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Retirement policy: A review of the role, characteristics and contribution of the Australian superannuation system

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Abstract

With a market capitalisation of over \$AUD1.84 trillion dollars and large annual flows, the superannuation guarantee has been regarded as the backbone of Australia's retirement policy scheme and a primary driver of economic growth. However, losses encountered in the aftermath of the global financial crisis (GFC) led to a major review of superannuation, mainly in response to the lack of accountability, comparability and transparency discovered within 'default' investment options. An outcome of this review was the 'MySuper' initiative, which imposes obligations on fund providers to reconfigure their default investment strategies in accordance with new regulatory requirements. Despite these policy reforms, other challenges like gender inequality, excessive superannuation fees, low financial literacy and lack of member participation in growing retirement savings, still remain. This paper provides a review of literature pertaining to the background, significant policy changes and ongoing development of the Australian superannuation system. We emphasise the role of superannuation in the economy, characteristics of the industry, plans and funds on offer, recent policy initiatives, and perceived inadequacies of the system. The paper concludes with possibilities for further empirical research.

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Introduction

In most developed countries, common symptoms underlying social disequilibrium, such as ageing populations, a decreasing birth rate, limited tax revenue, disagreement on raising taxes – not to mention the impact of the global financial crisis (GFC), have placed considerable pressure on welfare systems (Castillo 2012). Australia, with its weak working population growth and increased longevity, is no exception. Treasury (2010) highlights the burden of an ageing population on health, age-related pensions and aged care expenditures. This implies that more tax revenues have to be allocated to fund Australian social benefits for pensioners, specifically their living costs, medical expenses and other services needed for the elderly.

Clare (2007) predicts Australian male life expectancy will increase from 78.4 to 83.6 years and female life expectancy from 83.7 to 87.4 years by 2045. This longevity risk is a pressing issue, particularly given the fiscal costs of an aging population. As such, it is creating a retirement savings gap of approximately \$AUD836 billion or \$AUD79,200 per capita – being the size of the shortfall in reasonable retirement benefits for those Australians who outlive their life expectancy (Financial Services Council 2011).

The success of Australian retirement policies can be measured by the reduction of these gaps over time; however, these trends have the potential to threaten quality of life for Australian retirees. Like many other developed countries, Australia will have to make critical decisions concerning matters such as the continuing reduction of social security benefits due to government funding constraints, measures to increase productivity, and an increase in retirement ages. These policies may lessen the impact, but they are not the panacea (Treasury 2014).

For most Australians, retirement incomes are a combination of their personal savings throughout their working life, superannuation savings and/or a full or part-rate

age pension (Rothman 2007). Some choose to use their retirement savings to pay off their home mortgage, while others use their savings primarily for retirement income. Nevertheless, the Government has modified both the superannuation system and taxation to encourage Australians to maximise their retirement income via mandatory superannuation funds and voluntary contributions.

Superannuation may have long existed in Australia but it has only become widespread thanks to the introduction of Superannuation Guarantee (SG) in 1992 (Nielson and Harris 2010). Since the SG, Australia's superannuation industry has more than tripled in value (from approximately \$AUD480 billion in 1992 to \$AUD1.84 trillion in March 2014), thus exceeding Gross Domestic Product (GDP). These figures confirm that superannuation has become a prominent investment vehicle for Australian households. Government policy changes such as pre-tax salary sacrifice, after-tax personal and/or spouse contributions, and the introduction of '*MySuper*' have mostly been welcomed. However, the debate on inadequacies such as gender inequality, excessive fund management fees and a lack of superannuation investment awareness/financial literacy continues (Rothman 2007; Warren 2008).

This paper is motivated by recognition of the growing economic and social importance of superannuation, which is no longer simply a minor element of private retirement savings but has become a vital component of the Australian economy. Our paper reviews and integrates literature concerning the role and benefits of superannuation, main characteristics of the superannuation industry, superannuation plans on offer, and the *MySuper* initiative. In so doing, we identify relevant risks and perceived inadequacies of the superannuation system and its recent changes.¹ We

¹ As noted earlier there is debate about inadequacies such as gender inequality, excessive fees and lack of financial literacy. However, in this paper we do not address these inadequacies in detail because to do so sufficiently would require substantial discussion of the surrounding issues that warrant papers on their own.

conclude the paper with recommendations for further empirical research, especially the need to gain a better understanding of gender inequality, superannuation funds' disclosure and fee structures, operational and investment performance of passive and active investment strategies, financial literacy and member awareness of relevant products and services.

The role of superannuation in the Australian economy

Australia's retirement provision system is comprised of the age pension, the mandatory and fully funded superannuation guarantee scheme, and other long-term private savings such as voluntary contributions and property, fixed-income and stock market investments. This three-pillar system has been developed over time, not only to address the challenge of funding an ageing population, but also to solve a range of broader political, social and economic issues.

While the burden of age pension benefits grows heavy on the Government's budgetary obligations, superannuation² has asserted itself as a viable policy alternative to help maintain the lifestyles of older Australians in retirement. In the first half of the twentieth century, superannuation was confined to select groups of employees, such as public servants and high level staff in large corporations such as banks (APRA 2007). However, in the early 1980s, Australia's level of state involvement in retirement savings policy increased and superannuation became the preferred approach to deal with the issues of an ageing workforce. Nevertheless, Borowski and Olsberg (2007) show that only 45% of the Australian working population were protected by superannuation during this time. Of this 45%, 77% were male and 23% female, and largely employed in the public service sectors. The superannuation scheme that covered

² Australian superannuation is a private capital accumulation system which provides for both mandatory and voluntary retirement savings.

these workers came in different types but was mainly of a defined benefit nature. Further, due to the lack of preservation age and generous tax concessions, the scheme transformed from income supplementation for retired workers to a special form of severance payment with lesser taxable income (Borowski and Olsberg 2007).

