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Clean Pensions:

Factors Impeding Effective Delivery

of Retirement Income Solutions:

The Australian Experience

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This paper examines whether the Australian retirement savings regime delivers Clean Pensions. It explores the major factors impeding effective and efficient delivery of untainted retirement incomes which meet beneficiaries' best interests.

It provides a background to the Australian retirement income system and demonstrates the critical importance of clean pensions to individual well-being and societal cohesion. It then examines how clean the pension system is, having regard to three recent significant inquiries.

The system, whilst having many merits, fails to meet the test for Clean Pensions. There is evidence of substantial failings including clarity of purpose; conflicts of interest and breaches of duty; inadequacies, inconsistencies and inefficiency in delivery of product, services and advice; market structural issues; and market conduct deficiencies.

The underlying causes and solutions are examined, covering public policy, market structure, complexity and dependence on financial advice. Lessons can be drawn from the Australian experience for policy, governance and market structures more generally.

Introduction

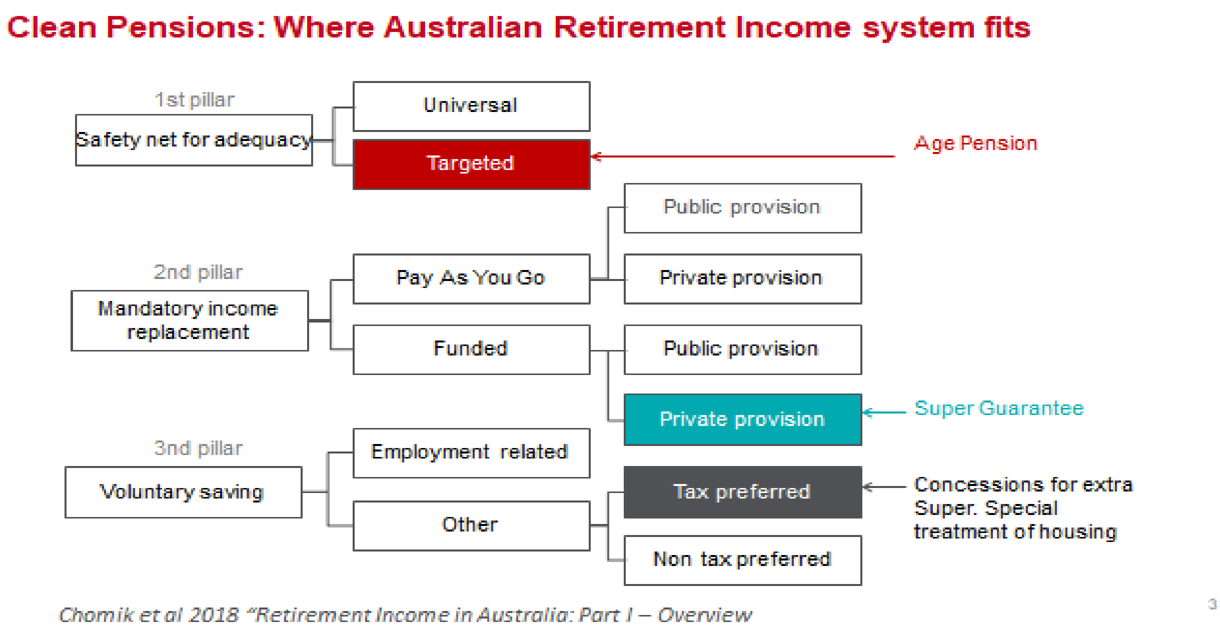
Good afternoon it's truly a pleasure to be here today. I've really enjoyed the presentations, debate and learning from the experience and insights of others.

The views I express in this document are mine alone and do not reflect those of my employer, UNSW Sydney or CEPAR.

I plan to spend the next 20 minutes drawing on the Australian experience with pension policy, market structures and their failings. I will define clean pensions, and consider what factors contribute to tainted pensions and what can be done to enhance pension regimes.

I will start by defining Clean Pensions as: 'Schemes that efficiently and effectively deliver retirement income solutions to individuals without loss from excessive rent seeking or poor decision-making or advice, arising from conflict of interests, abuse of power or unclear purpose. A clean pension is delivered untainted to members, where by their interests are paramount in decisions made about the retirement savings, including decisions as to how, what and when to accumulate, invest and draw down.'

Alternatively had I examined the question by reference to the OECD Recommendations on Core Principles for Pension Regulation I would have come to the same conclusion.

