SUPERANNUATION *and retirement incomes*

RAFAL CHOMIK, Senior Research Fellow, ARC Centre of Excellence in Population Ageing Research, Australian School of Business, University of New South Wales
JOHN PIGGOTT, Director, ARC Centre of Excellence in Population Ageing Research, Australian School of Business, University of New South Wales and Member, Australia–New Zealand Shadow Financial Regulatory Committee

In this paper we consider four aspects of the recommendations in Chapter 2 of the FSI Final Report and identify where they have fallen short or been limited by the inquiry's remit. First, while the recommended formal clarification of objectives for superannuation is welcomed, a broader understanding of policy interactions is required. Second, ineffective price competition may be addressed through a tender system of investment, but we agree that current reforms need time to settle. Third, the inquiry makes an important contribution by highlighting that the payout phase requires government intervention, but supply-side issues are not adequately addressed. Fourth, while 'independence' of boards appears attractive, the related evidence is scant and some governance questions remain unanswered. Overall, we conclude that a more complete perspective on retirement incomes is needed to develop a comprehensive retirement income policy.

The Financial System Inquiry's (FSI's) early deliberations and final report give considerable prominence to superannuation and retirement incomes. The prominence of the retirement income system in an inquiry focused on the nation's financial system is unlikely to have occurred in most other developed countries. It is a testament to the power of pre-funding retirement incomes (the absolute value of Australia's funds under management places it fourth in the world), and to the half-executed nature of our retirement income policy (Australia is alone in offering no structure to the drawdown of a mandatory pre-funded retirement plan).

It provides a welcome spotlight on the weakest part of Australia's retirement policy, the payout phase. It draws attention to issues such as behavioural bias and retirement product design. But the limitations of the scope of the inquiry, either designated or assumed, did not permit a comprehensive treatment of retirement policy, and this needs to be borne in mind in assessing the inquiry's contribution to the retirement income debate. There is much value in what is said, but there is much that has been left unsaid. Importantly, the interactions between the age pension, taxation, superannuation, and retirement planning decisions themselves, are not explored in any depth. It is difficult to determine appropriate policy and regulatory prescriptions without taking these interactions into account.

The findings and recommendations in the FSI's chapter on superannuation comprise four main points. First, the purpose of superannuation should be clearly articulated and 'enshrined in legislation'. Second, operational inefficiencies, brought about in part by lack of effective price competition, should be addressed through a tender system of investment. Third, the payout phase of superannuation requires government intervention. Fourth, the FSI has made an explicit recommendation about the governance of superannuation funds, indicating that the chair and the majority of the board of trustee directors should be 'independent'.

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In what follows, we consider each of these points and their treatment in the final report. Along the way we highlight the limitations imposed by the remit of the inquiry and indicate where arguments have fallen short. We conclude that while the FSI provides some progress towards this, a more complete perspective on retirement incomes is needed before a comprehensive retirement income policy can be developed.

Setting clear objectives for the superannuation system (FSI Recommendation 9)

This is the least controversial of the four major recommended actions. The idea that there should be a clear and identified purpose is self-evident and featured in a number of submissions (e.g. CEPAR 2014a; ASFA 2014).

While the purpose of superannuation is often discussed, it has not been formally stated. For example, the Super System Review (Cooper Review) in 2010 noted that the purpose of superannuation was 'to provide income for Australians in their retirement' but it did not actually recommend that this purpose be formally acknowledged. Some statutory basis exists in the 'sole purpose test' of Superannuation funds (*Superannuation Industry (Supervision) Act 1993 (SIS Act)* s 62), in that these must provide benefits for members on or after retirement or at a prescribed age (or death). But such a statutorily prescribed purpose appears to be as much about accumulating lump sums as providing retirement income. In the FSI, the purpose itself, such as 'to provide income in retirement to substitute or supplement the Age Pension', did not make it into the recommendation explicitly, but it is stated subsequently in the supporting text as an objective.

As the FSI discussion emphasises, formalisation of agreement on purpose should clarify policy intent, and simplify future policy decisions and their implementation. But the recommendation nevertheless raises various questions, some acknowledged in the report, which require further analysis.