Since the mid-1980s, there has been a significant focus on addressing concerns of inequity associated with parochial superannuation coverage in the workforce. As a result of the 1986 National Wage Case, which gave a 3% employer superannuation contribution in lieu of wage rises, superannuation coverage rose to over 79% of the workforce (Nielson and Harris 2010). Further, there was a significant increase of superannuation coverage in the private sector workforce from 32% in 1987 to 68% in 1991. However, this 3% contribution was too small to deliver major improvement in workers' circumstances, except those of high-income earners – not to mention the one-third of private sector workers left uncovered by the award (APRA 2007).

Recognising the long-term significance of retirement savings, a regulatory framework called the *Occupational Superannuation Standard Act 1987* (Cth) (OSS Act) was introduced in 1987 (Nielson and Harris 2010). The OSS Act set standard guidelines with which superannuation fund providers needed to comply in order to be eligible for tax deductions and to perform their duties as trustees in general law. However, the only punishment for non-compliance was to remove the tax concession status from superannuation funds (APRA 2007). The OSS Act³ was later replaced by the *Superannuation Industry Supervision Act 1993* (Cth) (SIS Act) after the introduction of the SG was proposed by the Keating Government in 1992.

The SG brought employer-funded superannuation beyond the limits of award coverage and required an employer tax deductible contribution of 3% for each

³ The OSS Act remains the key legislation to deal with the eligibility of concessional tax treatment (Pearson 2009).

employee into a regulated fund (Pearson 2009), with the proportion being progressively raised over time. For example, from 1 July 2014, the SG requires employers to contribute a minimum of 9.25% on top of their employees' wages into nominated superannuation accounts, with this rate expected to increase gradually to 12% by 2025 (Australian Taxation Office 2014d).

In order to be eligible for the SG, employees must not: (1) earn less than \$AUD450 per month; or (2) be aged 70 or over; or (3) be aged under 18 years of age and work less than 30 hours a week; or (4) perform domestic work for non-business employers for less than 30 hours a week (Jefferson and Preston 2005). For employers, a failure to comply with the mandatory contribution would become the basis for a non-deductable SG charge, which requires employers to pay the equivalent of the individual employees' shortfall in contribution, interest and an administrative charge.

The success of SG has led to high growth (i.e., from 48.1% in 1989 to 89.9% in 2012) in the coverage of superannuation for both full-time and part-time workers (Keegan et al. 2013). This has resulted in Australia gaining one of the highest private pension coverage rates in the world (OECD 2013a:91). It also highlights the positive effects of a gradual increase of mandatory rate and superannuation coverage in encouraging higher retirement savings.

Despite these successes, the ongoing Government's commitment to gradually increase the SG rate to 12% by 2025 might not be enough to provide Australian retirees with a reasonable living standard. Minifie (2014) asserts that delaying increases to the SG will result in many Australians retiring with less. Minifie also suggests that compulsory superannuation payments will be about 13% lower over the next decade due to such delays, thus reducing the retirement balances of average workers by approximately 5%, or \$AUD40,000.

Under the assumption that retirees own their residential property, ASFA's June 2014 budget report shows that \$AUD33,664 per year is needed for a couple who wish to have a modest retirement lifestyle⁴ or \$AUD58,128 per year for a comfortable retirement lifestyle⁵ (ASFA 2014). However, the average balance of retirement accounts for people aged 60-64 in 2010 was estimated to be \$AUD109,000 for males and \$AUD90,000 for females (Challenger 2012:14), not nearly enough to provide the ASFA's estimated annual incomes quoted above. This could explain why 68%⁶ of retirees aged over 65 in 2011 are still reliant on an age pension. Therefore, depending solely on SG for retirement funding may not be the solution.

In acknowledgement of this dilemma, the voluntary superannuation contributions scheme was introduced in 1993. The scheme enables eligible taxpayers to boost their retirement savings through tax deductions via concessional (pre-tax) and non-concessional (post-tax) contributions. Instead of being taxed at the marginal rate, concessional contributions get taxed at 15%, whereas non-concessional contributions are made after the deduction of personal income tax (Australian Taxation Office 2014a; 2014b). These voluntary schemes are widely used as a tax minimisation strategy (particularly by moderate- to high-income earners⁷) to achieve higher savings for retirement at the expense of reduced Government tax receipts (Feng 2014; Ingles 2009). Eligible low-income earners can also receive tax benefits to promote retirement saving such as the Government co-contribution payment and spouse contributions (Australian Taxation Office 2014c).

⁴ Modest lifestyle means the living standard is better than the age pension but retirees can only afford basic activities (ASFA 2014).

⁵ Comfortable lifestyle signifies that retirees can afford private health insurance, get involved in a wide range of recreational activities, purchase new technological equipment and automobiles, and go on occasional domestic and international holidays (ASFA 2014).

⁶ This figure is comprised of 41% full-rate age pension and 27% part-rate age pension.

