also creates anomalies as the difference does not represent the true value of a modest home resulting in significant discrimination against non-home owners in the asset test.

4

Australia's superannuation system

The structure of Australia's superannuation system

According to APRA statistics, there are the following types of superannuation funds in Australia:

- Corporate funds, which represented most superannuation funds until the 1990s, but now represent a small percentage of the total assets as most employers have outsourced their superannuation arrangements
- Industry funds are multi-employer funds and began with a focus on employees within a particular industry. However this specific industry focus is reducing as funds merge and some individuals stay with a single fund throughout their career
- Retail funds are operated by financial institutions and may seek investors (or members) from the general public or through employers. This distinction is important and will be discussed below
- Public sector funds were originally for all employees of the Commonwealth, State and local governments and related organisations. However, the default fund for many public servants is now an industry fund which may have a focus on public servants. It is also worth noting many of the larger public sector funds are not fully funded as they represent pay-as-you-go defined benefit schemes
- Self-managed superannuation funds (SMSFs) have grown significantly in the last two decades. However, as is noted in the published data, the asset allocation of these funds is quite different from the other “pooled” superannuation arrangements.

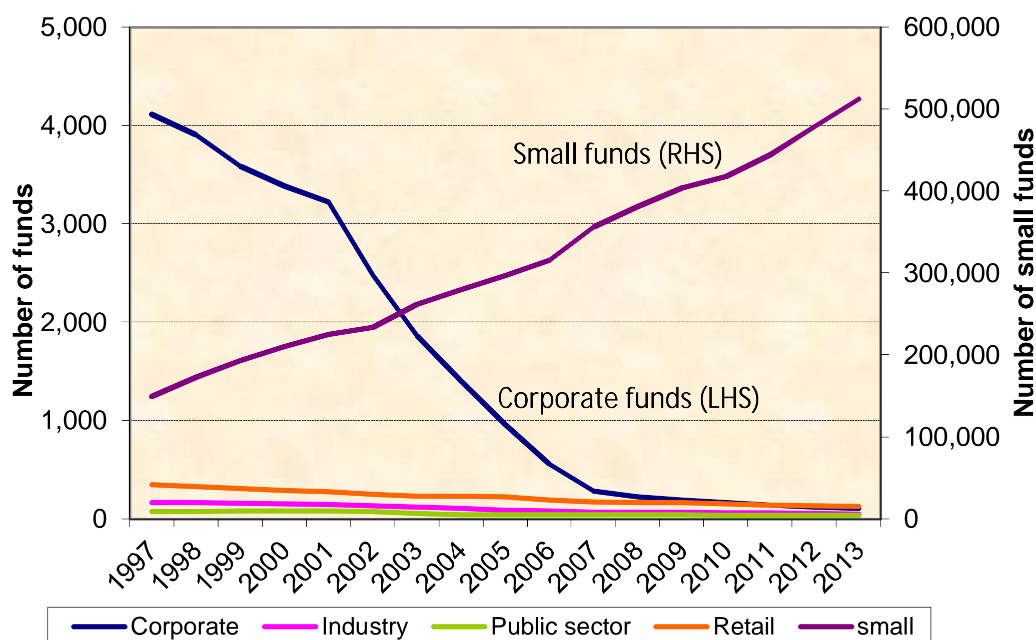
The APRA classification of retail superannuation funds comprises both superannuation arrangements for individuals and those arranged through employers. These employer arrangements often operate through a corporate master trust. In many cases, the employer transferred their original corporate fund into a master trust thereby taking advantage of the services and economies offered by the provider. The majority of master trusts are offered on a wholesale basis thereby providing significant cost savings to these members: in many cases the fees charged through the corporate master trust are lower than available through a relevant industry fund.

Recent research has indicated the assets of these corporate superannuation arrangements with active members within master trusts are at least $88 billion, which is 40% higher than all the assets in corporate superannuation funds.

Figures 3.1 and 3.2 show how the structure of the Australian superannuation industry has changed since 1997. Several features are worth noting:

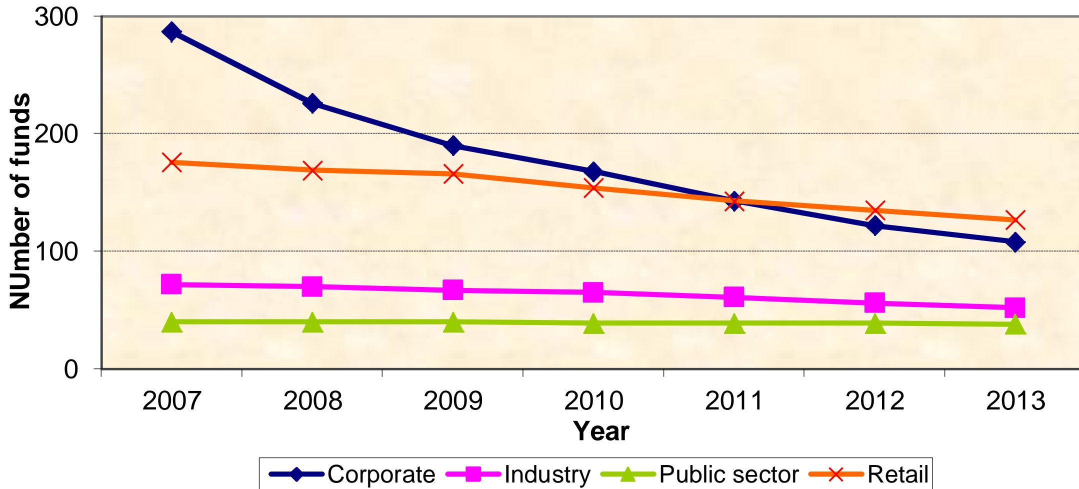
- The number of corporate funds has declined from more than 4,000 in 1997 to just over 100 today
- The number of SMSFs has more than trebled during the same period
- The number of all other types of funds is continuing to decline as many funds merge due to growing complexity, increasing regulation and stronger competition.

