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PRESENT PROBLEMS AND PROSPECTIVE PRESSURES IN AUSTRALIA'S SUPERANNUATION SYSTEM

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PRESENT PROBLEMS AND PROSPECTIVE PRESSURES IN AUSTRALIA'S SUPERANNUATION SYSTEM

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Note: This paper is a slightly expanded form of a speech given at the Association of Superannuation Funds of Australia Luncheon in Melbourne on 19 October 1994

1. Introduction

Australian superannuation has undergone some fundamental changes during the last decade or so. In the early 1980s, superannuation was relatively straight forward in Australia. Most employees did not have superannuation coverage, there was no SIS and OSSA had not even been born, there were taxes on contributions and investment income, RBL's were fairly simple, and there was no ISC! Superannuation was very different! During the 1980s it has become much more comprehensive in its coverage, but much more complicated and much more compliance orientated. We also have a totally new structure with the Superannuation Guarantee Charge.

In the 1970s, I believe that it was possible for an individual to have a fairly good understanding of the total superannuation system as it then operated, together with its various regulations. This is no longer possible. It has become too complex and we are therefore tending to operate in our own, relatively narrow, fields without considering the big picture from time to time.

It is this vista that is considered in this paper.

I plan to address three questions that arise from within the present system and then look forward to four pressures that I see emerging in the next decade or so.

Let me now turn to the current system.

2. The current system

The Government's superannuation strategy is fairly clear. It has legislated to increase the level of compulsory employer contributions to 9% of earnings and plans to encourage or mandate an employee contribution of 3% of earnings so that there is a total superannuation contribution of 12% of earnings for all employees. The primary objectives are to increase the level of savings within the economy and to reduce the future level of age pension costs as superannuation benefits will be providing a higher proportion of retirement income benefits. But will it work? Let me ask three questions.

2.1 Has the SGC increased savings?

It is too early to answer this question definitively and it must also be noted that we have been through a recession and are still pulling out of it. However, on the surface, it would appear that savings have grown. After all, we have seen the level of assets in superannuation funds (as measured by the ABS) increase from $117 billion in June 1990 to $174 billion in June 1994. This represents a compound growth rate of 10.5% per annum. Surely this significant growth of assets is due to extra savings. It certainly appears that way but, in fact, the major reason for this increase has not been caused by increased contributions.

Table 1: Growth rate and earning rates for superannuation funds

Date	Total Assets Super funds $ bill	Growth rate % pa previous year	Fund Earning Rates % pa Asset weighted All funds (ex Cap Stable)
June 1989	102.1	-	-
Dec. 1989	112.6	-	-
June 1990	116.6	14.2%	11.6%
Dec. 1990	115.8	2.8%	1.6%
June 1991	126.3	8.3%	10.2%
Dec. 1991	139.3	20.5%	20.7%
June 1992	144.4	14.3%	12.1%
Dec. 1992	146.1	4.9%	4.0%
June 1993	159.3	10.3%	11.9%
Dec. 1993	179.4	22.8%	26.1%
June 1994	173.7	9.0%	8.8%

Sources: ABS 5650.0 and Towers Perrin surveys

Table 1 clearly shows that the growth of the assets of superannuation fund reflects very closely the investment earning rates of superannuation funds. In fact, the compound yield for the five years to June 1994 is 10.9% per annum. After allowing for investment management costs of about 0.5% per annum (which are excluded from the Towers Perrin figures), the five year growth of the fund assets is virtually the same as the investment return over the five years. Furthermore, the table clearly shows a very close relationship between the two percentages for each twelve month period.

The point to note is that the growth in the superannuation assets has not come about by the level of contributions vastly exceeding the level of benefit payouts. That is cash flow has not caused the increase. Indeed, it can be suggested that the cash inflows to superannuation (that is the contributions) have been matched by the cash flows which include benefit payments, taxes, insurance premiums and administration charges.

Before proceeding, it is necessary to add one caveat. I am not suggesting that the SGC has had no impact. Compulsory contributions have clearly increased the level of contributions going into superannuation. However, in broad terms, they have been offset by the payments from the superannuation funds which have been higher than expected due to the impact of the recession. That is, if the SGC had not been introduced, the benefit payouts during the recession may have exceeded the contributions.

One other point is worth noting. These results also suggest that with total benefit payments matching the increased level of superannuation contributions, there has been a significant increase in the value of the assets held amongst individual retirees and other beneficiaries. This suggests that in terms of the providers in the financial services industry, there must exist expanded opportunities to provide appropriate services and products for the individual beneficiaries. In terms of the macro economic investment scene, it is also important to realise that the investment decisions made at this individual level will not be the same as the asset allocation decisions made by fund trustees.