⁷ The introduction of the 'Division 293' reduces the tax benefits for concessional contributions of high-income earners, e.g., incomes which are greater than AUD\$300,000. A Division 293 tax is effective from January 2014 for the assessments for the 2012-13 financial year in which the before-tax contribution is taxed at a 30% rate for those classified as higher-income taxpayers (Australian Taxation Office 2013).

Minifie (2014) claims that the three most obvious options to promote higher retirement savings are to: (1) seek lower management fees; (2) choose superannuation funds managers who consistently outperform their industry peers in regards to investment performance; and (3) make regular voluntary contributions on top of mandatory contributions for matching schemes and tax incentives.

Characteristics of the Australian superannuation industry

The SG is an integral component of what has evolved into a well-regarded Australian retirement provision system. Based on Mercer's global index in 2013, Australia is ranked B+, only behind Denmark⁸ in a qualitative assessment of its superannuation system. This B+ ranking indicates that Australia delivers a retirement '[s]ystem that has a sound structure, with many good features, but has some areas for improvement that differentiates it from an A-grade system' (Mercer 2013:26).

There are three main reasons the SG plays a stabilising role in the Australian economy (Allen Consulting Group 2009). First and most importantly, superannuation benefits individuals by encouraging them to save for their retirements through superannuation contributions. A larger retirement income is the most obvious benefit for all Australians taking part in a superannuation scheme. Increased income and savings means more comfortable living conditions for individuals and their households in retirement. Further, weak savings willpower and impulsive purchasing behaviours, especially in younger generations, are some of the contributing factors responsible for the failure of individuals to accumulate sufficient retirement savings (Brown et al. 2002; Gruen and Wong 2010; Parrish and Delpachitra 2012). Such issues can be

⁸ Denmark's retirement provision is A-ranked and described as '[a] first class and robust retirement income system that delivers good benefits, is sustainable and has high level of integrity' (Mercer 2013:26).

prevented, to a certain extent, by ‘forced’ compliance associated with superannuation saving.

The second main reason the SG plays a stabilising role in the Australian economy is that superannuation reduces reliance on the Government’s age pension scheme. This then allows the Government to allocate their resources to other policies and programs (Bateman 2002). A third main reason for the SG stabilising role is that significant expansion of superannuation assets generates financial liquidity. This then boosts Australia’s local economy through the stock market, banking sector and infrastructure development (Inderst 2014).

When evaluating the characteristics of the superannuation industry, it would be inadequate if one fails to consider its long-term investment performance. Long (2010) observes that the annual compounded net return of Australian superannuation funds between 1997 and 2009 was 3.04%, which was only just above the inflation rate (2.8%) and lower than bank term deposits (4.5%) and the All Ordinaries stock market index (6.6%) during the period. Given the poor performance reported, it is most likely high management fees and expenses reduce net investment returns of superannuation portfolios (Basu and Andrews 2014; Sy 2011).

In 2013, superannuation assets were estimated to be over 100% of Australia’s GDP (RBA 2014), but would have been much higher if Australia had not been affected by the GFC (Deloitte 2013; RBA 2014). Accordingly, a short-term financial crisis, like the GFC of 2008/09 (and its damaging impact on superannuation balances), should not be taken as a decisive ground to reject the benefits of longer-term superannuation performance (Allen Consulting Group 2009). Workers accumulate superannuation savings throughout their working life; hence, it is appropriate to appraise the outcome of this form of investment over a similar period (Gruen and Soding 2011; Industry Super Australia 2014). Allen Consulting Group (2009:27) shows that regular positive

returns were achieved over the last 50 years, with the only exception being the aforementioned GFC – to which most financial assets fell victim.

Despite recent performance, it is evident that superannuation is a stable investment pillar supporting the Australian economy and will remain so into the foreseeable future. For instance, not only did superannuation tax revenue contribute approximately 2% of GDP in 2013/14, the Australian Government also saved at least \$AUD1.8 billion (which is the amount it would have spent on pensions if not for superannuation accounts) (Australian Government 2014; Treasury 2014). As a result of the Government's ongoing efforts to sustain growth in superannuation investments, Allen Consulting Group (2009) forecasts that dependency on the age pension will start to decline by the mid-2030s, and that by 2050, only 28.3% of the population age 65 and over will receive a full pension, 45.3% a part pension and 23.4% will not require a pension.

Besides its benefits to individual retirees and the Government's budget, superannuation also plays an important role in stimulating domestic and international investments for the capital market, banking sector and infrastructure spending. Hence, it promotes growth prospects of Australian businesses by enabling their expansion and diversification within Australia and overseas (RBA 2014). With a market capitalisation of over \$AUD1.84 trillion dollars and large annual flows, the positive impact of superannuation on capital markets is obviously significant. As a result of the introduction of SG in 1992, Australia's national savings rate (which historically had been declining since 1970) has made a strong comeback. In fact, superannuation's share in gross national saving rose from under 20% of gross national income in 1989 to 35% in 2013, arguably due to factors such as mandatory contributions, tax incentives and changes in retirement lifestyle expectations (RBA 2014). In 2014, superannuation was regarded by CPA (2013) as the biggest contributor to managed funds. Specifically, ABS

(2013) reported that superannuation funds as of June 2013 accounted for 73% of consolidated assets in managed funds⁹, while life insurance corporations, unit trusts, friendly societies, common funds and cash management trusts were responsible for the remaining 27%.