Figure 3.1: The number of superannuation funds 1997-2013



Source: APRA Annual Superannuation Bulletins

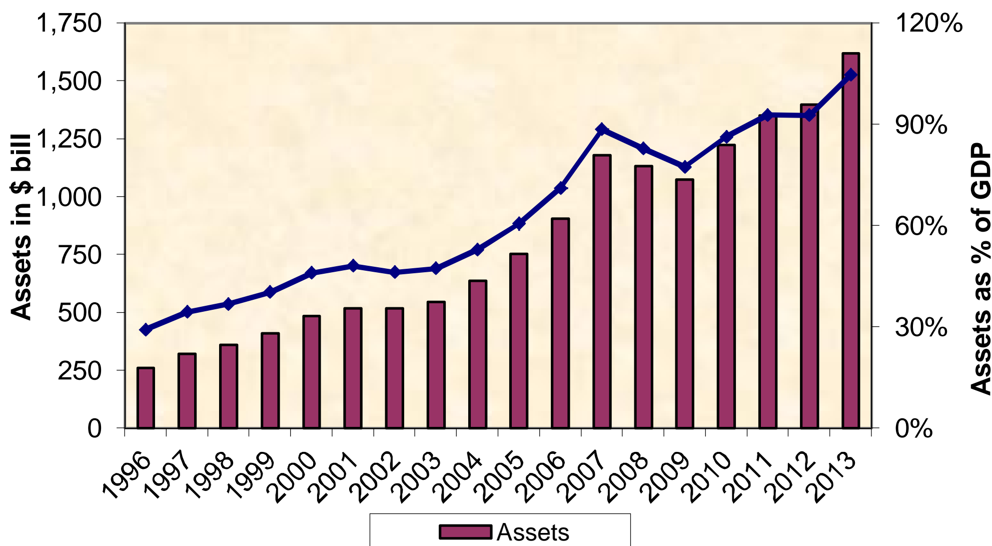
Figure 3.2: The number of superannuation funds 2007-2013



Source: APRA Annual Superannuation Bulletins

It is well known the importance of superannuation within the Australian economy has grown significantly in the last 17 years. Figure 3.3 shows this growth both in terms of assets and as a percentage of GDP. It is expected this growth will continue in future years as the superannuation system (both in the accumulation and pension phases) continues to mature.

Figure 3.3: The growth of Australian superannuation

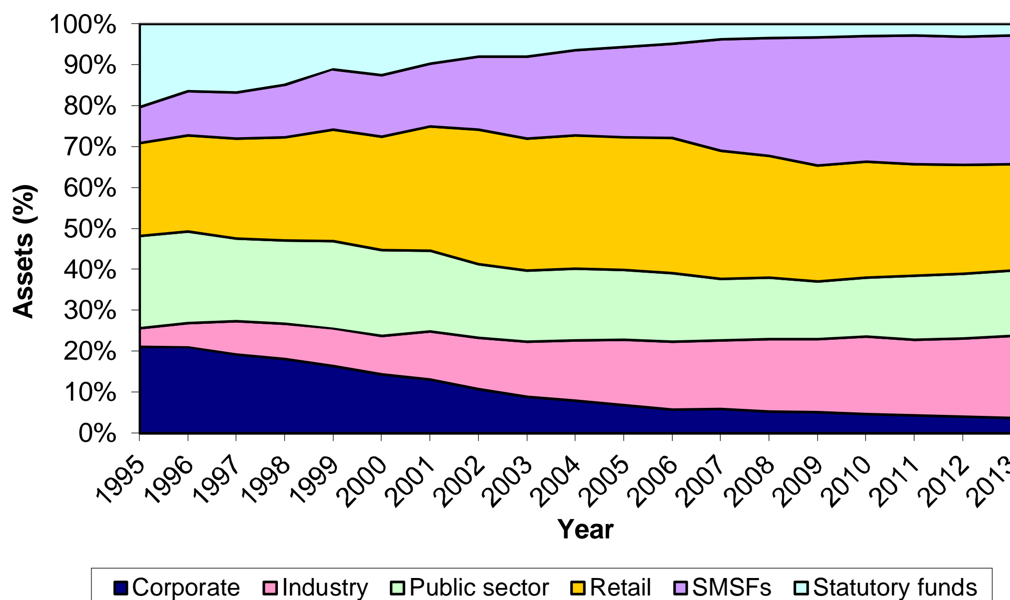


Source: APRA Annual Superannuation Bulletins and Reserve Bank Bulletins

However, as indicated earlier, this growth has not been uniform across all sectors in the superannuation industry. Figure 3.4 shows the changes in the relative size of assets in the different sectors:

- Growing importance of SMSFs increasing from 8.8% of assets in 1995 to more than 31% of assets in 2013
- Growth of industry funds from 4.4% of assets in 1995 to 20% in 2013
- Decline in public sector funds from 22.5% of assets in 1995 to 15.9% of assets in 2013 (noting many public servants are now members of industry funds)
- Decline in corporate funds from 21.2% of assets in 1995 to less than 4% of assets in 2013
- Relatively small growth in retail funds from 22.8% of assets in 1995 to 26.1% of assets in 2013
- Decline of life office statutory funds.