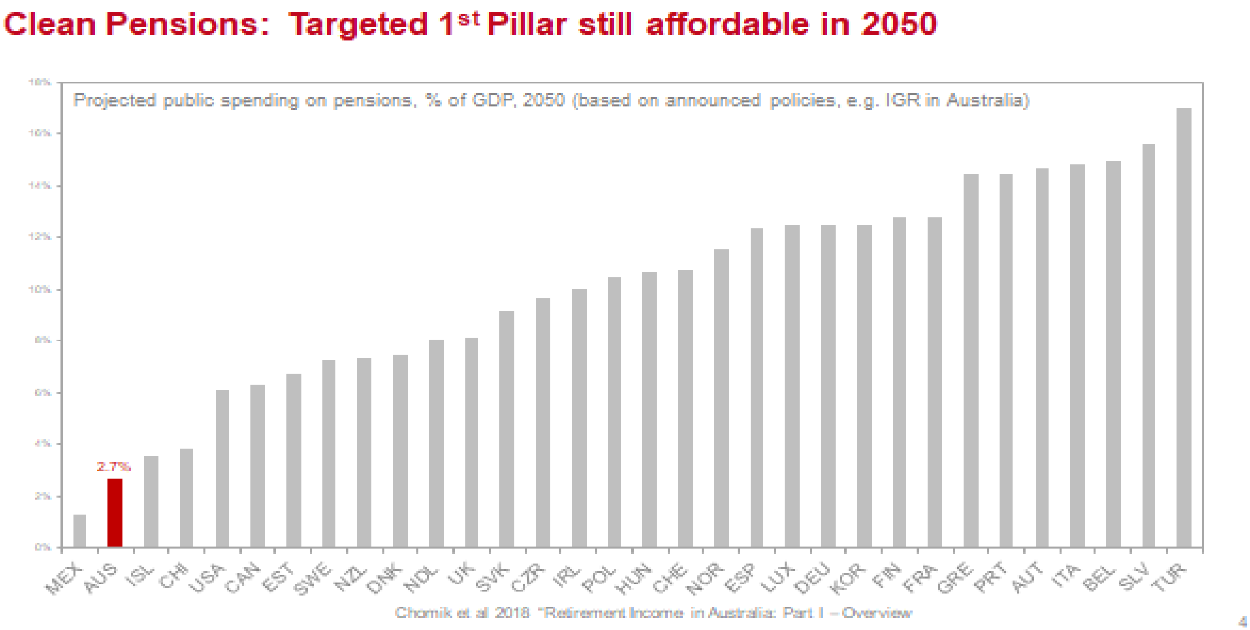


This slide shows where the Australian pension system fits within an OECD style framework. I will focus on Australia's mandatory 2nd pillar and discretionary 3rd pillar, and provide some context on the 1st pillar.

Background
Australia retirement income system has three principal elements. The first the targeted government provided unfunded aged pension, which is asset and income means tested.

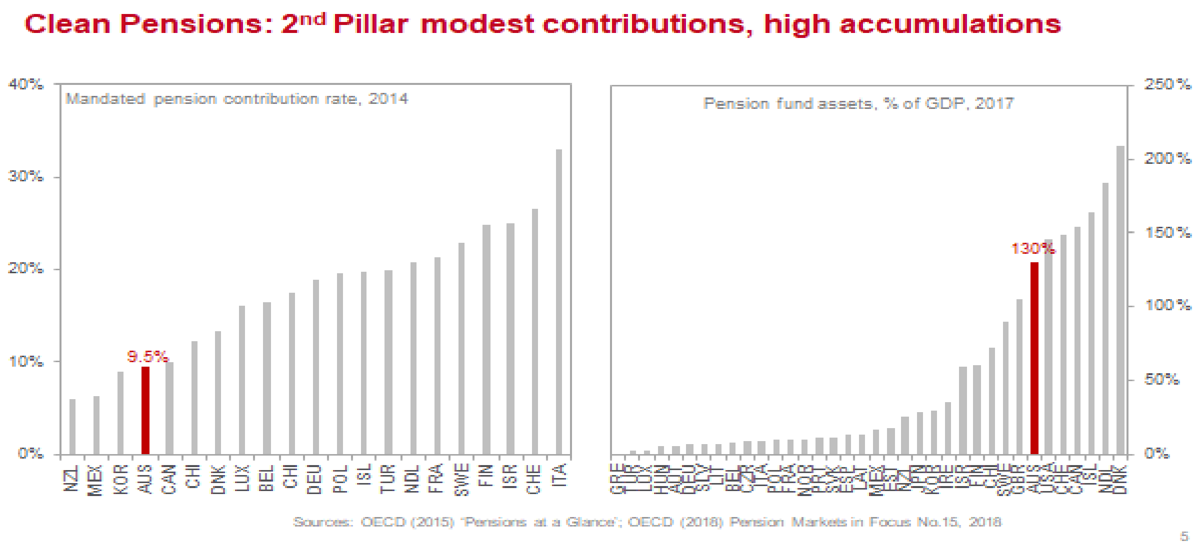
Currently 43% of eligible Australians draw the full government pension and a further 27% draw a partial pension. It's expected the number of people taking the full aged pension will reduce as superannuation balances increase; albeit the total percentage taking any pension is expected to remain unchanged at 70% over the next 30 years as our population ages. The age pension is just below adequate in the absence of other wealth.