The superannuation and banking industries dominate Australia's current financial sector and have interconnected with each other through, for example, retail superannuation funds managed as part of banking groups' asset management businesses, financial consultancy and other services (RBA 2014). The 'big four' Australian banks¹⁰ have diversified into wealth management, expanding their investments to cover life insurance and funds management (Hall and Veryard 2006). Consequently, the big four now own approximately 55% of retail superannuation fund assets, allowing the banks to generate profits from management fees and also from sales of superannuation products (RBA 2014). There is also a considerable number of superannuation funds (mostly not-for-profit funds) outsourcing their management tasks, including asset management and custody, financial advice and insurance to external fund providers like banking groups (Donald et al. 2013). In line with this development, services to self-managed super funds (SMSFs) have proven to be a lucrative market, drawing increased attention from the banks (RBA 2014).

The traditional functions of the banking sector – borrowing and lending – also do not escape from the scope of influence of superannuation. About 15% of bank funds now flow from superannuation. In turn, Australian banks hold 25% of assets purchased through superannuation, particularly bank deposits. RBA (2014) indicates that there is a significantly higher rate of allocation in bank deposits by superannuation funds as compared to other OECD countries over the last decade. It is reasoned that

⁹ Consolidated assets consist of assets invested via investment managers.

¹⁰ The 'big four' refers to the four major Australian banking organisations, namely National Australia Bank, Commonwealth Bank, Westpac, and Australia and New Zealand Banking Group.

superannuation funds have made certain changes to their allocation policies by emphasising conservative investments, such as bank deposits, as a way of reducing fund exposure to stock market volatility following the GFC (RBA 2014).

The role of the superannuation industry in financing infrastructure projects¹¹ has also received extensive consideration in recent times (RBA 2014). The continuing improvement of infrastructure is of great importance to the Australian economy, as it enables more effective utility of production processes. Therefore, cost-effective investment will increase economic output as a reflection of higher capital generation and labour productivity (Industry Super Australia 2014). Discussion by the G20 on how to resolve fiscal constraints faced by Governments in funding for infrastructure, suggest alternative sources like superannuation. There is no accurate figure on the allocation toward infrastructure assets by Australian superannuation funds but it is expected to be between 5% and 6%, on average, in 2013 (Inderst 2014). This translates into a dollar value of approximately \$AUD70 billion to \$AUD85 billion of total superannuation investments (Inderst and Raffaele 2013).

Overall, Australia's SG is not just tackling age benefits but also fuelling capital market investment and becoming the benchmark for OECD countries. Most OECD members are struggling to sustain their public expenditures, unlike Australia, which has adopted both public and private funding systems to finance age pension benefits. The estimated OECD average of public expenditure on age benefits¹² was 7.8% of GDP, while Australia only spent less than 4% of GDP in 2012 (OECD 2013b). This demonstrates the relative success of Australia's retirement provision scheme in resolving the issues of an ageing population; thus, reducing the financial burden on the

¹¹ Infrastructure is defined by Industry Super Australia (2014:20) as '[p]hysical and organisational structures needed for an economy to function. This includes roads and other transport networks, energy and communication networks, water and sewerage systems, as well as the health and education systems that build and preserve human capital.'

¹² The benefits from the public account are mainly comprised of pension benefits, operational expenses and insurance charges (OECD 2013b).

Government and taxpayers and allocating funds to productive sectors of the economy (e.g., schools, hospitals, infrastructure, etc).

Superannuation plans

Superannuation contributions are allocated into two main superannuation plans: (1) defined benefit (DB); and (2) defined contribution (DC) (or ‘accumulation’), and have been established to comply with Australian Prudential Regulatory Authority (APRA) requirements and SIS legislation. Based on the nature/activity of the plan, the construction and formation of each investment portfolio can be varied but are generally classified in terms of risks faced and contributions made by employers and employees.

The defining characteristics of a DB plan are quite complex, even in its simplest form. The calculation of DB plan benefits essentially involves three factors: (1) salary (which can be an average over five years or the amount of final salary, depending on each fund provider's formula); (2) years of service; and (3) notional taxed contribution rates. Additionally, there are formulas for a normal retirement, resignation, termination, death and total and permanent disablement (QSuper 2013). The investment performance of the fund has no effect on employees' retirement benefits, as the fund operator bears all the risk. Upon the preservation age, eligible employees are generally offered two choices: withdraw a lump sum of their defined benefit or receive a regular income stream.

DB is designed based on the assumption that retirees, on average, live until 80 years of age (Bodie et al. 1988). Arguably, any increase to Australians' life expectancy will become a major threat to the financial viability of DB plans over time. This implies that DB fund members could bear the risk of administrative and investment costs which end up being greater than the benefits received. The government would also bear this risk, as DB fund members would have to fall back on the pension to cover any shortfall in retirement savings. Further, DB plans do not offer much flexibility when it comes to

employment termination and portability. As discussed in Bodie et al. (1988), members have to forfeit their future indexation in the event of a career change; thus, reducing their total working life benefits. With DC plans, in contrast, members just rollover their investment savings when changing careers.

