# "Future Challenges: Australia's Superannuation System"

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## Introduction

It's a great pleasure to address ASFA's 2012 National Conference on New Directions, in your 50th year. I suspect the 40 pioneers from your first conference in 1962 would be impressed to find their successors hosting the largest superannuation event in the Asia-Pacific.

Superannuation in Australia today is worth around $1.5 trillion – equivalent to our national GDP – and this is expected to rise to around $6 trillion by 2037. Superannuation is an integral part of our financial system: boosting national saving, providing capital for financial markets and guaranteeing a nest egg for millions of Australians. Superannuation has become more than a financial asset, it is a national institution.

As you are all acutely aware, superannuation is a key part of Australia's retirement income system. As two of the three pillars of Australia's retirement income system, superannuation is growing in importance. Total early and age retirement payouts are currently lower than age pension outlays; however Treasury projects that, by 2018, age retirement benefits will exceed age pension outlays.

Today I want to talk about the future challenges for our superannuation system, in terms of three key features of our retirement income system against which any "new directions" must be measured.

Super is ultimately about providing Australians with better incomes in retirement. While government has a responsibility to get the broad parameters right, the super industry itself has a responsibility, amid some challenging times ahead, to look after the interests of members by providing a system characterised by **adequacy**, **sustainability** and **integrity**.

Before I go on, though, let me provide a brief snapshot of the broader economic backdrop to the operation of our superannuation system.

**Challenges in the medium term and the short term**

Over the last year or so, I have talked about four broad medium-term changes sweeping across our economy and the wider world.

First is the challenge of sustainability, including environmental sustainability. Climate change and water issues reflect basic bio-physical forces that will inevitably keep these issues on our policy agenda in the years ahead.

Second is advances in technology. We've only seen the beginning of the digital revolution. We'll continue to see "disruptive" technology transform every aspect of our lives and work, and we cannot yet predict what those changes will entail.

Third is shifting demographics, particularly the ageing of the global population. We are projecting the proportion of Australia's population aged 65 and over to rise from 13.5 per cent today to around 22.7 per cent by 2050. As well as generating higher costs in health and aged care, population ageing will have an impact on economic growth, as the overall participation rate declines. This is not distant: it can already be seen in our Budget numbers.

The most recent Intergenerational Report projects that, by 2050, there will be only 2.7 people of working age for each Australian aged 65 years and over, compared with 5 working-aged people per aged person in 2010 and 7.5 in 1970. I will come back to the implications of the demographic pressures in a moment.

Fourth is the rise of Asia and the shift in global economic weight from west to east. Twenty years ago, China and India combined accounted for less than one-tenth of the global economy compared with over one-fifth today. This growth path is expected to see China surpass the US in size by the end of this decade and, in turn, be surpassed by India by mid-century.

As part of this economic re-emergence, the middle class in the Asia-Pacific is expected to grow from half a billion in 2009 to 3.2 billion by 2030. By 2030, around 60 per cent of spending by the world's middle class – on everything from household goods, to holidays, to health care (and financial advice) – will come from the Asia-Pacific region, compared with around one quarter today.

These four forces of change will shape our lives across the coming decades. But in the short term, there are some more immediate challenges facing Australia and the rest of the world.

The first is the volatility in the world economy, likely to be a feature for some time. Weaker growth, particularly in Europe, weaknesses in global financial and credit markets and remaining uncertainties, like the US's looming fiscal cliff, continue to weigh on global confidence. Indeed, developments in Europe and the US are impinging negatively on what are inherently more uncertain growth paths of emerging economies like China and India.

The second challenge is the structural change underway in our economy as a consequence of Asia's rise. The initial impacts of Asia's growth – a terms of trade shock and a high Australian dollar – directed labour and capital to resource-related sectors and away from other sectors, particularly manufacturing, which are shrinking in relative shares of the economy. This widespread structural change builds on a long shift towards services, which now account for almost 80 per cent of total output and employment. As I've argued consistently, structural change is inevitable. It shouldn't be hindered, but it should be well managed so that any negative social impacts are minimised.

The third challenge involves productivity where, for a range of reasons, growth has slowed over the past decade, notwithstanding some improvement over the past year. In the 2000s, almost half of income growth was due to the terms of trade impact. With the likely peak in the terms of trade, productivity growth – as it has been for most of our past history – will ultimately be the driver of improving Australians' future living standards. Given declining overall participation rates due to the ageing population, we confront a period of much slower income growth than we have become used to over recent decades. Minimising this impact will require clear commitment from business and their employees, while governments at all levels will need to ensure enablers and incentives create the right environment for innovation.