2.2 Is 12% the correct long term level for contributions?

The long term Government objective is a superannuation contribution rate equal to 12% of earnings. This objective of 12% was based on reasonably standard actuarial assumptions and it is fair to claim that, on average, 12% does provide a reasonable level of retirement income for a male who has worked full time from age 20 to 65.

However most individuals will not work full time for 45 years. Indeed, there is a very strong pattern in the workforce for people to retire earlier. As one retires earlier, the accumulation period is shortened and the period of retirement is lengthened, thereby increasing the rate of contribution required.

In addition, the 12% contribution rate is not sufficient for most females for a number of reasons. These include the fact that women live longer and therefore need a higher accumulated retirement benefit, many women have a broken career with five or ten years out of the workforce and then many have some part time work before returning to the full time work. In these instances, 12% is certainly not enough to provide a reasonable level of retirement income. As an example using the figures in Knox (1993), the expected level of retirement income (expressed as a percentage of the individual's final salary) is 61.1% for males retiring at age 65, 48.9% for females retiring at age 65 and 34.3% for females retiring at age 60.

The important conclusion is that a 12% contribution rate will not provide an adequate retirement income for most future retirees. This result also means that many retirees will continue to rely, at least in part, on the means tested age pension funded by the Government.

2.3 Even if 12% is sufficient, will it provide a reliable level of retirement income?

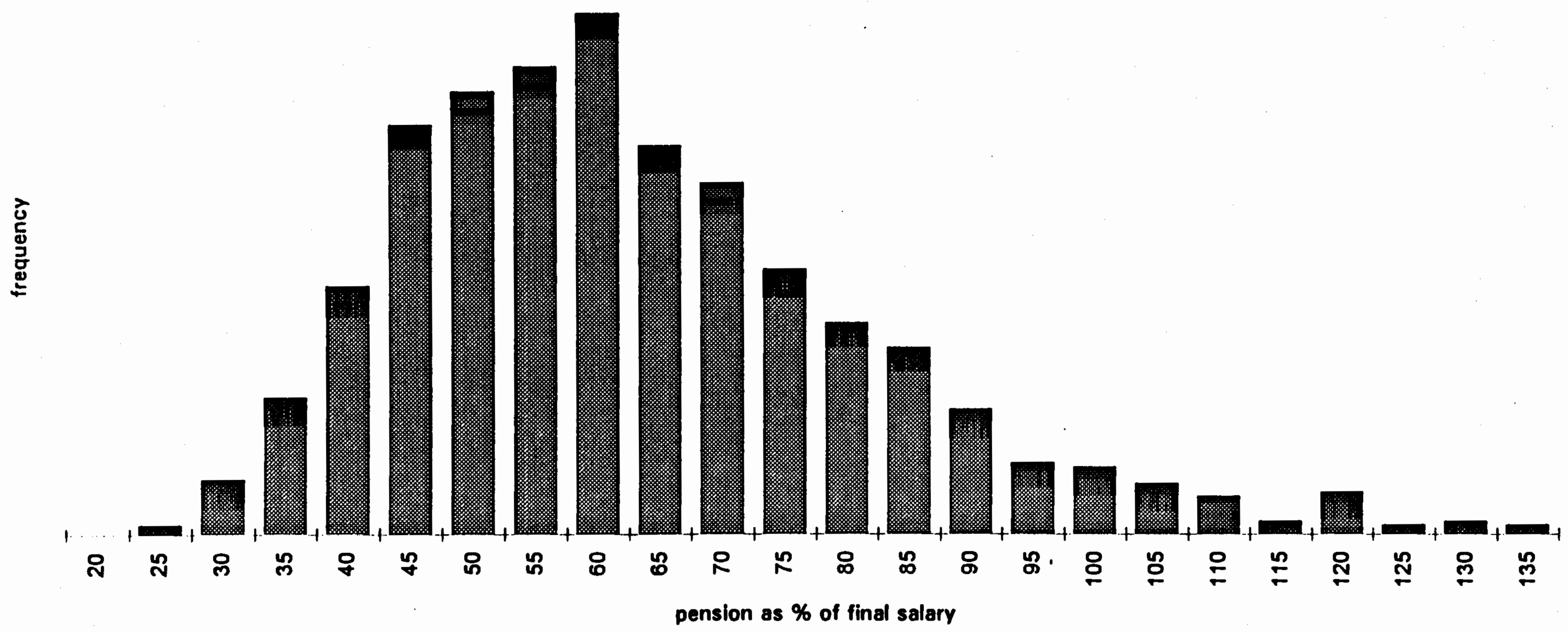
It is well known that the investment risk is borne by members of a defined contribution superannuation fund. That is, the member's ultimate retirement benefit is influenced by the variable investment returns. This fact is important and must be taken into account as we review the efficacy of the total system.