Unlike many countries the scheme is affordable and is projected to represent ~2.7% of GDP in 2050.



The second pillar is a government mandated and tax incentivised scheme for accumulating retirement savings. Employers deduct 9.5% of their employees' pre-tax income and invest contributions net of tax in their fund. These funds collectively have $2.7 trillion invested, which represents about 50% of household's financial assets but less than 25% of individuals total assets, verses 60% in real estate.

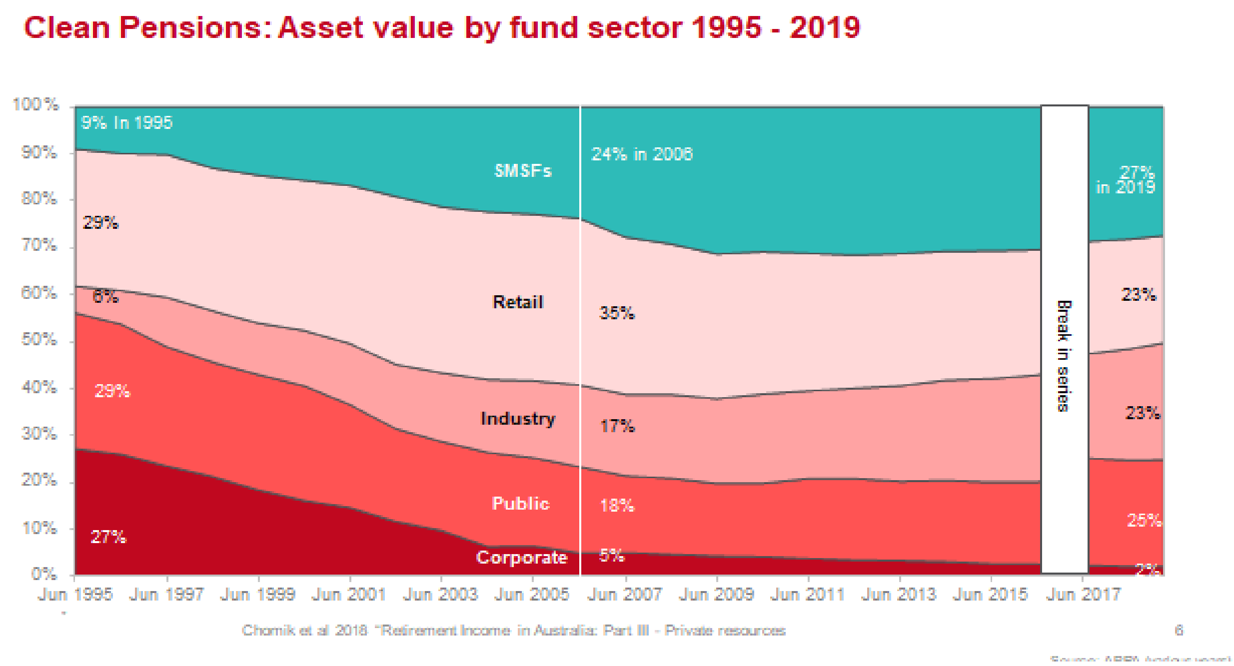
This next slide demonstrates the 2017 global comparison of contributions and total fund pool as % of GDP. In 2019 pension assets as a percentage of GDP had risen to 150% putting it near the top globally. This low-cost high accumulation system indicates a pretty well-functioning system and in many senses it is.



The third pillar is discretionary superannuation whereby individuals can make 'top-up' contributions from post or pre-tax income. This pillar also includes the family home.