Fourth is the challenge of fiscal sustainability, which has a particular bearing on our subject today. Revenues as a share of GDP remain well below their mid-2000s peak and, at the same time, expectations on government service provision at all levels continue to rise. There is widespread public expectation that governments will supply increasingly costly health and aged care, and deliver other worthy programs like the NDIS. Basic arithmetic will tell you that these new costs cannot be met without raising more revenue or cutting expenditure in other areas. We need to have a national conversation about what governments – at all levels – should be expected to deliver and how we will pay.

I have spoken about these short to medium term challenges in depth at a number of public events over the year. Rather than go further into these, I articulate them to provide a framework for today's discussion. Two of these forces in particular have significance for our superannuation system – the ageing population and the increasing pressure on medium term fiscal sustainability.

**Australia's superannuation system**

Our superannuation system has already earned a strong international reputation. Australia's system was recently ranked third in the world, behind only Denmark and the Netherlands, against the three key features of adequacy, sustainability and integrity.[1]

Australia is now a relatively high saving economy by international standards, largely due to the marked shift in saving behaviour by households but also, in part, to the compulsory superannuation system. The contribution superannuation makes to national saving has risen from around ½ per cent of GDP in 1992 to about 1½ per cent of GDP currently and, over the next few decades, is estimated to rise to close to 3 per cent.

There are various reasons higher national saving is particularly welcome at the moment, though some sectors are adversely affected. With the international environment more uncertain than over most of the preceding 15 years, borrowing less and saving more makes us more resilient to possible adverse developments. While our terms of trade remain high by historical standards, the recent decline only emphasises that some (unknown) portion of our current national incomes is temporary. And there are benefits to saving more now to support a progressively older population, before the impacts of population ageing become more pressing.

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[1] Mercer Global Pension Index October 2012.

Superannuation's large pool of stable and unleveraged superannuation assets contributes to financial stability by adding depth and liquidity to financial markets; providing an alternative source of finance for other sectors; and acting as an important buffer against external shocks.

In addition to the rise in total flows into superannuation funds, an increasing proportion of financial asset acquisition has been going into domestic equities and deposits, particularly in the post-GFC period. This has helped Australian banks and non-financial firms shift toward safer forms of financing in an environment where debt financing is less readily available and is seen as more risky than it was pre-GFC.

These significant contributions to national savings and financial stability, while important, are really just externalities. At its heart, superannuation is about achieving better retirement outcomes, and therefore improving future wellbeing, for Australians. And Australians should reasonably be able to expect that a system to which they are obliged to contribute, in conjunction with the age pension and any other savings, will assure them an **adequate** income in their retirement; that the system is **sustainable** in the long term; and that the system has **integrity**.

**Adequacy**

When we talk about adequacy we generally refer to replacement rates; that is, the percentage of an individual's working life spending that they need to maintain the same standard of living in retirement. There can be no doubt that, in introducing the superannuation guarantee, Australia has improved retirement income adequacy. And the increase of the superannuation guarantee over time to 12 per cent will further assist in increasing projected replacement rates for Australia's retirees.

As an example, Treasury's projections indicate that an individual earning median wages (75 per cent of average weekly ordinary time earnings or AWOTE) who is currently aged 60 and retiring in 2017 would have a projected replacement rate of around 65 per cent. Compare this to a 30-year-old individual entering the workforce today, earning the same amount and contributing over a working life of 37 years – their projected replacement rate is around 90 per cent.

Clearly superannuation is a long-term game and, over time, there will be peaks and troughs in investment returns. Nevertheless, Australians expect that their obligatory contributions, entrusted to others to manage, will grow over time to provide them with an adequate level of income in retirement.

I am not necessarily advocating any particular investment pattern, although I do have reservations about excessive reliance on equities. But you are the experts in this field and are best placed to make those investment decisions, with, as I said, members' interests as the ultimate goal.

What members would really like to know is how do you, as trustees, manage the peaks and troughs of the investment market to ensure a fair return for them? As trustees of members' contributions, how are you addressing the demands to develop products that will manage risks over time and that will meet members' expectations of retirement income? How is industry responding to future challenges?

The Government ensures the superannuation sector is provided with a steady, guaranteed and concessionally-taxed supply of money. No other industry has this guarantee. None. I would suggest that the superannuation industry has a responsibility to its stakeholders, including members and the Government, to invest money prudently so the returns are in the best interests of members and to develop new products to meet the demands of our ageing population.

To date, the superannuation sector has focused primarily on the accumulation phase. But as the system matures, as more people move into the withdrawal phase, and as people in general live longer, there will be increased demand on the industry to assist individuals to manage the various phases of retirement and key risks like longevity.