Because of their flexibility, DC plans¹³ have become the most common form of retirement saving since inception of the SG. This plan allows members to accumulate savings over their working life but they cannot access the lump sum of their accumulated contributions and investment returns until preservation age.¹⁴ Unlike DB plans, an employers' obligation to their employees' accumulation retirement plans is discharged after they comply with SG mandatory contribution requirements; hence, employees in DC plans are expected to bear all the systematic risks associated with financial market investments (Bodie et al. 1988). Brown et al. (2004) describe this phenomenon as 'risk transfer costs', which are any cost associated risks that are transferred from employers to employees. If members in DC plans fail to achieve their retirement goals, the government will have to compensate any shortfall in their savings with social security benefits. However, as a result of DB and DC plans, the amount of retirees receiving full pensions will be reduced considerably in the future (Allen Consulting Group 2009).

Often employees in DC plans are provided with various types of investment options so that they can directly align personal objectives/preferences with their risk tolerances. For example, UniSuper offers two investment options to their members, namely pre-mixed and individual asset class options. These two options allow members

¹³ Once contributions have been made into an account, any access to these savings prior to retirement can be penalised/taxed at the highest tax rate of 45%. Individuals may obtain access to their superannuation accounts when they reach 55 years of age (the preservation age) with a tax penalty (taxed at a concessional rate) and 60 years of age without a tax penalty. However, the preservation age will be increased from 55 to 60 years of age between 2015 and 2025 (Australian Taxation Office 2014e).

¹⁴ Upon retirement, former employees are entitled to withdraw their superannuation as a lump sum, an annuity or the combination of both; with some taxation implications for those aged less than 60 years old (Australian Taxation Office 2014f).

to gain exposure to investments such as Australian government bonds, Australian income shares, Australian shares, cash, global companies in Asia, global environment opportunities, international shares, listed property, sustainable high growth and diversified credit income (UniSuper 2015). Pre-mixed options are designed and managed by the fund provider to achieve a diversified blend of investment choices to satisfy a range of retirement preferences. The degree of risk, member suitability, performance objectives, recommended investment timeframe and expected return/loss are provided to assist members in making informed decisions. Pre-mixed options include balanced, capital stable, conservative balanced, growth, high growth and sustainable balanced investment strategies (UniSuper 2015).

Alternatively, members can construct their own investment portfolios with individual asset classes. This second option is commonly referred to as ‘Do it yourself’ (DIY). With DIY options, members are required to monitor and manage their asset allocations (UniSuper 2015). Other fund providers, like Australian Super, even allow members to select their preferred ASX 300 listed stocks, exchange traded funds (ETFs) and term deposits (AustralianSuper 2015). However, if employees fail to select their preferred choice of investment, they are generally placed into a balanced, ‘default’ option, which is designed to capture a wide variety of domestic and international asset classes (AustralianSuper 2015; UniSuper 2015).

The distinctive characteristics of DC plans are that both employers and employees can contribute to the employees’ retirement account. For example, DC plans allow employees to make voluntary contributions, with tax incentives based on their income and eligibility, as noted in an earlier section of this paper. Prior to the reform of superannuation in the 1980s, most plans were DB orientated. However, as DC plans have become more prominent over time, DB options have been gradually reduced or closed, especially to new members (AMP Capital 2012). For instance, APRA (2014)

shows that total superannuation assets consisted of an 83.6% (or \$AUD891 million) allocation towards DC funds, with only 16.4% (or \$AUD176.6 million) allocated to DB funds. As such, the rising dominance of DC schemes has driven fundamental change in the Australian superannuation system. The aggressive shift to DC plans has resulted in individual members having to bear more responsibility than their DB counterparts regarding retirement savings, particularly when determining choice of fund, risk tolerances and asset allocations.

DC and/or DB plans are commonly offered by the following five superannuation entities: (1) public sector funds; (2) corporate funds; (3) industry funds; (4) retail funds; and (5) self-managed funds (APRA 2005; Choi et al. 2002; Drew and Stanford 2002). Public sector funds are superannuation entities operated by agencies or business enterprises largely owned by the Government. As such, public sector funds are limited to public sector members only. DB plans used to be widely exercised within these funds but contributions can now be made through DC and/or mixed DB/DC plans. Examples of public sector funds include the Commonwealth Superannuation Scheme (CSS) and Public Sector Superannuation (PSS) (APRA 2005).

Corporate superannuation funds are sponsored by a single employer or a group of different companies banding funds together for the benefit of company employees. Although some corporate funds are made available to the public, the majority of them remain non-public offer. Corporate funds have also moved away from DB plans and are now offering DC plans or a combination of both. The Trustee Board is designed to have equal employer and member representation, thus ensuring equality of power when it comes to investment decision-making (APRA 2005).

Industry funds are associations of 'not-for-profit' companies who represent industry members and manage large pools of superannuation funds. The nature of industry funds is similar to corporate funds, both having standard employer sponsors

and high member participation rates. This is because industry funds were traditionally not available to the public but most have become more commercial in recent years. This could also explain their increasing efforts to create more products for customers within the superannuation industry. Examples of industry superannuation funds are UniSuper, HESTA, CBUS and HostPlus, which are tertiary education, health, construction and building, and hospitality funds, respectively (APRA 2005).

Being described by Clements et al. (2006) as the largest and fastest growing investment vehicles within the industry, retail superannuation funds are managed by banks, fund managers and insurance companies and therefore operate on a commercial ‘for profit’ basis. The primary focus of retail funds is to offer a wide range of wealth management products to the general public. Retail funds consolidate a number of sub-funds into one large investment portfolio with single corporate trustees and trust deeds, known as ‘Master Trusts’. These pooled accounts enable numerous individuals and companies to participate (APRA 2005).