The funds are invested in superannuation trusts, principally defined contribution:

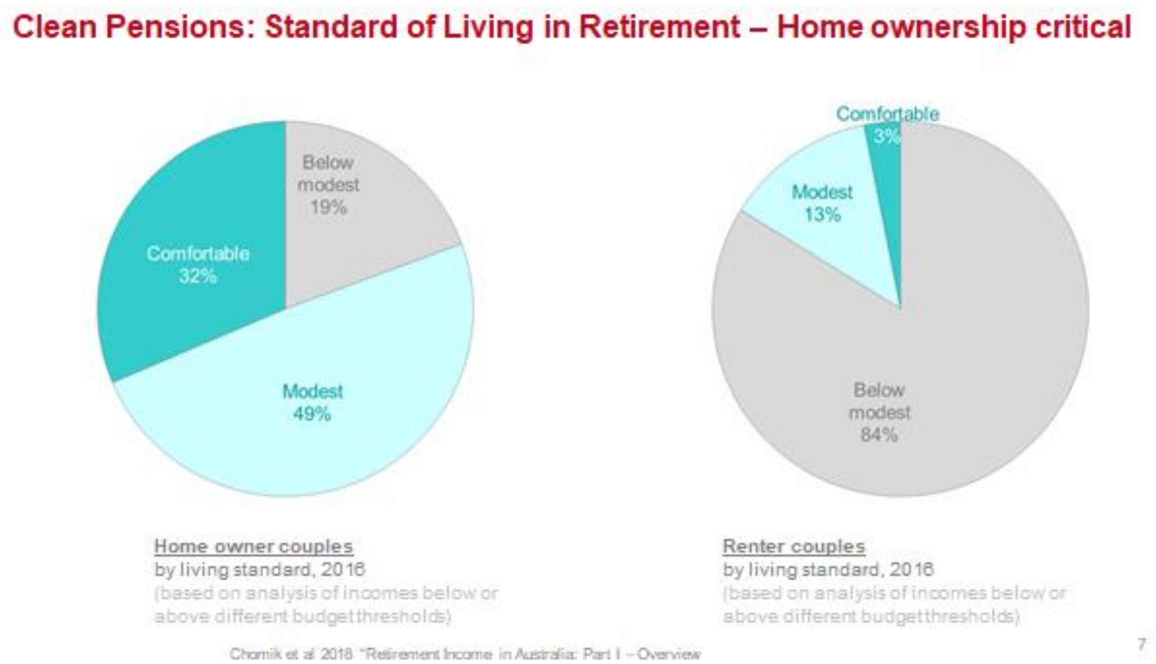
- 23% in Retail Funds managed by financial services companies. Note recent outflows.
- 23% in Industry Funds under the auspices of industry based trade unions
- 25% in Public sector funds, partially unfunded
- 27% in Self-Managed Super Funds where individuals manage their own funds.



Trustees of these superannuation funds have an obligation to exercise their powers in the beneficiaries' best interests, and when a conflict arises they must give priority to the beneficiary. In theory this should ensure that the system delivers clean pensions.

The largest savings vehicle is real estate, substantially in the form of the family home which forms part of 3rd pillar. It is capital gains tax free and mostly excluded from the means test for the aged pension and long-term aged care. Investment properties are also significant and tax advantaged with full deductibility of interest and a 50% deduction on capital gains.

Overall the system provides a modest to comfortable outcome for 81% of couples (or singles) who own their home. However for those who don't own their home 84% have below modest retirement incomes.



Under the rules at retirement individuals can take super as a tax-free lump sum or draw down through a allocated pension, and very few have true annuities. This leaves most risk with individuals and with no default to guide their complex decisions. 60% choose to engage a Financial Adviser to assist in navigating these significant complexities and risks of homeownership, superannuation and access to government support. These advisers have an obligation to follow processes to 'ensure' they give appropriate advice and priority to their clients' interest. However current legislation stops short of mandating a best interest's duty. It is harsh but fair to say that many lack the skills and experience to advise on the full spectrum of retirement risks and solutions.

Clean Pensions

That's how it works: but how clean is the Australian pension system?

The answer is aided by a series of major reviews; namely, the Financial Systems Inquiry, the Productivity Commission Review of Superannuation and the Royal Commission into Misconduct in the industry. All of these reviews raised serious questions about the system. On the positive side, we have had these reviews, the issues are in the open, and the government and business are addressing them seriously.
Let me elaborate.

Financial Systems Inquiry (2013-2014)
In 2013 the government established a Financial Systems Inquiry which observed in relation to Australia's retirement incomes system that: "Australia's superannuation system has considerable strengths… [however it] …is not operationally efficient due to a lack of strong price-based competition. Superannuation assets are not being efficiently converted into retirement incomes, and it recommended, consistent with CEPAR's submissions:

- Setting clear objectives for superannuation including retirement incomes
- Improving operational efficiency, reducing expenses and increasing returns
- Improving efficiency in retirement including default to a retirement income solutions (CIPR's)
- Delivering more seamless solutions through an individual's life course

The big issue it highlighted, notwithstanding a well-developed AUD$2.7 trillion retirement savings regime, is there's no mandated definition of what superannuation savings are for, compounded by inadequate competition and returns. It not unsurprisingly concluded the system is not efficiently delivering retirement incomes or broader economic benefits. Interestingly the FSI was headed by the former CEO of a major player and included the former CEO and directors of other major players. It's a good report but its expression is more measured than the subsequent Inquiries.