Figure 3.4: The changing asset size of different sectors in the superannuation



Source: APRA Annual Superannuation Bulletins

Asset allocation

The overall asset allocation for each type of fund has not changed significantly during the last five years. Table 3.1 shows the major asset classes for SMSFs in recent years while Table 3.2 shows the asset allocation for the default investment strategy for superannuation entities with more than four members (noting the tables are not directly comparable as the classification of assets are not the same).

Table 3.1: Asset allocation for SMSFs

Asset class	2009	2010	2011	2012	2013
Shares	30.9%	33.4%	33.3%	30.4%	32.8%
Cash and term deposits	29.7%	27.5%	28.9%	33.0%	30.6%
Trusts and managed investments	20.2%	19.9%	18.7%	17.0%	17.6%
Property	15.1%	15.6%	15.7%	16.5%	16.1%
Other	4.2%	3.6%	3.4%	3.2%	2.9%

Source: Australian Taxation Office, Self-managed superannuation funds: A statistical overview

Table 2: Asset allocation for default investment strategies super funds with more than 4 members

Asset class	2009	2010	2011	2012	2013
Australian shares	27.8%	29.0%	28.8%	27.5%	26.5%
International shares	22.2%	23.1%	23.5%	23.2%	24.9%
Property	10.4%	9.9%	9.5%	10.1%	9.5%
Australian fixed interest	7.8%	10.1%	10.0%	8.6%	8.5%
International fixed interest	5.7%	5.7%	6.2%	5.4%	5.9%
Cash	12.0%	8.9%	8.4%	8.9%	8.2%
Other	14.2%	13.2%	13.5%	16.3%	16.5%
% of all assets in entities with more than four members	*45.5%*	*45.8%*	*42.3%*	*42.9%*	*43.7%*

Source: APRA Annual Superannuation Bulletins

These numbers represent the weighted average across each sector, and while not representative of the asset allocation of any particular fund, provide some interesting differences between these two types of funds:

- The super funds have more than 30% of their portfolios invested overseas whereas SMSFs have much less invested offshore according to the ATO

- The SMSFs have about 30% invested in cash and term deposits compared to less than 9% in cash for the super funds
- The SMSFs have more than 17% of their investments invested in trusts and other managed investments whereas the super funds primarily invest through wholesale mandates and therefore tend not to use trusts or managed investment vehicles
- The "Other" investments item is not defined and may be important, especially as it represents about 15% of assets for the super funds. The APRA instruction provides the following examples of other investments - hedge funds, gold coins, art, and antiques. However we suggest it would also include private equity, infrastructure and commodities.

The conclusion is clear. The asset allocation of a typical SMSF is quite different from the default investment strategy in pooled superannuation funds.

The available APRA data in respect of the default investment strategies represents less than half of all the assets in these superannuation funds. There is no comprehensive data available in respect of all superannuation assets. This is a major shortcoming and is likely to be rectified in the future with APRA now requiring more data in respect of fund investments. Nevertheless it makes it difficult to assess the role of superannuation assets within the economy, as a whole, when detailed data and historical trends are not available.

Some historical observations

Prior to the mid-1980s, superannuation was primarily a voluntary system. Many employers provided superannuation as an "employment benefit" to attract and retain high quality staff. As such, employers providing superannuation were heavily involved in the management and design of superannuation plans. It was more widespread amongst white collar workers than blue collar although some, particularly larger employers, also provided superannuation for blue collar workers.

The major drawbacks of superannuation prior to the mid-1980s were:

- Limited coverage of employees
- The ability to withdraw benefits on leaving an employer with potentially minimal benefits remaining at retirement
- Poor levels of vesting with resignation benefits including minimal employer financing.

With the introduction of Award superannuation in the 1980s, the voluntary nature of superannuation changed. Compulsory superannuation was expanded in 1992 through the introduction of the SG legislation, gradually increased to its current level of 9.25%, with legislated increases to 12% by 2019.

The SG has increased superannuation coverage significantly although there remain some groups who do not receive compulsory superannuation. These include:

- Self–employed
- Unemployed
- Those earning less than $450 a month
- Those unable to work due to disability.

Preservation requirements were also introduced and increased in several stages to limit the drawdown of benefits before retirement. New vesting requirements and the SG legislation ensured more appropriate benefits were provided on resignation.

Although the preservation requirements have significantly removed the ability to withdraw benefits before retirement, there are really no restrictions on drawing down benefits at and after retirement. As noted earlier, superannuation savings can be used prior to becoming eligible for the age pension.

International comparisons

The provision of financial security in retirement is critical and most countries are now grappling with the social and economic effects of ageing populations. Yet, a comparison of the diverse retirement income systems around the world is not straightforward. As the OECD (2011) comments: “Retirement-income systems are diverse and often involve a number of different programmes. Classifying pension systems and different retirement-income schemes is consequentially difficult.”[10]

Furthermore, any direct comparison of systems is difficult as each system has evolved from country’s particular economic, social, cultural, political and historical circumstances. There is no perfect system can be applied universally around the world. However there are certain features and characteristics of retirement income systems are likely to lead to improved benefits for individuals and households, an increased likelihood of future sustainability of the system, and a greater level of confidence and trust within the community.

