Friendly Societies of Australia

26 August 2014

Mr David Murray AO
Chairman
Financial System Inquiry

Sent via: fsi@fsi.gov.au

Dear Mr Murray

Friendly Societies of Australia – response to the Financial System Inquiry interim report

The Friendly Societies of Australia (FSA) welcomes the opportunity to comment on the Financial System Inquiry (Inquiry) interim report.

The FSA is the industry association that represents 10 of Australia's 12 APRA-regulated friendly societies. Friendly societies help Australians become financially independent and plan for "life-events" through the provision of savings, investment and insurance products.

The FSA contends that insurance bonds can address medium to long-term budget risks, and adequately respond to the need to encourage Australians to save for life-events in a balanced manner that superannuation savings cannot, or should not, fund. The insurance bond framework is a proven and longstanding product framework that, with no more than a simple tax-rate adjustment, can: strengthen the medium to long-term financial adequacy of a wider group of people than the current financial services framework provides for; and increase the range of social and economic opportunities available to Australians through a growing and sustainable life-event savings pool.

FSA response to the Inquiry's interim report

Notwithstanding the Inquiry's observations on superannuation for retirement, the interim report is silent with respect to the critical need for Australians to have access to, and for financial institutions to be encouraged to create, attractive pre-retirement, life-event savings and investment products.

Given the current challenges facing the Australian Government to pass a range of reforms to reduce expenditure on social welfare, health and education programs, and the need to encourage greater competition in the superannuation system and longer-term savings, the FSA recommends that:

> The Inquiry, in its final report, acknowledges the need for reforms to Australia's financial system to promote sustainable pre-retirement life-event savings and investment products as viable competitors to the all-pervasive superannuation system.

Context

In its submission to the Inquiry's terms of reference, the FSA recommended:

1. A reduction in the tax rate on friendly society (and corresponding life office) investments from 30% to 20%. This would:
   - increase private savings to enable individuals to better provide for life-events;

- address the significant lack of tax neutrality in concessions favouring superannuation over insurance bonds – both of which are essentially about long-term savings;
- recognise that Australia's superannuation savings pool of more than $1.8 trillion generates, in absolute and relative terms, too little tax revenue; and
- be revenue-positive for Government.

2. The introduction of a government co-contribution scheme for friendly society education savings plans for Australian families to assist and encourage this form of savings – which directly contribute to increasing our education standards; and
3. The immediate restoration of an appropriate tax-free threshold on taxable benefits paid to minors under friendly society education savings plans which are currently taxed at punitive rates as high as 66% due to an unintended outcome of tax changes by the previous Government when it removed access to the low income tax offset for minors.

The FSA's recommendations:

- represent a coherent and measured response to structural challenges as highlighted in the 2014-15 Budget;
- will reduce the growing reliance on government funded social welfare due to Australia's ageing population;
- are tax revenue-positive, the scale of which will be significantly increased if the recommended reduction to the tax rate on friendly society insurance bonds is logically extended to insurance bonds issued by mainstream life insurance offices; and
- will boost Australia's long-term education capacity, increase workplace productivity and participation rates, up-skill Australia's workforce, and expand employment opportunities and subsequent earnings capacity.

These long-term tax paid savings recommendations are entirely consistent with the Treasurer's ambition to end Australia's "age of entitlement".

Differentiated tax treatment of saving vehicles
In our first submission to the Inquiry, the FSA articulated its concerns that friendly society (and mainstream life office) insurance bonds, over recent decades, have been subjected to major competitive disadvantage relative to superannuation, with respect to the tax rates on both contributions and fund earnings.

The FSA is pleased that the Inquiry has formed a similar view, in so far as noting that "the tax system treats the returns from some savings vehicles more favourably than others" and that this "…unequal tax treatment of savings vehicles distorts the asset composition of household balance sheets and the broader flow of funds in the economy."