Productivity Commission (2016-2018)
Following the Financial Systems Inquiry the Australian Government requested its Productivity Commission to review the super system's efficiency and competitiveness. The Commission noted the critical role super plays along with housing and the aged pension, but it found that it needed to be upgraded for modern work practices , such as, gig economy employment and casual work, to give proper consideration to the retirement phase and rectifying structural flaws.

It found significant under performance by some funds, most notably Retail Funds, excessive and unwarranted fees, excessive number of individuals with multiple accounts (10 million), products that were complex and lacking "simple and salient information and impartial advice".

Underlying this was an industry with inadequate competition, governance and regulation that has been inadequately “chipped away at” by policy initiatives. It found Trustee boards need to improve their skill base, better manage conflicts of interest and promote member outcomes; that Regulators need clearer roles, accountability and powers to monitor Trustee conduct; and, member’s need a stronger voice.

Interestingly they noted they hadn’t looked ‘at the broader role of superannuation in retirement incomes or the impact of super on national savings, public finances or intergenerational equity.’ They also noted there was little precedent globally for a comprehensive review of the efficiency and competitiveness of pension systems. This is an excellent report direct but informed and very Australian. Possibly other countries could benefit from a similar review.

Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (2018 - 2019)

In 2018 a Royal Commission was established to investigate and make recommendations in relation to Misconduct in Banking, Superannuation and the Financial Services Industry. The commission was a quasi-judicial public inquiry with considerable investigative powers. It examined, inter alia, whether superannuation fund Trustees appropriately considered the best interests of members and whether financial advisers provided impartial independent and unbiased advice to individuals saving for or drawing down their retirement savings. It’s fair to say that the roots of this Royal Commission were political and its purpose was to deflect political criticism and cause public humiliation or embarrassment.

In 2019 it released 1,700 pages listing failings and making 76 recommendations, which have been largely accepted by government. Rectification and remediation costs are likely to be well over A$3bn, compounded by a massive funds outflow from Retail funds. The hearings made daily front page news as it grilled Trustees, directors, management and Regulators.

It exposed serious failings in the system relating to conflicts of interest throughout the vertically integrated value chain, trustees failure to act in members’ best interests, funds delivering inadequate returns, deducting premiums for inappropriate insurance and charging fees for no service, and financial advisers providing inappropriate or poorly researched advice.

Chief Executives and Chairs of major public companies resigned and many executives’ in the wealth management, superannuation and insurance divisions followed. The regulators and directors didn’t escape criticism - It’s fair to say they are both increasing their scrutiny and becoming less ‘understanding’. Whilst much of what the report said was not new it did get public, government and media attention and changed the industry’s commitment to addressing acknowledged weaknesses.

Tentative Conclusion
Based on these Inquiries it would be hard to conclude that the Australian Superannuation system universally provides Clean Pensions, as we clearly do not have effective, efficient and untainted delivery of retirement income solutions.

However is this fair? Do these deficiencies really strike at the heart of determining whether we have clean pensions? We have a system, it works reasonably well; we have regulators and legislative frameworks to oversee it and inquiries to keep everybody honest. Should we just see these deficiencies as evidence of a system working towards optimum?

The superannuation system after all delivers:

- A growing and relatively stable pool of funds and source of capital
- A means of maintaining consumption and GDP growth as the population ages
- Individual ownership of retirement resources, and
- 3 pillars that, with better consideration to home ownership for pension access, is both affordable and adequate

and we have had no big disasters, albeit inefficiency and impaired effectiveness.
Perhaps this is something we can debate later?

Why did this occur and what are the implications?
Firstly, let me examine the key drivers impeding the efficient and effective delivery of Retirement Incomes in Australia, and explore some possible solutions. This may also give valuable insights or food for thought for other countries on the same journey.

Political failures
Political failure has been at the heart of the systems inadequacies. These failures resulted from respective government's inability to take a hard look at the system. Ironically our superannuation system was devised as a means of breaking a cost of living – wage inflation spiral, whilst still providing taxation revenue. Hence super was taxed upfront, had mandated savings deducted from wages, but did not address the pension phase – its core purpose.

There is a lack of clear, sustainable and stable public policy on the purpose and rules of engagement for superannuation. This creates uncertainty and a lack of trust in the system, including concerns about how future governments may seek to direct the investment of, tax or otherwise appropriate or interfere with individual's retirement savings. The point is the constant change and future uncertainty in rules and taxes has challenged public confidence in the system.

Intergenerational equity issues are also an increasingly significant issue for the government, as they seek to reduce generous superannuation and investment concessions whilst not discouraging retirement savings and assisting younger generations into home ownership.