With these desirable outcomes in mind, the Melbourne Mercer Global Pension Index uses three sub-indexes – adequacy, sustainability and integrity – to measure each country’s retirement income system against more than 40 indicators. A copy of the 2013 report, which compared 20 countries, is attached.

The following findings are worth noting:

- Australia was second in the adequacy sub-index suggesting our overall framework and design has many positive features to deliver adequate retirement benefits
- Australia was fourth in the sustainability sub-index suggesting our system is currently better placed than most other countries

[10] OECD (2011), *Pensions at a Glance, Retirement Income Systems in OECD and G20 Countries.*

- Australia was the top country in the integrity sub-index suggesting much of the recent superannuation reforms, such as the APRA Prudential Standards, are leading the world.

Overall, Australia was placed third of the 20 countries. However, that does not mean our system is perfect and the report noted Australia's index value could be increased by the following changes:

- Introducing a requirement part of the retirement benefit be taken as an income stream (as discussed later)
- Increasing the labour force participation rate amongst older workers thereby improving sustainability
- Introducing a mechanism to increase the pension age as life expectancy continues to increase
- Increasing the minimum access age to receive benefits from superannuation plans so retirement benefits are not available more than five years before the age pension eligibility age
- Removing legislative barriers to encourage more effective retirement income products.

It is also worth noting the asset allocation of Australian superannuation funds is quite different from many other countries. A paper entitled "Asset Allocation of Pension Funds around the World", prepared by Mercer for the Financial Services Council earlier this year, is attached and provides reasons for these differences.

The taxation of superannuation

Whilst recognising the Financial System Inquiry is not a taxation inquiry, it is important to recognise various taxation arrangements affect the behaviour of both superannuation funds and individual members and therefore the efficacy of the overall system.

Until 1983, tax was very simple with contributions and superannuation investment income generally not subject to tax. Only 5% of lump sum benefits and all pension benefits were subject to taxation.

This changed in 1983 when a more significant tax on benefits was introduced. In 1988, the system was significantly complicated by the introduction of tax on contributions and investment income although there was a broadly offsetting reduction in the tax on benefits. This brought forward Government revenue – an approach which differed from retirement systems in most other developed countries where tax was generally based on benefits rather than contributions. What was purported to be a simple change created much confusion and it took many years for all aspects of this change to be properly legislated.

In 2007, the superannuation tax system was revised significantly with the removal of taxes on benefits from age 60 (other than some death benefits). Although known as Simpler Super, the changes increased further complexities, many of which are unresolved. New taxes on

contributions were introduced, some of which have already been modified several times and subsequently even more taxes introduced.

There have been a number of tax incentives introduced to encourage saving through superannuation. Many of these have been short lived, because they were ineffective, overly complex or poorly targeted. Two of these remain:

- The Government co-contribution which matched employee after tax contributions and is subject to an income test. Although it remains in place, the rules have changed frequently and the current level of Government contribution is significantly less than previously. The continual changes have resulted in confusion and a loss of interest amongst some superannuation members
- The Low Income Earners Government Contribution which effectively offsets contribution tax for those earning less than $37,000. This is a logical tax change as it broadly removes an anomaly whereby contributions for low income earners can be taxed more heavily than if the contributions had been taxed as normal income.

Over recent years, there has also been considerable discussion about the taxation of superannuation, including the size of the taxation expenditures and the equity of the overall system. The taxation of most superannuation arrangements (excluding some public sector arrangements) can be briefly described as follows:

- Concessional contributions, up to an annual cap, are subject to tax of 15% with an additional tax of 15% for those earning over $300,000
- Concessional contributions, beyond the annual cap, are taxed as though they formed part of the member's taxable income
- Non-concessional contributions, up to an annual cap but with a three year averaging permitted, are not subject to any tax
- Non-concessional contributions, beyond the permitted cap, are subject to a punitive tax
- Investment earnings in the accumulation (or pre-retirement) phase are subject to tax at 15%, together with a lower rate of tax on capital gains
- Investment earnings in the pension (or post-retirement) phase are subject to no tax
- Superannuation benefits received by individuals after age 60 are not subject to any taxation.

There are many complexities not mentioned above, but this summary highlights the basic rules apply to most superannuation funds and their members.

There are several issues related to superannuation we suggest the Inquiry should consider:

- The presence of annual caps means some individuals or households are not willing to contribute to superannuation when they have the capacity to do so. For example, when their family costs reduce later in their career. This restriction means they choose to invest in a range of other opportunities (such as negatively geared property). We recognise the need for contribution caps and recommend lifetime caps are a fairer

approach over the long term whilst also providing potential investors with a broader range of opportunities, when they have funds available.

- The differential in the tax on investment income between the accumulation and pension phases creates a distortion and is one factor encouraging the growth of SMSFs. It also means certain investment strategies become more attractive in the post-retirement years. These effects will become more pronounced as the baby boomers move into retirement with significant savings.
- The annual publication of the Taxation Expenditures report by Treasury expresses the value of the current superannuation taxation concessions. However, as discussed in the attached paper[11], Mercer believes this publication is misleading and does not generate a balanced debate. In particular, it concentrates on the superannuation pillars and does not recognise the government support of the age pension (or Pillar 0) within the overall system.