Figure 1 shows the range of retirement incomes (expressed as a percentage of final salary) that individuals may receive assuming that the fund's investment returns can be represented by a Normal distribution with a mean of 5% real and a standard deviation of 8%. This presentation shows retirement incomes ranging from under 35% of final salary to in excess of 100% of final salary. Whilst the underlying assumptions may be debated, the major cause of the different levels of retirement incomes is the investment returns received, particularly in the years immediately preceding retirement. This means that members who are retiring after a boom period may be much better off than members who are required to take their benefit after a series of poor investment returns. They might have had exactly the same career pattern, but the retirement benefits may differ by a factor of in excess of 2 to 1.

A related factor in the Australian environment, particularly if the Government encourages the move to life annuities, is that many retirees will face an annuity rate risk at retirement. In essence, this means that the level of annuity that they receive is determined by the interest rate at the date of their annuity purchase. Hence two individuals who retire with similar career patterns and the same benefit, but purchase annuities two or three years apart, may end up with very different levels of retirement income.

In summary, a 12% contribution rate, even for males who have worked full time for 45 years, does not guarantee an adequate retirement income. The ultimate level of retirement income, is determined by the fund's investment earnings and, if an annuity is purchased, the annuity rates available at the particular date of purchase.

Figure 1: Superannuation pension as a percentage of final income for a male working full time from ages 20 to 65 with a 12% superannuation contribution rate



3. Prospective Pressures in the System

3.1 Political Pressure

There is no doubt that superannuation and politics now mix. The superannuation industry is clearly in the political arena and with almost all Australian employees now receiving superannuation contributions, changes to the superannuation system affect a very large proportion of the Australian electorate.

Politicians will respond to pressures in the super system. As an example, we saw that with the Government's recent response to the problem of the small payments issue.

An area where there will continue to be political pressure is in the area of directed investments. This issue was raised again at the ALP national conference in Hobart. Would superannuation funds invest in airports, in ANL, in infrastructure bonds, or would they have to be forced to invest there? Although the Government has recently reiterated its position that it will not direct investment (ASFA National Conference, November 1994), this issue will not go away.

Let me make it very clear that I do not support directed investments for the following reasons.

As has already been discussed, the retirement benefits paid from defined contribution funds are directly related to investment returns. If the short term returns from these compulsory investments (which tend to have a longer term horizon) are not as attractive as other investments, some members, particularly those approaching retirement, may consider these investments undesirable.

It should also be noted that no two superannuation funds are the same. They have different liabilities and therefore must have different investment strategies and, in turn, different assets. Each fund has its own members with different ages, different risk profiles, different expectations, etc. We cannot consider all superannuation funds to be the same. Furthermore, they may even be established for different purposes.

The Government has every right to encourage investments in particular areas such as infrastructure bonds, venture capital, etc. In fact, in certain areas I believe that some taxation support and incentives may be appropriate.

However, these taxation incentives should be available to all investors including individuals and institutions and not restricted to superannuation funds. That would provide a level playing field so that if trustees thought it appropriate, they would invest in these types of investments. As I have intimated above, this is a topic that will not go away and will be here for a long time.

3.2 Prudential pressure

There is an increasing concern within the community that superannuation money is safe. It arises from both the Maxwell affair in the UK and the introduction of compulsory superannuation in Australia. The new SIS legislation is partly in response to this concern. The pressure for more prudential arrangements will not disappear, especially if there is a major failure of an Australian superannuation fund. Again, the pressure on the Government of the day will be to respond. The Government wants to make superannuation as safe as possible but without providing any guarantees. They will do this by continuing to adjust and possibly increase the prudential arrangements and requirements. Hence, at least for the time being, I believe that the direction in respect of prudential requirements is one way.