Governments increasingly recognise that if this is not carefully managed it will have a detrimental impact on their political aspirations, the economy and social stability – as discovered by Labor party in the recent Federal election.

Another big issue is with the $750bn in Self-Managed Superfunds that operate as self-controlled, tax advantaged, advice dependant personal super funds. They are a ticking time bomb, exposing ageing retirees to losing control of their savings from a combination of cognitive decline, over reliance on advisors, elder abuse, mismanagement and/or fraud.

Briefly, responses to these political issues might include:

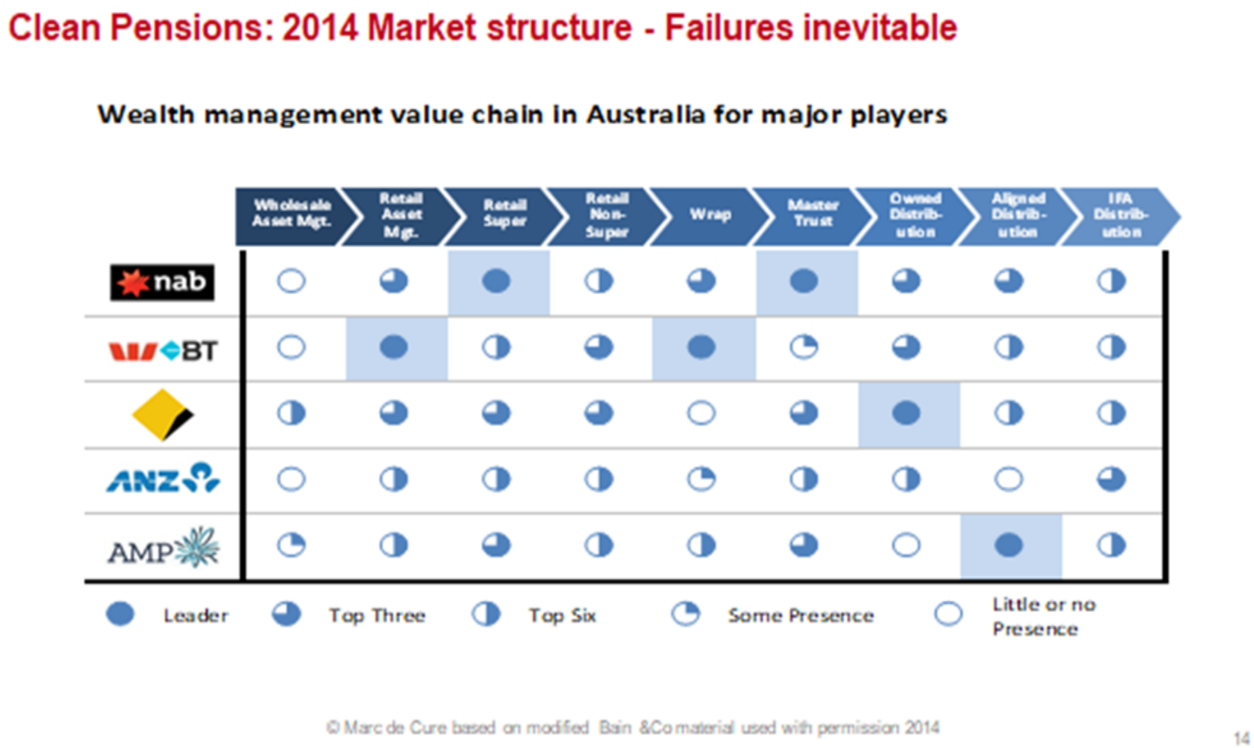
- Separating control of superannuation from political influence with, say, an independent overarching Commission not unlike a Central Bank.
- Defining the purpose of superannuation and retirement savings in legislation. Including what retirement savings should be designed to cover
- Conducting a system wide review of retirement savings, and developing a holistic, consistent and self-supporting public policy and regulation. There are many inconsistencies and inefficiencies between policies in relation to tax and means test concessions for long term care, pensions, super, investments and the family home that need to be addressed urgently. The government has already announced the setting up of a unit within Treasury to examine this issue.
- Ensuring there are strong incentives and protections for individuals seeking retirement self-sufficiency, whilst providing an adequate support for those in genuine need i.e. a more generous and targeted age pension to ensure all Australians have reasonable income in retirement. This could be done at no net cost of the budget or material detriment to any Australian in retirement.
- Deciding who is best placed to manage which retirement risks e.g. government, individual or financial services industry, and designing products and legislation accordingly.
- Improving protections for SMSF as their member's age, and possibly introducing a simple default transfer to a non-self-managed fund under pre-defined circumstance.