The superannuation guarantee has existed for over 20 years and has, in that time, grown in size and maturity. Members reasonably ask: what has super delivered for me? And, more importantly, what will super deliver for me into the future?  That means asking tough questions about the industry's readiness and capability to meet future challenges.

**Sustainability**

Looking ahead, there are challenges for the current superannuation arrangements.

An obvious one – particularly for fiscal sustainability– is the ageing of our population. It is worth noting that, while the pressures on our fiscal sustainability are serious, Australia remains much better placed compared to many other OECD countries.

We are ahead of the game in seeking to address this fiscal pressure by closing defined benefit systems for the public sector while compulsory superannuation is taking pressure off the age pension.

The question remains, however, whether the current framework for our superannuation system will be sustainable into the future.

While changes to the superannuation guarantee have been important for improving adequacy, they will clearly come at the cost of forgone revenue. Also, governments over time have introduced a range of concessions that encourage increased voluntary savings in superannuation. Again, these concessions come at a cost, indeed a very significant cost.

With the Commonwealth budget coming under increasing pressure over the next few decades, the fiscal sustainability of all policies, including superannuation, will demand greater public scrutiny. This scrutiny will be even more important to the extent that existing concessions are seen to favour some at the expense of the majority.

**Integrity**

The other important aspect of the superannuation system is integrity. I see this as a broad concept which encompasses robust governance frameworks underpinned by regulation and protection for superannuants, ensuring value for money and reasonable costs for members and Government.

A concern for Treasury has been the underlying costs of managing the system. To address this concern, the Government commissioned the Cooper Review and responded with the Stronger Super reforms which have introduced SuperStream and MySuper to improve efficiency and reduce costs in the system.

Currently, businesses use a multitude of different systems in processing superannuation data and payments, leading to widespread use of manual payment and poor data quality, processing delays, and duplicated and lost accounts.

The SuperStream measures will see greater automation, common data standards and a network to centralise information and transactions. MySuper will provide a low-cost default superannuation product that removes unnecessary and costly features.

We have estimated that, for a 30-year-old on average weekly earnings, the combined efficiency savings of MySuper and SuperStream could result in an extra $40,000, or an additional 7 per cent, in retirement income savings. Over an individual’s working life, that represents a substantial amount of money, fundamentally increasing his or her wellbeing in retirement.

And surely increased transparency, reduced costs and reduced inefficiencies are in the best interests of all members.

I know that industry has been actively involved in the design and implementation of these reforms over the last twelve to eighteen months. Outcomes for members can only be improved through genuine two-way engagement between the industry and government.

One of the emerging issues for the integrity of the system is the growth of self-managed super funds (SMSFs). SMSFs have an important place in the market for those investors wanting control over their investments. However this flexibility raises some issues for all sectors of the industry to consider. For some SMF investors, it is important that they understand that the greater flexibility and potentially greater returns can come with increased risk.

Going forward, greater transparency on the implications of operating a SMSF will be important as will be the increased accountability requirements of SMSF trustees. Another central issue for managers of super funds will be ensuring value for money for the management of members’ superannuation savings – which has clearly been a key driver of SMSF growth.

A final point before I conclude: an issue often raised with me relates to the call for access to the pool of superannuation savings for infrastructure. The growth of superannuation in Australia has led to large amounts of money looking for viable investment options. At the same time, there is a range of investment projects and business opportunities looking for funding. This sounds like a perfect match.

Indeed some funds are already doing the sums and deciding that these infrastructure investments will improve returns for their members. However, given infrastructure can be a high-risk investment, and adequacy depends on managing the balance between risk and return, I consider that it is important that trustees make investment decisions based on the merits of the investment itself. Making it mandatory for superannuation funds to invest in infrastructure, or introducing more tax concessions to encourage increased infrastructure investment, may lead funds to make decisions and take on risks that they otherwise would not deem prudent.

I and others have concerns about the impact that this direction would have on the integrity and fiscal sustainability of the retirement system.

**Conclusion**

While Government has a role to play, the superannuation system is largely entrusted to the industry. As Australia negotiates the challenges of fiscal sustainability and an ageing population, citizens will be looking to the industry for productive and responsible innovations that have the best interests of retirees as the focal point.

Australia's superannuation system is currently highly effective and internationally respected. That's not to say that changes, or new directions, won't need to be made in future. But any change must be measured against its capacity to improve the adequacy, sustainability and integrity of the super system, and hence its capacity to improve the wellbeing of Australians in retirement.