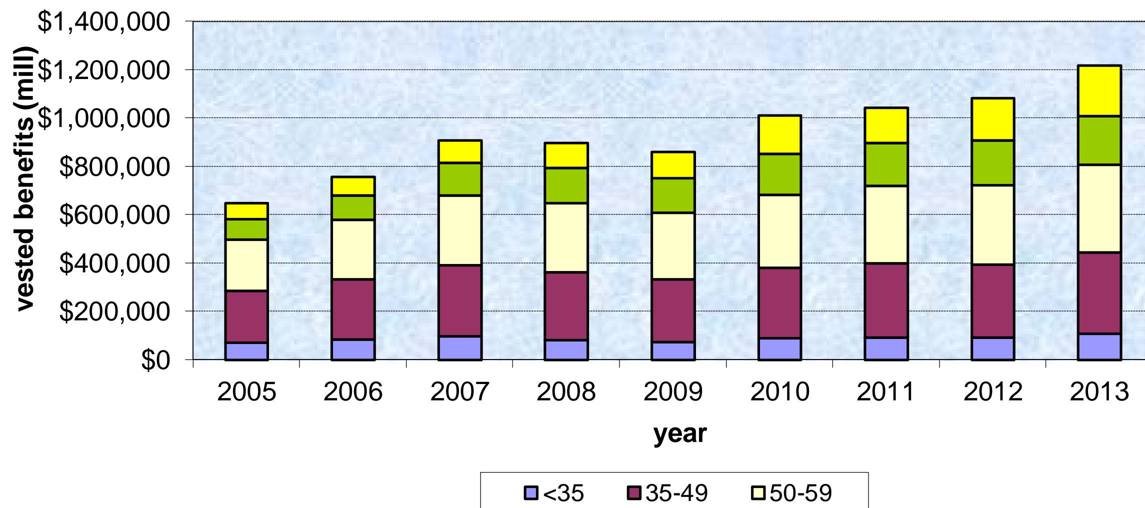
Income oriented outcomes

The major objective of a retirement system, comprising several pillars, should be to provide an appropriate and sustainable level of income for the individual or household during their retirement years. The Australian system ranks well when compared to many other arrangements, however, with the demise of defined benefit pension schemes, it does not deliver regular retirement incomes to most retirees. This represents a major shortcoming.

Figure 3.5 shows the allocation of vested benefits by age for superannuation entities with more than four members (i.e. excluding SMSFs) from 2005 to 2013. Not only are the total benefits increasing the proportion held by older members is also rising. For example, the proportion of vested benefits held by members aged 60 and over has risen from 23.3% to 33.7% during this period. This trend will continue and highlights the growing importance of the assets held by retirees.

[11] Shortcomings of super tax expenditures, April 2013

Figure 3.5: Vested benefits by age of member

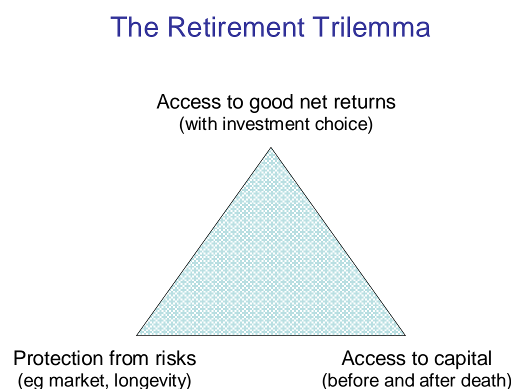


Source: APRA Annual Superannuation Bulletins

The following diagram identifies the trilemma faced by retirees who seek:

- Good investment returns (net of costs) and some investment choice, which has been their experience during the accumulation years
- Protection from many risks, including longevity, market and inflation
- Access to some capital during their retirement to cover unexpected expenses and/or the ability to pass their unused benefit on to family members.

Figure 3.6 The Retirement Trilemma



This combination of different needs faced by retirees during their years in retirement leads to a conclusion a single product is unlikely to be the ideal solution. Even an indexed lifetime annuity does not respond to the varying financial needs faced by many retirees as they pass through different life stages following completion of their working career. A portfolio of products is preferable.

This portfolio should include the following features:

- Limited access to a lump sum benefit at retirement to enable the retiree to prepare for their post-work lifestyle
- Some access to capital during retirement to enable retirees to respond to unexpected expenses and have some spending flexibility
- An income product in the first period of retirement could be an annuity or drawdown product with some constraints and/or guarantees, which provide adequacy and security
- A pooled insurance-type product to provide longevity protection for the later years could be a deferred annuity or pooled product provided by the pension plan or insurer
- Provision for phased retirement where individuals are continuing to work (say, in a part time capacity) whilst also drawing on their retirement savings.

This overall design would enable members, if desired, to:

- Seek good investment returns, particularly in the earlier years of retirement and thereby not be overly conservative, when their realistic life expectancy is likely to be more than 20 years
- Have access to some capital, both at retirement and during the subsequent years
- Have some protection from risks, including longevity, market and inflation. The actual products available to provide this protection will vary and should not be prescribed in detail, thereby encouraging innovation and development. However, the desired outcome should be same.

It is also important such a range of products must operate within a robust framework contains several levers to ensure the overall system is able to respond to changing social, economic or longevity conditions. These levers could include any or all of the following:

- Softer ‘guarantees’ in respect of pension benefits e.g. less than full indexation of income streams
- Sharing some of the mortality profit from those who die early with survivors
- Smoothing investment returns to reduce volatility and the effect of sequencing risk
- Varying regulatory capital requirements as economic conditions change
- Adjustments to the minimum and maximum amounts in respect of drawdown products
- Gradually raising the eligibility age for the age pension, should life expectancy continue to increase.