While the Inquiry was understandably silent on the specific competitive disadvantage of the tax treatment of insurance bonds relative to superannuation, the FSA notes the referral of the differential tax treatment of savings vehicles to the Tax White Paper process. The FSA will be contributing to that process in due course.

Applying greater competition to superannuation
Given the mandated nature of compulsory superannuation contributions, there is no meaningful competition to superannuation with respect to other long-term savings vehicles available to Australian families. By reducing the tax rate that applies to insurance bonds to 20%, we believe that enhanced competition can be brought to this market, for the benefit of consumers, in relation to the allocation of funds that are currently earmarked for voluntary contribution into superannuation.

At present, Australian families are actively encouraged, through tax arrangements and the compulsory nature of superannuation, to prioritise this decades-long savings strategy – with a singular bias and imbalance towards retirement funding. The need to promote pre-retirement savings strategies is more critical and urgent given the Inquiry's observation that:

> "There is little evidence of strong fee-based competition in the superannuation sector, and operating costs and fees appear high by international standards. This indicates there is scope for greater efficiencies in the superannuation system."

Bearing in mind that the Inquiry has noted that Australian superannuation funds have scope to improve their efficiencies, when compared to international standards, the FSA contends that the time is right to promote insurance bonds as an effective means of delivering greater life-event savings options for Australian families, as well as exerting competitive tension on the superannuation sector.

As stated in our first submission, fund earnings in an insurance bond are currently taxed at 30% (without any capital gains tax discount concession), while earnings on superannuation are subject to a maximum tax rate of 15% (with a capital gains tax discount concession). The superannuation tax rate of earnings (in the accumulation phase) can be reduced to 10% if realised capital gains for assets are held longer than 12 months. The superannuation tax rate is also reduced to nil when in pension mode.

Insurance bonds offer a platform for balanced financial adequacy throughout an individual's life prior to retirement, however at the current tax rate of 30%, lack the universal appeal and encouragement needed to make them sufficiently attractive to lower-taxed investors, so as to ensure they are a sustainable savings option.

The lack of competition in the long-term savings market is evident given neither compulsory nor voluntary superannuation contributions will assist Australians in the pre-retirement life phase to:

- fund future common and foreseeable life-events, such as home deposits and ownership, raising and educating children, sinking funds to pay debt, health and aged-care, funeral expenses, job loss provisions, formal child care funding, and support for aged parents or family members with disabilities;
- better prepare for difficult financial times that inevitably arise at some point in their lives; and
- improve and sustain financial and social standards via self-reliance and a savings culture that does not resort to social welfare dependency in the first instance.

Australia's savings pool outside of the superannuation system is currently inadequate to fund these known life-events, given the structural challenges highlighted in recent federal budgets, and is not likely to improve any time soon without reforms to the current long-term savings frameworks.

Conclusion

The FSA urges the Inquiry to recognise the qualitative benefits that an increase in medium to long-term life-event savings could deliver to our society. We believe the insurance bond tax framework is the best funding mechanism for this purpose, and can deliver significant benefits across a number of levels, including:

- increasing overall national savings by encouraging a savings culture, recognising that there are several life-events to fund, and not just retirement alone;
- increasing the employment opportunities available to Australians by facilitating access to a higher standard of education;
- reducing reliance on government and social welfare by encouraging personal responsibility;
- increasing government tax revenue by diverting some discretionary savings away from superannuation (including zero taxed income streams) to a greater tax rate of 20% in a high integrity tax-paid framework that is already in place; and

- attracting new savings at the 20% tax-paid rate, so as to encourage new products and innovation for effective intergenerational transfers, especially as part of estate planning.

We look forward to the Tax White Paper process to further expand on the benefits that can be achieved for Australian families and the economy through a more competitive insurance bond framework.

Please contact me on 08 8236 4704, or Jim Aliferis, Senior Policy Adviser, on 02 8035 8442 or jaliferis@coba.asn.au to discuss any aspect of this submission.

Yours sincerely

MATT WALSH
FSA President