For most members of industry, corporate and public sector funds, accumulations are probably mostly devoted to providing resources through retirement. But for self-managed superannuation funds (SMSFs) this is not always true. While many SMSFs doubtless have as their primary goal the provision of resources for retirement, the 'Red Book' (the policy guide prepared by government departments for incoming governments following an election) prepared for the 2010 election described SMSFs as 'the tax minimisation vehicle of choice' (Dunnin 2010). Much debate about the taxation of superannuation funds would evaporate if the purpose could be better crystallised, and the tax avoidance-motivated SMSFs were re-labelled (and taxed differently). SMSFs therefore provide a good example of how a strong statement of purpose clarifies what should and should not be thought of as a retirement income instrument.

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The issue of purpose also begs the question of what constitutes a maximum legitimate accumulation for income in retirement, an issue which the FSI explicitly avoids. Whatever the answer to that question, it should guide the limits to resources enjoying superannuation taxation arrangements. The FSI suggests that the ongoing process leading to the Tax White Paper (to be completed by end-2015) should take account of the appeal to purpose, but the FSI offers no views of its own on tax design, thresholds, or related matters.

Other definitional matters come into play in a discussion about purpose; for example, the definition of what constitutes a stream of 'income' and how to define 'retirement'. Such definitions directly affect superannuation products and parameters. To what extent does funding retirement include aged care costs? How equivalent are lump sums, phased withdrawals and longevity products (see discussion below) and should those who 'roll over' their superannuation to start drawing down a minimum amount be counted as retired and incur different levels of tax? Or should age be the deciding factor — an approach which would minimise the adverse impact of retirement policy on choices regarding income drawdown and labour force participation? These questions will become more important as Australia responds to the challenges of population ageing. The absence of such discussions in the FSI underscores the need to have a comprehensive inquiry about retirement incomes with an adequately framed remit.

Introducing greater competition into superannuation

A key thrust of the inquiry has been to improve the level of efficiency and competitive pressure in the superannuation industry in the presence of scheme members who have been compelled to participate in the system but are mostly disengaged or lack capacity to drive market discipline. This was recognised in the Cooper Review and ultimately led to the introduction of MySuper default products. Indeed, by looking at insights from behavioural finance (CEPAR 2014b), the FSI builds on the Cooper Review's departure from past initiatives that instead sought only to increase engagement and choice among Australians in their retirement planning.

The FSI recommends that the government introduce a formal competitive process to allocate new default fund members to products, unless a review by 2020 concludes that reforms thus far have significantly improved competition and efficiency in the system.

The inquiry also notes an alternative. This is to increase competition by abolishing the process for selecting default funds via Australia's industrial relations framework. This would allow all MySuper products to be available as defaults to be chosen by employers, not just those currently linked to awards as determined by the Fair Work Commission (FWC). Opening the door for retail funds to be able to pitch for default product status, could be expected to foster greater levels of competition.

The government has indicated a preference for the alternative option of opening up the default product market; but it is worth considering in more detail the main recommendation of the FSI.

Those concerned with a lack of competition in superannuation often refer to the level and variance of account fees involved, particularly compared with the lower fees charged in overseas markets. There is, however, some debate about the evidence. Comparability with other occupational schemes is hindered by the fact that the Australian environment is characterised by the importance of Defined Contribution (DC) accounts relative to Defined Benefit (DB), more choice (whether useful or not), more in-house investment management, and greater levels of investment in equity compared with other markets (see, for example, Schroders 2014). There are also claims that not all fees are counted appropriately or included in comparisons (see, for example, FSC 2014, which criticises Minifie et al. 2014 for excluding administration fees).

The objections are not always valid. For instance, Sweden's centralised administrative DC nature means that it can offer plenty of investment choice at a low cost. The model of in-house or external investment management should not be an excuse for higher fees. And, most importantly, many of the international comparisons are to occupational pension systems that manage far fewer assets than Australia's. As the FSI points out, the scale of Australian superannuation system implies that fees could be lower than they currently are (see Rice Warner 2014 for more details). Some recent fee reductions as part of the introduction of MySuper suggest that the reforms ought to be allowed to settle before further reforms are made.

Chile is often used as an example of a country where pension fund fees are said to be lower. It is also the country which runs the type of competitive process that the FSI has recommended.