Finally, self-managed superannuation funds (SMSFs) are small, tailor-designed funds with a maximum of five members, all of whom must be trustees of the fund. Contributions can be made to SMSFs from trustees within the fund, self-employed businesses, and/or those employed by their own company. SMSFs are growing rapidly due to greater flexibility in investment choice, tax advantages and use of leverage (i.e., instalment warrants and property investments) (APRA 2005).

Table 1 illustrates specific details of the superannuation funds mentioned above. Notably, superannuation assets total \$AUD1.62 trillion. By June 2013, SMSFs and retail funds had become the first and second largest funds, respectively, accounting for 57% of the total assets under management. It is also noted that SMSFs have grown at an impressive rate, increasing from less than \$AUD280 billion in 2004 to over

\$AUD508 billion in June 2014. On the other hand, most corporate funds have outsourced their investment management to retail funds over time (Chant et al. 2014).

[Insert Table 1]

The *MySuper* initiative

The losses experienced in the aftermath of the GFC led to a major review (see Cooper 2010a; Cooper 2010b) of the management and performance of superannuation accounts (Ahmadi Pirshahid et al. 2013). The Cooper review identified several weaknesses impacting on the performance of superannuation funds, and consequently, net returns on retirement savings. These include lack of member awareness, unreliable and/or misleading financial disclosure, poor management of funds, high management fees and product complexity.

While the Australian Securities and Investments Commission (ASIC), APRA and Australian Taxation Office (ATO) may have authority to regulate superannuation funds' managers, their roles do not yet have much influence over fund performance. Regardless of the fact that superannuation is the backbone of Australia's social policy scheme, Cooper (2010a) notes that the management of superannuation funds have been almost privatised and there is no national default fund operated by the Government. Therefore, this could explain some of the issues encountered with 'default options', such as the lack of accountability, comparability and transparency within the system, inadequate accounting and financial disclosure and the high level of management fees and charges incurred across the Australian superannuation industry (Cooper 2010a, 2010b).

By recognising the limitation of default options, a cost effective product called '*MySuper*' was introduced to the superannuation system on 1 January 2013 (Iskra 2012). The ultimate goals of *MySuper* are to enhance competition within the superannuation industry, achieve cost effective fees for members within the existing

default investment structure, and become the centrepiece product for compulsory superannuation (Charaneka and Ebsworth 2013; Cooper 2010a; Gruen and Soding 2011; Minifie 2014; Sy and Liu 2009). The following sub-sections discuss the Australian superannuation default fund environment and investment strategies employed following the establishment of the *MySuper* regime.

Regulatory structure

Most DC members are offered investment choices at the commencement of their employment; however, the vast majority choose to disengage (Warren 2008; Gallery, Newton and Palm 2011). Consequently, such superannuation accounts are placed in default options (Iskra 2012). This disengagement by new members could be due to system complexity, members' lack of financial literacy (Cooper 2010a) and/or employees' perception of default options having their employers' endorsement (Beshears et al. 2009). As such, the *MySuper* initiative offers a number of features designed to assist members who do not wish to engage in their superannuation investments and prefer to be part of a large, 'diversified' superannuation fund.

MySuper's characteristics, as described by Cooper (2010a), are specific requirements for trustees to: (1) deliver low cost outcome for members; (2) aim for better transparency and comparability, particularly in regard to long-term net performance; (3) provide intra-fund advice and effective communication; and (4) offer embedded retirement products. Although *MySuper* has been designed as a simple, diversified and cost effective product (Gruen and Wong 2010), trustees' responsibilities for making investment decisions in the best interests of their members remain high priority. While Weaver (2005) found that asset allocation of default fund options consist between 70 to 90 per cent equities, there are no regulatory rules or restrictions on how trustees approach investment strategies, risk profiles or asset allocations (Productivity Commission 2012). However, as part of the reform agenda, *MySuper*

places strong emphasis on trustees' disclosure of the degree of investment risk, expected return and the justification of what investments are suitable for its members.

There are several key policies and regulatory requirements for *MySuper* products (Treasury 2011). First, each registered trustee can only offer one *MySuper* product licenced by APRA but exceptions are permitted in some cases. By 1 July 2017, trustees are required to transfer all accrued default superannuation amounts to an authorised product, although *MySuper* products have been made available since 1 October 2013. These arrangements will provide full benefits of *MySuper* to all default option members, while allowing time for industry to process the transition. It should be noted, however, that existing members' accounts related to defined benefit schemes or certain other legacy products are not affected by these changes. Second, in relation to investment strategies, products can be offered as either a diversified balanced or lifecycle option. No age restrictions are placed on members who wish to select a lifecycle strategy. Also, lifecycle strategies can be varied across four different age groups.

Third, *MySuper* fund providers must deliver a single diversified balanced option with a standardised set of fees, whereas lifecycle product fees can be priced differently across four age groups. Further, funds have the freedom to offer a discounted administration fee to corporate plans that are negotiated on behalf of employees. For instance, tailored *MySuper* products (which may have different fees, member services and investment strategies) are allowed to be offered to employers with more than 500 employees. However, details of such tailored products and discount administration fees must be reported to APRA and also made available to the public.

Fourth, fees are generally restricted to administration, investment (with some allowance on performance-based fees) and transaction fees (i.e., buy/sell spreads, exit and switching fees etc.). Fifth, and similar to standard superannuation compliance,

funds regulated by APRA¹⁵ must disclose: net returns based on the standardised *MySuper* guidelines; the number of times they have achieved their investment targets; other relevant information (e.g., average fees per member, liquidity etc.); and expected taxation consequences. Finally, default life and total and permanent disability insurance must be offered on an ‘opt-out’ basis. Some funds may also offer additional coverage and other products such as income protection insurance. Such costs are simply deducted from members’ accounts.