It is expected the sharing of risks between plan members will lead to improved results, on average, as well as providing outcomes have some form of bias towards those who have been most affected by the adverse effects of any unexpected changes or experience. The actual form of pooling will vary over time but the important conclusion is a pooling arrangement with levers will lead to a better outcome than one focussed solely on the individual retiree.

Such developments should improve the adequacy of retirement incomes, ensure their sustainability over the longer term and, importantly, increase the trust individuals have in the retirement income system. The overall system must focus on the provision of retirement income, not just the accumulation of wealth. This income must be delivered from an efficient and fair framework sufficiently robust to cope with the changing conditions lie ahead.

Within Australia, there is an urgent need to find a better balance between the individual orientation of a defined contribution superannuation plan and a collective (or pooled) approach where there is some sharing of risks within and between generations. Such developments should not just focus on adequate incomes but also ensure the system is sustainable and has integrity over many years.

5

The role of group insurance

The life insurance industry has faced some headwinds in recent years. Net cash flows for life insurers, after operating expenses but before investment income, over the past three years have been negative[12]. Premium income in 2013 ($38.8bn) was below 2011 ($40.2bn)[11]. Net profit derived by the industry has declined since 2010.

The superannuation industry is a significant customer of group risk insurance, often purchased through a tender process. Group risk premium has grown from $3.0bn in 2011 (7.5% of industry premiums) to $3.8bn (9.7% of industry premiums)[11]. However, APRA reports the source of this growth “has been underpinned by substantial premium rate increases, particularly in group insurance, driven by the industry's worsening claims experience across most benefit types.” Following a declining trend since 2009, group risk business did not generate a profit for the life insurance industry in the year to 30 June 2013.

APRA notes contributing factors raised by the industry and also sets out some additional factors. These include:

- Increased stress and mental health claims
- Improvement in benefit and claim definitions without corresponding increases in price,
- Increased consumer awareness of the significant insurance benefits available through superannuation funds with limited evidence of health
- The potential anti selection effect of older policies where members in poorer health are more likely to retain their cover than those in good health.

In response to the above, APRA reported the insurance industry has been increasing prices for large schemes. APRA has also introduced guidance on good practice for tendering group insurance business and has looked to work with Appointed Actuaries to balance the interests of all parties. This hardening of the group insurance market is consistent with our own experience in the marketplace, to the concerning point where we have observed fewer insurers willing to submit a quote for group insurance tenders. Where terms are offered, we are witnessing instances of material premium increases as insurers seek to restore profitability to this book of business.

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[12] APRA Insight, Issue Three, 2013

The superannuation industry relies on a healthy and competitive group insurance marketplace. It is important members genuinely in need are able to access insurance benefits before retirement. It is equally important members are able to purchase insurance at a fair price so not to be faced with excessive premiums which erode the value of their retirement benefits. This requires the issues have resulted in the recent poor industry experience to be addressed.

Superannuation can be an effective and economic way of delivering a level of insurance coverage to a broad cross section of the Australian population, addressing the underinsurance issues have been persistently reported in Australia for many years. However this can only be achieved where the group risk market is able to deliver competitive premiums, supported by well managed insurers.

The life insurance and superannuation industries are presently faced with improving the core management of the nation’s book of group risk business. This needs to be supported so competitively priced insurance balances the needs of all members (both those who claim and those who do not) and is readily accessible. At the heart of addressing these issues will be a combination of prudent policy terms, supported by sound underwriting and claims management practices. Competitively priced insurance balances the needs of all members is a pre-requisite to ensuring we are able to continue to address underinsurance through the provision of compulsory insurance through superannuation.

Whilst the insurance and superannuation industries manage their response to these current profitability issues, this distracts from the potential to continue to innovate and provide more effectively for member’s needs. For example, there is potential for funds to improve benefit designs to more appropriately tailor the level of cover members purchase across all ages through the introduction of life cycle designs where the youngest members perhaps purchase less (or no) cover when they have no dependants. Of course, mortality risk is not limited to the period before retirement. There is also the need for insurers to innovate more in the post-retirement market to address longevity risk.

6

Opportunities to improve efficiency and efficacy in superannuation

There are many opportunities to improve the efficiency and efficacy of superannuation in Australia. Two critical areas include compliance and technology.

Compliance

Superannuation funds are required to comply with thousands of pages of legislative requirements. Each time the Government the day has a “new idea”; a common approach is to add new requirements on to existing requirements. A rationalisation of existing requirements is rarely undertaken. Requirements for superannuation funds are now spread over many Acts, regulations, prudential standards and Class Orders. Therefore requirements are often difficult to find, follow and interpret. Many legislative requirements have been included for particular reasons which ignore broader policy issues or create inappropriate reactions and outcomes.

Seven examples are provided below.

1. Legislative complexity

Superannuation funds have to comply with the following pieces of legislation in relation to disclosure to members:

- Requirements in the Corporations Act, many of which are overridden or modified by the Corporations Regulations, Schedules to the Regulations or ASIC Class Orders
- Requirements in the Corporations Regulations which may have been overridden by Schedules to the Regulations or modified by ASIC Class Orders
- Requirements in the SIS Act which may be modified by ASIC Class Orders
- Requirements in the SIS Regulations which may be modified by ASIC Class Orders
- Requirements in APRA Prudential Standards
- Requirements in Family Law legislation

The range of legislation leads to considerably higher costs for trustees and their advisers as they analyse extremely complex legislation each year. These costs are inevitably passed on to the members.