3.3 Participants' Pressure

The next area of pressure will come from participants (that is, the members of the funds). This can be considered to be a direct development from consumerism. Members are much more "super aware" than ever before. There is more information coming to them, there are more dollars in their account and there is much more press coverage. As a result of this, and as the level of members' accounts continue to increase, members will have two questions. They will be:

1. Can I change funds or choose my own fund?
2. Can I nominate or choose my own investments?

Both of these questions are already on the agenda, but the pressure for change will continue and I suggest that it is moving in one direction: that is, increased member choice for both fund and investments.

This will be particularly important if the Government introduces compulsory member contributions. After all, if I am forced to contribute some of my taxed dollars into superannuation, why can't the member choose where it will go in terms of both the fund and the investment strategy.

Within this context, I am not supporting the widespread movement of funds between superannuation funds. Some member choice of funds will come, but we must ensure that the total system is not destabilised by it. For instance, if a member wishes to move dollars from fund A to fund B then as far as accrued dollars are concerned, (ie the accumulation amount), the legislation ought to require at least 12 months' notice. That will ensure that the funds will have sufficient time to pay out the benefit without upsetting the fund's long term investment strategy.

As far as member choice of investments, the pressure will continue to grow but, as has been said before, there are important issues in terms of education of members, matters relating to default mechanisms, and there may also be an effect on the macro economic situation. That is, do members have a different pattern of investment choice when compared to fund trustees?

Speaking of members, communication to members will continue to be important. The pressure for greater communication will increase. It must not only inform, but it must also engender confidence and be honest. Superannuation cannot be a black box. More, not less information, will be required. An increasing number of members will require access to a wider range of information. However, I am not suggesting that trustees cut down a forest of trees for each annual report. In fact, it is likely that many annual reports are not read. It may be that the industry needs to simplify what is provided to members but, at the same time, provide members with ready and easy access to more information, if they desire it.

It is also worth noting that communication is provided by many different parties in the superannuation arena. These include the Government, advisers, employers, unions, consumer groups, the media, the funds and trustees. Many of the messages that members may be receiving could be slightly different, even conflicting. In fact, some of the information will be wrong. Members will be confused. All parties involved in superannuation must be ready to respond to that confusion, simply, appropriately and in a manner that gives members both correct information and confidence.

3.4 Policy Pressure

The Australian retirement income system is not yet stable. Two systems for providing retirement income exist. They are the means tested age pension and superannuation. The problem is that these two systems are not integrated.

There is no consistency in benefit forms. One is lump sum, one is pension.

There is no integration as far as retirement ages are concerned. One provides the age pension from 65 for men and going on 65 for women in the future. The other has a preservation age of 55, going on 60. A five year gap will remain.

The systems are driven by different pressures and are constantly under review. Furthermore, the existence of these two non-integrated systems does not engender the environment where individuals want to save both before or after retirement.

The years after retirement are particularly important within a national savings strategy. It was noted earlier that the level of benefits being paid out of superannuation funds over the last five years was similar to the level of contributions going in. That is many retired people are now receiving significant benefits. This will continue to increase as the superannuation system matures and the population ages. We must therefore have a system where retired people with their accumulated superannuation benefits are encouraged to invest wisely, to maximise their investment returns and in turn to allocate this capital to the benefit of the economy. This does not happen at the moment. The investment of these benefit dollars is critical to the future of this economy. We must therefore have an environment that encourages the maintenance of the stock of savings after retirement.

Furthermore, we must have an environment where people are encouraged to continue to work after they retire from their full time position. The current dual retirement income system does not do that. We have an ageing population and a reducing number of workers to support an increasing number of older people. One way to help overcome this problem is to encourage people not to retire early and to stay in the workforce, either in a full time or part time capacity. It is a very simple measure and if the incentives are right, people will do it. The incentives at the moment are not right for most Australians.

Speaking of incentives, we must also have incentives, to encourage workers to save, both within and beyond superannuation. The simplest approach would be the introduction of a rebate at the point of contributions: that is, where behaviour can be encouraged. A two cent difference has changed the pattern of our petrol purchases and a rebate at the point of contribution can change our savings behaviour.

4 Conclusions

There has been a superannuation revolution in the last decade. There is no way that this could have been predicted ten years ago. We have now reached a situation where nobody can know the whole industry in detail. It is too complicated, too big and has too many segments. There will be more changes. These changes will be in response to pressures from members and on politicians, pressures from within the system and pressures and changes from overseas.

The superannuation system is extremely important for all Australians, both in the macro-economic sense and at the individual level. The overall retirement income system is not yet fully developed. Let us seek a system that is

- rational;
- robust to cope with changing circumstances; and
- rewarding for each of the parties involved.

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