Chile's pension funds are worth US$170 million, serving about five million contributors (who are charged fees as a fixed proportion of salary) and five million retired members (who are not charged fees). The government runs a tender for default fund status every two years based on initial preselection and subsequently on the lowest fee bid (an auction *for* the field). The fee then applies to all new defaulted contributors in the fund as well as those exercising choice and those who have been previously defaulted into the fund. The fund must also offer up to five investment options, each of which has a guaranteed level of return, topped up if necessary from a reserve equal to 1 per cent of assets (Chant West 2014).

Such a system could in theory deliver significant reductions in fees. But this does not come without concerns. For example, it could result in a drive toward a concentrated oligopoly in place of what is currently about 300 or so funds. Chile's four largest funds hold 96 per cent of pension assets (Chant West 2014).

It may also introduce a structural bias toward passive investment, as more expensive active investment becomes less attractive. This is not necessarily a bad thing if we accept that active management is a zero sum game, but passive management can also result in less exposure to unlisted assets and raise systemic risk by increasing trading commonality.

There are also practical concerns about fee-only tendering, since it is long-term net investment performance that matters. The FSI suggests that preliminary work on the practical aspects of the competitive process should begin and it points to other examples where tendering has worked and resulted in an average reduction in fees of 43 basis points (Rice Warner 2014). Whatever becomes the future model to increase competition in Australia's superannuation system, the consensus appears to be that current MySuper and SuperStream reforms need time to take effect before major changes are introduced.

Decumulation: The gap in the Australian retirement policy framework

Perhaps the most valuable contribution of the FSI chapter on superannuation is its treatment of the retirement phase. The panel is generally cautious about involving government, or interfering with consumer choice. Yet the rationale of the central recommendation and the accompanying material for this section is that the 'potential gains to members, the economy and taxpayers from a more efficient retirement phase are significant and warrant intervention'. This recognition alone is a significant contribution to the retirement policy debate. The complexity of decision making around retirement and financial choices is recognised; behavioural biases are briefly discussed, and the limited range of retirement income products available in Australia is flagged. The report also points to the contrast between Australia and other countries where retirement income streams are more broadly accepted.

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The discussion of these issues hangs on a recommendation that every superannuation fund should be required to offer a 'Comprehensive Income Product for Retirement' (CIPR). But there are various design issues to resolve with such a default (CEPAR 2014c). The inquiry appears uncertain about how far to go in the direction of encouraging the purchase of retirement income products with longevity risk pooling, although it emphasises that greater longevity insurance would make retirees better off, and possibly also shift some longevity risk from the government (through the age pension) to the private sector. It is comfortable with removing 'product development impediments', but does not recommend the use of tax or age pension incentives to encourage their purchase, although they should not discourage their use (p. 126). It does recognise that:

> … increasing the range of products alone will not be sufficient to improve outcomes for retirees significantly, because behavioural biases and other system incentives will continue to impede the widespread use of pooled longevity risk products, despite evidence that many individuals would be better off. (p. 126)

This leads to a statement in the conclusion of the superannuation chapter that if introducing pre-selected CIPRs is not effective, age pension and tax incentives could be considered. While the potential role of tax policy and age pension design is acknowledged, the inquiry again abstains from venturing into discussion about how design of these policy instruments might be used to facilitate a stronger overall retirement income environment in Australia.

While the section is valuable in giving the issue of retirement incomes genuine profile, its discussion of the underlying issues and policy directions is restrained. For example, while behavioural issues are acknowledged, there is no systematic analysis of the force of defaults, or in what circumstances they might be most effective.

There is little on supply side impediments to a more developed retirement income product market, such as government provided hedging instruments (for example, long-dated inflation-indexed bonds). Counterparty risk, either real or perceived, is not raised as a possible reason why long-dated longevity insurance products are not purchased, and consequently, the potential role of government as a provider of these products is not discussed either.

Nor is the institutional regulatory complexity confronting these kinds of products fleshed out. An important reason why decumulation structures are deficient in Australia is that there are so many different responsible agencies for a product developer to deal with: DSS, APRA, ASIC, and the ATO. And even though all of these agencies are involved in the development of products, there is no single agency for a potential provider to approach. Further, none of the agencies listed have a mandate to deal with retirement income issues and/or promote their development. In the absence of such a mechanism, the prospects for a successful retirement income product market in Australia are poor. Yet Australia needs such a market more than almost any other OECD country because of its reliance on pre-funded superannuation for consumption smoothing.