2. Fair Work Act

Currently, each Modern Award sets out a list of funds which can be used as a default fund by employers. Employers are also able to use a fund (or its successor) which it was using prior to September 2008.

The legislation was recently amended to require (from a date no earlier than 1 January 2015) employers to contribute to a fund listed in the relevant Modern Award. Generally a maximum of 15 funds will be listed in each Award. The Fair Work Commission has already established a process for determining which funds are listed in each Modern Award and funds wishing to be listed must submit an application for the first stage of listing. Applying funds will be assessed by an "expert" panel against a set of criteria.

Although the intention was to ensure disengaged members will belong to a high quality fund, this process is likely to result in a significant disruption of superannuation arrangements for millions of Australians for the following reasons:

- More than one million new accounts may need to be established because the current employer default fund is not listed in the relevant Modern Award, resulting in:
  - An increase in the number of lost accounts
  - Two sets of administration fees for relevant employees, potentially on an ongoing basis as it is likely few members will merge their existing and new accounts. For those who do merge accounts, a withdrawal fee will be incurred
  - A potential loss of insurance cover where members may not satisfy the relevant underwriting requirements to be eligible for cover in their new fund and who may lose existing cover permanently if they rollover their existing account to the new fund or if their existing account is no longer sufficient to provide ongoing insurance cover
- The potential for hundreds of thousands of employees to become members of funds which are less appropriate to their circumstances (including higher fees and less appropriate insurance arrangements). This is partly because the criteria require corporate master trusts to be assessed on their rack rate fees rather than the actual (lower) fees charged to the majority of members who are employed by larger employers
- Additional cost and red tape for employers in choosing a new default fund, advising employees and processing requests from employees who wish to retain their existing fund
- Additional cost and red tape for employers who have employees covered by more than one Modern Award where it may be necessary to have different default funds for different groups of employees and potentially change an individual employee's default fund each time the employee changes roles and becomes subject to a different Modern Award
- Significant costs being incurred by superannuation funds in applying to the Fair Work Commission for listing in more than 100 Modern Awards

- A significant reduction in competition in the superannuation industry, as funds are not listed in a significant number of Modern Awards may not be able to maintain a viable membership base.

3. Artificial restrictions on investment

Superannuation is an ideal vehicle for long term financing of infrastructure and other major projects in Australia. However, the following specific superannuation requirements, designed for other purposes, create barriers and discourage such long-term investment.

- Portability requirements to transfer a member's benefit to another fund within three business days
- Disclosure requirements which place too much emphasis on fees (encouraging trustees to adopt investment strategies involving lower cost), liquidity and risk.

4. Tax on death benefits

Following the Simpler Super changes in 2007, the tax on superannuation benefits was simplified significantly with a major exception being the tax on death benefits. Although no tax applies if the benefit is paid to a dependant, significant tax can apply if the benefit is paid to a non-dependant (generally adult children). Likewise, no tax is payable if a benefit is taken by a member suffering from a terminal medical condition or after age 60 while the member is still alive. This can lead to the following outcomes:

- Considerable additional pressure and concern for a member close to death as they may be forced to consider whether they withdraw their super tax free (under a terminal medical condition or retirement condition of release) where no tax will be payable or take no action and have their death benefit beneficiaries impacted by tax
- Opportunities to minimise the tax using withdrawal and re-contribution strategies, with the associated advice and transaction costs. This leaves tax being paid by the uninformed or unprepared, often being those at the lower end of the income scale.

5. Definition of permanent incapacity

From 1 July 2014, superannuation funds will be restricted in the definition of disablement which can be used for new members. It will no longer be possible to provide insurance payable in the event of the loss of limbs and/or sight for new members joining a superannuation fund. Likewise, definitions covering inability to perform daily living activities will also be banned for new members. However such insurance can continue for members already insured for such benefits.

The now disallowed definitions have been developed by the superannuation and insurance industries over the last 40 years to better cater for superannuation members who are not in the workforce or who work on a casual basis and to provide greater clarity claims will be paid in specified circumstances.

The new requirements will result in almost all group insurance policies being renegotiated by trustees and insurers in respect of new members with flow on effects to communication material and confusion for members.

The new restrictions will not benefit members and will have a significant adverse impact on those new members who would have received insurance proceeds under the current definitions but not under the replacement definition (assuming cover under a replacement definition is available, which may not always be the case).

Presumably the new requirements have been put in place to ban definitions which might be considered to have gone “too far”. However they have resulted in bans on sensible and reasonable definitions which are appropriate in today’s environment.

6. Amount of disclosure

The superannuation industry is currently in a state of disclosure overload. Mercer is a keen supporter of disclosure, and also supports consistent disclosure across the industry, however the effectiveness of the current disclosure requirements has been reduced due to the volume and format of disclosure required.

Effective disclosure is also important to fund members. A recent study showed 90% of members considered it important or very important their superannuation fund provides communications are easy to understand and use[13]. Another study found 46% of members taking a literacy test on superannuation correctly answered 4 or less out of 10.

This suggests working Australians need help in understanding issues related to their superannuation[14]. It is therefore important the mandated requirements result in material which is not only easy to understand and use but also does not include unnecessary information which will dissuade readers from reading the material.