Market failures

I now turn to the second major cause of our problems – market structure.

I presented a discussion paper to Treasury in 2014 on Competition in Financial Services, focused on wealth management and superannuation. In this paper I highlighted a number of inhibitors to competition, their detrimental impact and suggested solutions.

This following slide shows the value chain participation by major players in 2014.



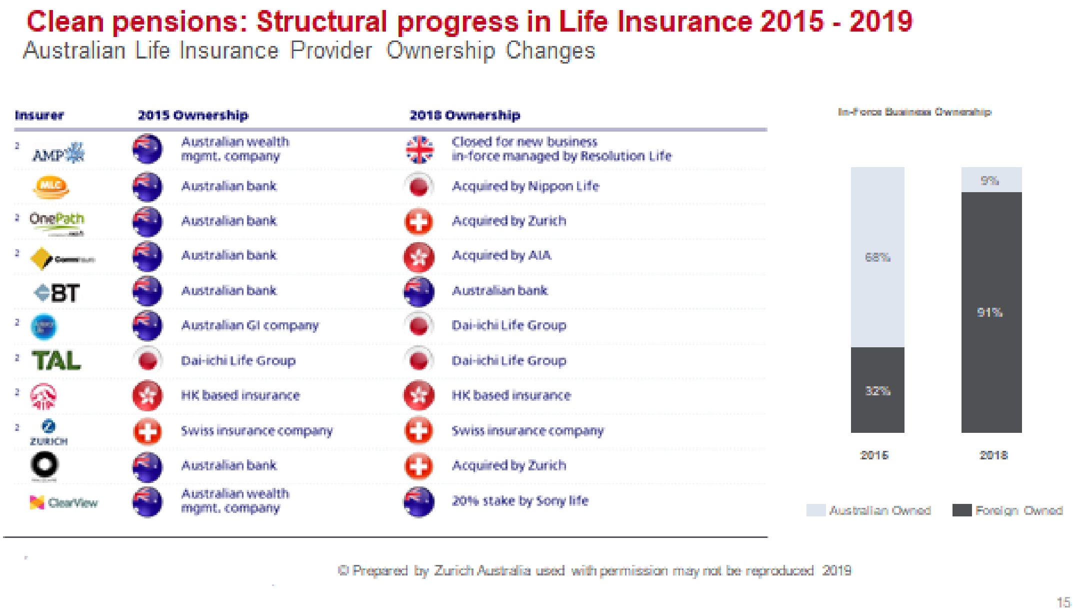
My primary points at the time were the major banks and wealth management groups:

- Controlled the majority of distribution through aligned or owned advice, and genuine IFA's were in the minority. This gave significant market power to these institutions to control the value chain. In addition the Industry Funds had dominant control and access to customers within award based industry super.
- Control was reinforced through incumbency whereby individuals stayed with their provider due to the difficulty of shifting and complacency, notwithstanding poor outcomes. An issue exacerbated by poor engagement, financial literacy and the complex issues and product choices involved.
- Had significant scale advantage, with the other players taking fragmented roles, with their weak positions exacerbated by poor access to distribution.
- Operated vertically down the value chain from advice to platforms, trustee services and underlying product manufacture; and across segments of banking, wealth, trustee services and insurance: They could choose where to compete, control pricing and dominate key relationships.

This led to major conflicts of interest and with their market domination resulted in poor competition, inefficiency, high costs and low returns: This was made worse by inadequate mandated product disclosure rules (refer research by Prof Hazel Bateman).