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These shortcomings in the chapter are perhaps inevitable in a report whose primary remit is the financial system rather than retirement incomes *per se*. However, the decision to emphasise retirement incomes to the extent evident in the report is both welcome and prescient, given the impending impact of demographic shift on our pre-funded system.

Governance issues

The FSI touches on governance issues within superannuation and makes three recommendations: (1) that funds be required to have a majority of independent director trustees (including an independent chair); (2) that penalties be introduced for a director trustee's failure to act in the interests of members; and (3) that conflicts of interest be deemed disclosed only when acknowledged by all director trustees.

The measures aim to bring the governance of superannuation funds closer to that of financial institutions overseen by the Australian Securities and Investments Commission (ASIC). Intuitively, all of these measures seemingly strengthen the checks and balances required for a board's independent decision making in favour of its members above and beyond those already present in existing trust law, statute, prudential regulations and guidance, and industry best-practice principles. However, while the latter two recommendations on governance within superannuation are less controversial, the recommendation about independent director trustees has faced an ongoing and heated debate in Australia.

Insisting on a majority of independent director trustees would affect not-for-profit public offer funds that follow the 'equal representation' model under the SIS Act. In this model half the board is made up of directors nominated by employees and half by employers (though independent trustee-directors can be invited to join the board). It is consistent with the origins of the superannuation system that mainly consisted of single-employer sponsored funds, which is increasingly less the case. It does not apply if there is no standard employer sponsor. The arrangement is not dissimilar to most other OECD countries (Stewart and Yermo 2008).

This FSI recommendation echoes that of the Cooper Review, which, among a raft of recommendations on superannuation fund governance, recommended that one third of trustee directors be independent. Abandoning the equal representation model was rejected by the then Labour Government but it resurfaced in a recent consultation initiated by the Coalition Government (Commonwealth of Australia 2013). In public comments, the government has also indicated a preference for independent boards.

The notion that formally unaffiliated, independent director trustees will have a positive effect on governance and member outcomes is intuitively appealing, yet, as pointed out by the Productivity Commission (2012a), this is not based on evidence. Governance overall is shown to have an effect on performance (Ambachtsheer 2007). But rather than disadvantage members, there is some evidence that funds with 'equal representation' boards outperform corporate funds with independent boards (APRA 2014). Apparently, boards that include employee and employer stakeholders are associated with lower fees and agency costs, but it is difficult to link this directly to governance (Bryan et al. 2009).

There were other facets of governance to which the FSI pays little attention. For example, the actual levels of skills, competence and effectiveness of superannuation fund boards. This is despite research that some boards still lack adequate expertise and training, feel unconfident with relevant financial decisions, and can suffer from bias about their own abilities (Russell Investments 2010; Mercer 2014; Gupta et al. 2008).

The Productivity Commission (2012b) has previously indicated that a specialised review of superannuation fund board governance be assembled to look at the actual evidence of effectiveness. The FSI chooses not to follow this route.

Concluding remarks

The FSI does Australia a favour in opening up superannuation policy to official scrutiny. It attests to the importance of the superannuation system, especially as it matures and demographic transition bites harder. The report examines all of the important issues, although it inevitably falls short on in-depth analysis of some. It provides strong policy leadership on competition in the accumulation phase, and emphasises the importance of an income framework when thinking about drawdowns. It also makes some sensible recommendations regarding superannuation fund governance.

But understandably, it touches on, but avoids making any recommendations about taxation. Taxing super must be done in a fashion consistent with Australia's overall tax structure and the stated purpose of superannuation, and should take account of the age pension. In some ways, sensible taxation policy could act as the glue holding the various branches of Australia's retirement policy together. But policy formulation and recommendation in this area requires a remit to deal comprehensively with retirement policy in its totality. The Henry Review provides a way forward, but more work needs to be done to shape the taxation of superannuation into a policy which is sustainable.

More generally, this work should be undertaken as part of an inquiry focused specifically on retirement incomes. The FSI flags its importance, and an initiative is now needed to take this a further step forward.

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