A survey conducted by Chant et al. (2014:7) reports that as of March 2014 there were 120 superannuation fund entities registered for *MySuper* products and two thirds of these were in the industry and corporate sectors. Despite the fact that most retail providers have become trustees for the majority of corporate funds in terms of investment management, only a few of the larger retail providers have been permitted to offer multiple *MySuper* products. Also, retail funds have shown more interest in offering lifecycle products than others, particularly corporate and industry funds who, on the whole, have simply rebranded their existing default funds to satisfy *MySuper* requirements. Notably, retail providers offer 17 out of the 23 lifecycle products available, being the largest distributor in the market.

Investment strategies

Under section 52(f) of the SIS Act 2003, trustees must formulate investment strategies in the best interests of their beneficiaries (members); that is, minimising risks and maximising returns in an ethical manner (Drew and Stanford 2004). To assist in making these investment decisions, financial experts such as consultants and advisors are

¹⁵APRA is also required to publish quarterly information on net returns for *MySuper* products (APRA 2012; Shorten 2011).

usually engaged in the construction/management of superannuation portfolios (Drew and Stanford 2003). Similar to the existing default options, *MySuper* fund providers have different investment portfolios designed but most are consistent with the diversified, ‘balanced’ approach.

In an examination of the strategic asset allocation of *MySuper* products, the survey of Chant et al. (2014:8) shows that most *MySuper* providers allocate over 70% of their portfolios to growth assets, which is consistent with Weaver’s (2005) study (as mentioned previously). Within the growth assets, equity investments are weighted approximately 52% (consisting of 27% domestic shares and 25% international shares) of the total asset allocations. These figures suggest that equities are still the dominant asset class in terms of weighting and influence over the performance of Australia’s retirement savings. Besides traditional equity investments, the study also reports a variety of growth asset classes included in *MySuper* portfolios, such as infrastructure, private equity, hedge funds and commodities. Global growth properties (both listed and unlisted), international inflation-linked bonds, currency hedging and other alternative securities¹⁶ are also included in *MySuper* investment strategies (Chant et al. 2014).

In addition to passive and active management of funds, research shows that the allocation of assets within the portfolio is also important. For example, there is evidence to suggest that balanced portfolios, which tend to have only a moderate allocation to equities, may not be optimal. Sy and Liu’s (2009) study focuses on a comparison between passive and active management of funds. Sy and Liu support the diversification benefits offered by balanced portfolios and claim passive management funds are more optimal for investors because of their lower transaction and management costs. This finding is consistent with a single, diversified and low-cost

¹⁶ Non-traditional alternatives are responsible for approximately 20% of the growth assets invested (Chant et al. 2014).

MySuper product; however, whether this is an appropriate default portfolio for disengaged members remains to be seen. In an attempt to investigate how different asset allocation strategies for U.S. 401(k) plans impact retirement investment outcomes, Poterba et al. (2006) find that, at modest risk aversion, the expected utility of a 100% allocation to an equities investment allocation strategy tends to be much higher compared to conservative strategies. Basu and Drew (2010) further explain that a high allocation to equities offers better promise for investors in achieving their target retirement savings. This is because equity investments have historically outperformed fixed income securities over longer time periods. They also explain that a high concentration in equity investments is actually less risky on most occasions if risk and return are calculated over longer time periods.

Another option associated with *MySuper* is called ‘lifecycle’ investing. Lifecycle investing provides trustees with more flexibility in allocating members into different investment mixes based on age (Productivity Commission 2012). A lifecycle approach aims to reduce sequencing risks, particularly concerning the possibility that members may suffer a great loss in their savings when it matters most (i.e., near retirement) (Chant et al. 2014). An underpinning assumption is that members become more risk-averse with respect to their investment performance as retirement approaches. Therefore, lifecycle strategies focus heavily on growth assets when members are young but then shift to more conservative assets as they approach retirement age (and for whom wish to preserve their capital). Although lifecycle options may deliver lower expected returns in comparison with balanced options, it provides potential for lower effective fees when viewed on an asset-weighted basis.

The implementation of the lifecycle option falls into two different categories, namely member switching and cohort funds (Mercer 2014:4). For member switching, fund providers employ existing balanced options and systematically shift members

from the aggressive options to the more defensive ones as they grow older. Unlike the lifecycle switching approach, cohort funds focus on grouping members with similar characteristics (mainly based on their age and circumstances) in pursuit of generating higher returns for its members. The main criterion for grouping members together is based on the date at which members expect to retire. However, Mercer (2014:5) argues that not all members know their expected retirement dates; therefore, an alternative approach for grouping members is based on their date of birth.

Basu, Byrne and Drew (2011) assert that the conventional lifecycle strategy may actually prevent members from achieving greater returns when their investment portfolios grow larger. The lifecycle strategy may also undermine members' wealth accumulation objectives, particularly if they are switched into conservative assets before they can accumulate adequate retirement savings. It is important to lower the degree of investment risk and prevent unnecessary volatility as members approach retirement but not at the expense of meeting long-term retirement objectives. To overcome this issue, Basu, Byrne and Drew (2011) propose a dynamic lifecycle strategy that places strong emphasis on satisfying members' retirement targets. Unlike conventional lifecycle strategies, the dynamic lifecycle strategy enables fund managers to move assets in both directions, from high growth to conservative assets and *vice versa*. Their findings suggest that not only does the dynamic lifecycle strategy have a higher probability of performing better than the lifecycle strategy but also has a reasonable chance of outperforming a 100% equity strategy.