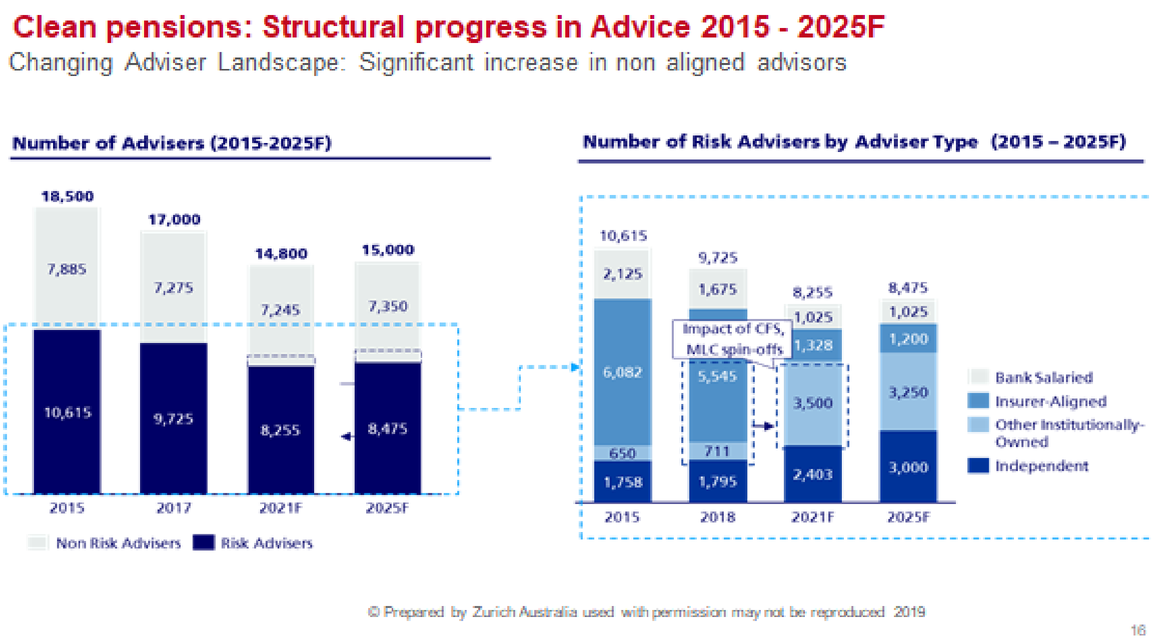
It's not unsurprising with these issues the system let us down - we didn't need a Royal Commission.

Slide below shows the change of ownership of life insurance companies since 2014. Much of the heavy lifting in life insurance has already been done.



So industry structural changes have started to correct these deficiencies with the value chain breaking up and Banks moving out of life insurance and some superannuation related activities. This didn't happen because of the Royal Commission or the Productivity Commission Inquiry: it happened because the Banks and other incumbents increasingly realised that they neither had the expertise nor the capability to offer a competitive product and achieve a satisfactory return on the capital.

This next slide demonstrates the massive shift to independent and non-aligned advice since 2014. You may also recall the earlier fund sector slide showing retail shrinking from 35% to 23% market share.



You will note the massive reduction in aligned advice, the steady increase in IFA's by number and percentage and the growth in owned but not aligned advice.

Trustee services are also shifting to independent players. But more is required and likely.

The lessons learned in the past must not be forgotten we are currently experiencing an increase participation by Industry Funds across the value chain and they are potentially about to make the same mistake that the major banks and wealth managers.

Notwithstanding good progress the system's failure to manage the asymmetry in power and knowledge between individuals, government, financial advisors and product providers, and avoiding conflicts of interest needs to be addressed. Measures may include mandating:

- Separation of ownership and provision of advice from product providers.
- Separating the ownership of product provision and trustee services.
- Introducing default retirement solution to reduce complexity and its associated cost, and reducing the need for, and power of, advice.
- Improving the adequacy of product disclosure information for those who choose not to take proposed default option.

There are other more technical and product based failures in the system including:

- Inadequate tools for product providers to manage risks such as market, liquidity, solvency, counterparty, morbidity and longevity risks, complicating underwriting.
- Insufficient suitable assets to match long duration liabilities of income stream products.
- The poor symmetry of knowledge and access to healthcare impacting longevity risk
- Potential equity issue from significantly different cohorts particularly by wealth in relation to longevity and morbidity risk pooling
- The equity risk premium is likely to increase and the returns on debt decrease, as an increasing proportion of investment capital supports retirement incomes, and is seeking lower volatility. With the implication of increasing the cost of risk products and reducing returns on savings, and possibly reducing available equity capital.

Solutions may include:

- Government provided guarantee or underwriting of longevity risk or a stop loss for systemic shifts in longevity, government backed/issued long dated inflation protected bonds and longevity bonds, and rules to balance the underwriting risk due to asymmetry of genetic information, and selective access to advanced health care.
- Greater awareness and management of the increasingly significant retirement savings pool as a source of global capital by business, governments and central banks, and its impact on the availability and cost of equity/debt.

- Changes to regulatory capital requirements and/or some form of incentive to invest in higher risk assets.
- Re-examining expectations of directors, management and regulators for avoiding the issues previously highlighted. Have we missed the point and are we addressing the wrong cause? I suggest we need to look first at industry structure and government policy failings, and get the settings right first. The rest will fall into line.

All of these points and their application to other countries can be explored in greater detail in our subsequent discussion session.

Summation

To sum up, notwithstanding its strengths and fourth ranking in the Mercer Global Index, the Australian pension scheme has a number of deficiencies which means it doesn't get a clean bill of health. The reasons for this are many fold and complex but hopefully I have provided an insight into what they are and some potential solutions.

Thank you for listening and I hope I have created some questions, challenges or insights for your own deliberations. I look forward to discussing this in the open forum.