Product Disclosure Statements (PDS)

When PDS requirements were first introduced, it was necessary to include “everything a member needs to know”. ASIC and lawyers tended to take a conservative approach which led to PDS of extreme length, often over 100 pages which discouraged reading by members. New requirements to produce short “8 page” PDS were implemented to try and solve this problem. In general, this has been a step forward; however more and more mandated information has to be squeezed into these 8 pages. Some of the mandated wording is repetitive or irrelevant and adds little value leaving limited room for key information. Prospective members and members now have to find the additional key material on the fund’s website.

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[13] Mercer Super Trust Member Experience Study, June 2013

[14] Mercer Super Sentiment Index, February 2013

Periodic statements
Periodic Statements are generally the most important communication from the fund to the member each year. Members are more likely to read this "personal" material than anything else sent to them by their fund. However legislative requirements are discouraging members from reading these statements by requiring too much generic material to be included and restricting the use of valuable benefit projections.

Product dashboards
Product dashboards are a new requirement for MySuper products (likely to be extended to other super products). The intention was to provide an easy reference which prospective members could use to compare products. However, the requirements are extremely confusing with different funds adopting different interpretations. Inappropriate requirements and terminology have resulted in dashboards which are more likely to confuse and mislead than assist members.

Website disclosure
An extreme amount of material will, from 1 July 2014, need to be made publicly available on super fund websites and kept up to date at all times.

The amount of data which must be made available is excessive, resulting in higher costs to be met by fund members. For corporate master trusts, the requirements are particularly onerous due to the multiplicity of arrangements provided by the fund. Much of the material is specific to particular groups of members and it would be preferable if such material could be made available to those particular members using a PIN to access. However, it appears this is not possible as the data must be publicly available and members will need to search through huge amounts of material to find the material relevant to them.

Further the disclosure of executive remuneration for RSE licensees in the SIS Act is far more detailed than the disclosure regime already in place under the Corporations Act for listed entities. It is unclear why this more detailed information is necessary.

7. APRA Statistics
The amount of statistical information which must be provided to APRA by superannuation funds on either a quarterly or annual basis has expanded significantly. Each item reported involves a cost to fund members. The need for all of the voluminous statistical requirements is questionable and the value of the resultant information to APRA and the industry is likely to be significantly less than the cost of producing it.

Technology

The superannuation system is currently undergoing a major transformation via the data and payment standards i.e. SuperStream. The longer term aim of this transformation is to introduce efficiencies in the processing of members accounts reducing the cost of operations, rework ,

reducing the time to allocate and potential the members fees for administration. This initiative makes sense and Mercer supports its intent and objectives.

The implementation of rollover automation was the first stage in this process and whilst initial review indicates it is successful in its intention to remove paper and cheques and speed up the allocation to member accounts, there are still a number of efficiencies can be achieved.

Over time all funds not just RSE's should be required to automate the sending and receipt of rollovers further reducing the amount of paper and cheques and standardising the process of rollover handling across the industry. In addition there is opportunity to improve the member identification processes and data quality can be further enhanced. This would further reduce the time to process, reduce duplication of member accounts and improve the member experience by reducing the amount of paperwork required to be completed.

However, the rollover implementation was in part successful due to the clarity of the entities involved in the transaction and the rules of engagement to enable a successful outcome i.e. fund to fund. The second stage of SuperStream i.e. contribution and member registration remittance introduces a far greater number of players and impact points to the overall end to end process. In some superannuation fund arrangements, employers (and/or their payroll software providers) do not have a direct relationship with superannuation funds or their administration providers.

As a result it is difficult to influence or engage them on issues such as data quality, payroll software operations, timing of data remittance, internal procedures and processes and employee engagement. For the intent of SuperStream to be realised, there is an expectation employers will have systems in place to ensure superannuation data is accurate, which is less likely to occur in the small to medium enterprises. Until there is more rigour around employer engagement in the timing and quality of superannuation data, errors will still continue to occur and therefore administrative overheads in time to identify and resolve data issues and process will continue.

The intended regulations on "pass through" have expectations an employer can nominate one fund as the 'primary fund' to receive and pass through all of its superannuation data. Payments are made separately. Whilst the intent is to improve efficiency for the employer by having a one stop remittance methodology, this concept places additional requirements on funds to offer technology solutions ultimately will cost default fund members and provide no real benefits to fund members or employers. As payments are not linked, employers will still need to make multiple payments to all destination funds, potentially this could be in the hundreds. This will increase transposition areas when submitting payment reference details in the data file. End destination funds will no longer have a direct relationship with the employer which has the potential to dilute the data it receives to administer the member accounts or additional data will need to be received separately as it is outside of the data standards (e.g. defined benefit information). The fund which has been nominated by the employer to pass through the data will

need to have technology capability or outsource at cost to be able to manage this process. This cost will be borne by its fund members unless funds can pass back/on the costs to employers or end fund recipients.

Again the intention of "pass through" has merit, however it can deliver greater efficiency within the industry if:

- It wasn't compulsory for all funds, as this creates a competitive opportunity
- It included payments being linked giving employers a true one stop shop (which is in reality a clearing house function) and
- It allowed for a user pays environment whether at the front or back end, again introducing competitor and market opportunities.

APPENDIX A

Attachments

1. Melbourne Mercer Global Pension Index 2013

2. “Asset Allocation of Pension Funds around the World”, prepared by Mercer for the Financial Services Council, February 2014

3. “Shortcoming of super tax expenditures”, Mercer April 2013

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