Overall, the motivation behind *MySuper* is to help disengaged members participate in an economically simple investment option and to mitigate unnecessary risk. The introduction of the lifecycle investment strategy provides an important dimension to the range of products offered in the market, as risk tolerance varies based on members' ages. However, it may not be straightforward for all members, as the

MySuper product offers different asset allocations and limited performance history. This also might lead to the emergence of a proliferation of cohorts with differing experiences and expectations over time – not to mention the concerns raised previously by Basu, Byrne and Drew (2011). Also, profit generated from superannuation funds can be varied based on fund managers' performance and the amount contributed by members via their employers and/or voluntary contribution. Without a generally accepted benchmark of annual net return for *MySuper* options (both balanced and lifecycle options), there is a high possibility of failing to provide sufficient retirement benefits for members.

Conclusion

Australia's retirement provision system is comprised of three pillars, including the age pension, mandatory private retirement funds (i.e. SG), and voluntary contributions. This retirement system has changed dramatically over the past century as a result of ongoing collaboration between the public and private sectors, and continuous development of social and public pension policies. Since the introduction of the SG, superannuation fund coverage has grown significantly, with the ultimate aim of providing all Australian workers with adequate retirement savings. The system aims to satisfy the basic retirement needs of Australian people and facilitate investment choices for individuals. SG has been viewed as a major contributor to Australian economic growth. It injects tremendous amounts of retirement savings into financial institutions, enabling local investment communities to raise much needed capital; hence, providing an effective platform for investment and sustainable growth. Most importantly, in the face of an aging population, SG is believed to be the most viable solution to ameliorate financial losses derived from the reliance of age pensioners on national budgets.

Despite the increasing economic significance of superannuation due to the gradual increase of mandatory contribution rates, the system has not avoided scrutiny. The compulsory superannuation system has been criticised by researchers (Agnew, Bateman and Thorp 2013; Bateman 2003; Bateman et al. 2012; Borowski 2009; Chardin 2011; Gallery et al. 2011; Lusardi and Mitchell 2011, 2013; Samy et al. 2008) for its ignorance of those in less advantaged labour market positions. The benefits of superannuation funds are yet to reach many financially vulnerable and illiterate groups because of their limited capacity or unwillingness to engage and comprehend system complexity.¹⁷ As a result, the vast majority of superannuation members are being allocated into default investment options such as the *MySuper* initiative. This implies that fund managers will be responsible for generating investment strategies and portfolios which meet the diverse objectives and risk tolerances of many superannuation investors. Further, with the management of funds being shifted to trustees or fund providers, fund managers will increasingly play a vital role in investment outcomes, including the future retirement benefits of their members. This also infers that superannuation members will be exposed to greater risks; for example, market inefficiencies, principal-agent problems, high superannuation fees, and political/regulatory instability.

Although the Government has attempted to address these issues by introducing a simple, cost effective and diversified product such as *MySuper*, the effectiveness of this reform remains controversial. *MySuper* not only reflects the Australian Government's ongoing development of the superannuation system but also limitations of the system as a whole. The new regulatory environment aims to provide a general blueprint for APRA regulated funds to comply with, specifically disclosure of financial information

¹⁷ Arguably, the system has served higher-income earners well in terms of taxation benefits received, while those on lower-incomes have found it difficult to accumulate adequate retirement savings.

and performance standards. However, there is no standardisation in constructing *MySuper* investment strategies. Each superfund provider still exhibits a diverse and wide range of investment options, while gender inequality and members' low financial literacy and disengagement remains neglected.

The need for a better understanding of the Australian superannuation system is apparent, as empirical evidence does not currently support a thorough understanding of the issues raised in this paper. In order to gain a better understanding of the Australian superannuation system, empirical investigations could be carried out on gender inequality, superannuation funds disclosure and fee structures, operational and investment performance of passive and active investment strategies, financial literacy, and member awareness of relevant products and services. The importance of such research is clearly underpinned by the size and scope of the Australian superannuation industry (\$AUD1.84 trillion – the 4th largest system in the world and greater than national GDP). With so much at stake, failure to grasp the complexities of the evolving retirement system will clearly have long-term ramifications for the Australian economy and, more importantly, its people.

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Table 1: Superannuation entities

Type of Funds	Total assets (\$AUDb)	Number of funds	Member accounts ('000)
Public sector	256.90	38	3,337
Corporate	61.30	108	512
Industry	324.70	52	11,524
Retail	422.80	127	14,395
Small (included SMSF)	508.00	512,375	968
Pooled superannuation trusts (PST) ^(a)	99.40	61	-
Balance of statutory fund ^(b)	45.40	-	-
Total	1,619.00	512,761	30,736

(a) The trusts in which a number of regulated superannuation funds, approved deposit funds and other PSTs are invested and managed by fund managers. Investment income of the PST is taxed at concessional rate (APRA 2005).

(b) These are assets that are held for retirement purposes in statutory funds in life insurance companies, excluding any assets in life office statutory funds by superannuation entities.

Source: Adapted from APRA (2014)