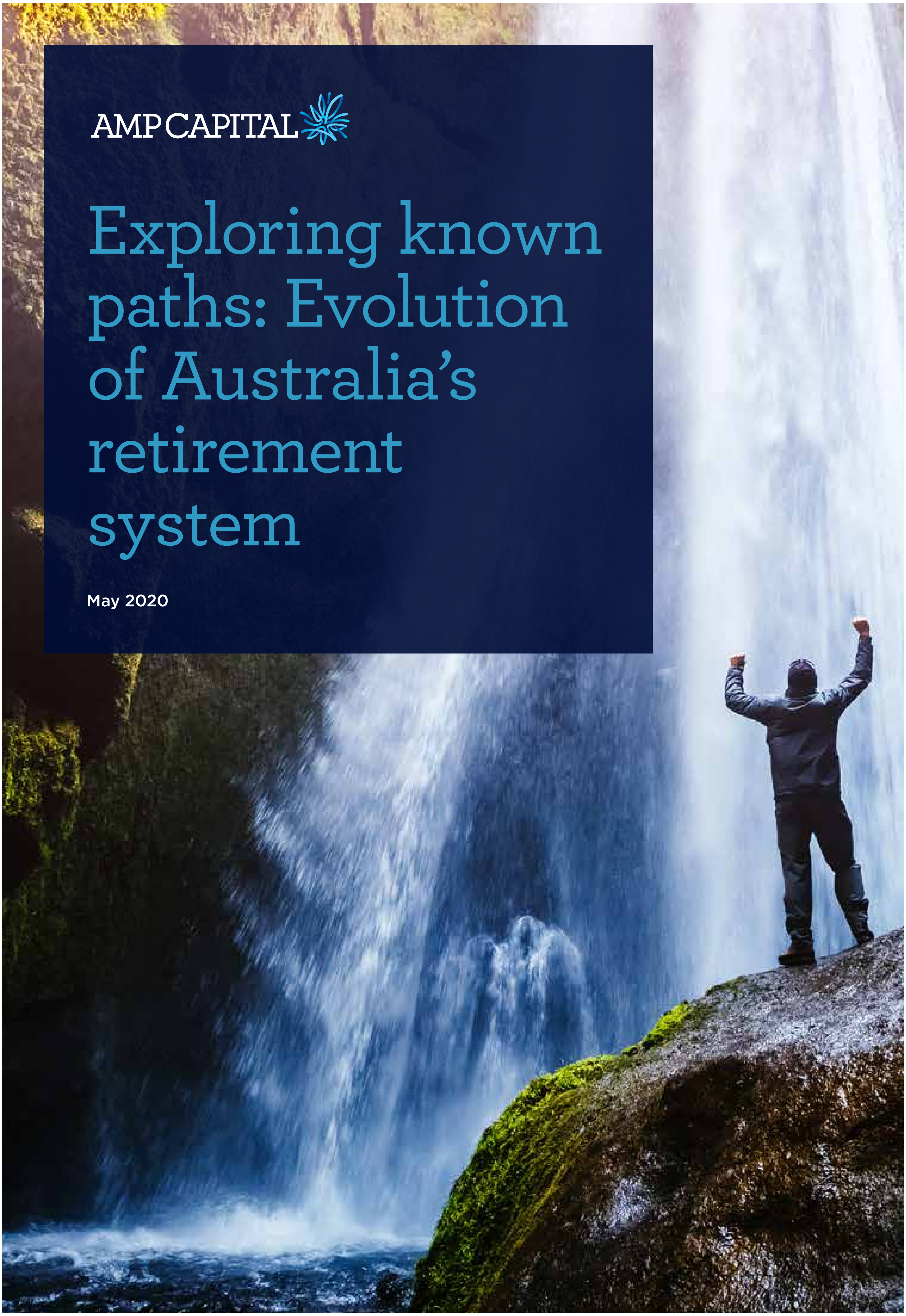
Exploring known paths: Evolution of Australia's retirement system

May 2020



AMP Capital

Japan is the world's third-largest market and a powerhouse of the global economy, particularly for commodity exporters like Australia. For years it has been a major exporter of automobiles, consumer electronics, computers, semiconductors and iron and steel. It has large chemicals, pharmaceuticals, textiles and processed foods sectors, mostly for internal markets.

Craig Keary
Director, Asia Pacific Region,
AMP Capital

For decades past it was also among the slowest growing of the major economies, but that has changed in recent years. Its traditionally volatile growth rate had steadied in the years ahead of the coronavirus outbreak.

Since 2011, the economy expanded at between one and two per cent annually, a slightly lower clip than Australia. But Japan's sheer size – worth around $US5 trillion each year or four times the size of Australia's economy – had a much larger impact on the rest of the world[1].

Its unemployment rate, ahead of the current crisis, had been declining for more than a decade and, at around the low twos, was the envy of most developed nations. Inflation was negligible.

But Japan has a challenge that while not unique, is more extreme and more urgent. Its ageing population.

Apart from the municipality of Monaco, the median age of citizens in Japan is higher than anywhere else in the world, at 46.9 years[2]. Australia ranks 57, and the median age is more than eight years younger. Around one quarter of the Japanese population is over the age of 65 years. This is expected to reach 40 per cent by 2060[3].

"Age support ratios" measure the number of working age people per pension aged person, and are commonly used to rank countries. Japan sits at the bottom of the list when it comes to youth.[4] The consequence is clear – Japanese workers have to either save substantially more or work longer to fund retirement incomes.

In many respects Japan leads the way focusing on challenges arising from an ageing population. But there is one aspect in which Australia may be able to provide a few ideas – compulsory retirement savings accounts, or as it's known in the land Down Under, superannuation.

1 https://data.worldbank.org/indicator/NY.GDP.MKTP.CD?locations=JP

2 http://world.bymap.org/MedianAge.html

3 https://data.worldbank.org/indicator/SP.POP.65UP.TO.ZS

4 Images.content.deloitte.com.au/Web/DELOITTEAUSTRALIA/%7B36820ccf-af06-4814-a79b-3b7364d80d96%7D_Deloitte's_Dynamics_of_Australian_Superannuation_Report_2019.pdf

Schemes in Australia

Retirement incomes has always been part of the Australian government's remit. The Constitution signed in 1901 gave the Commonwealth explicit power to legislate for the provision of age and invalid pensions. In fact, almost 100 years ago in 1923, the government of the time established a powerful Royal Commission to examine the possibility of having a comprehensive national insurance scheme for retirement, sickness and disability[5].

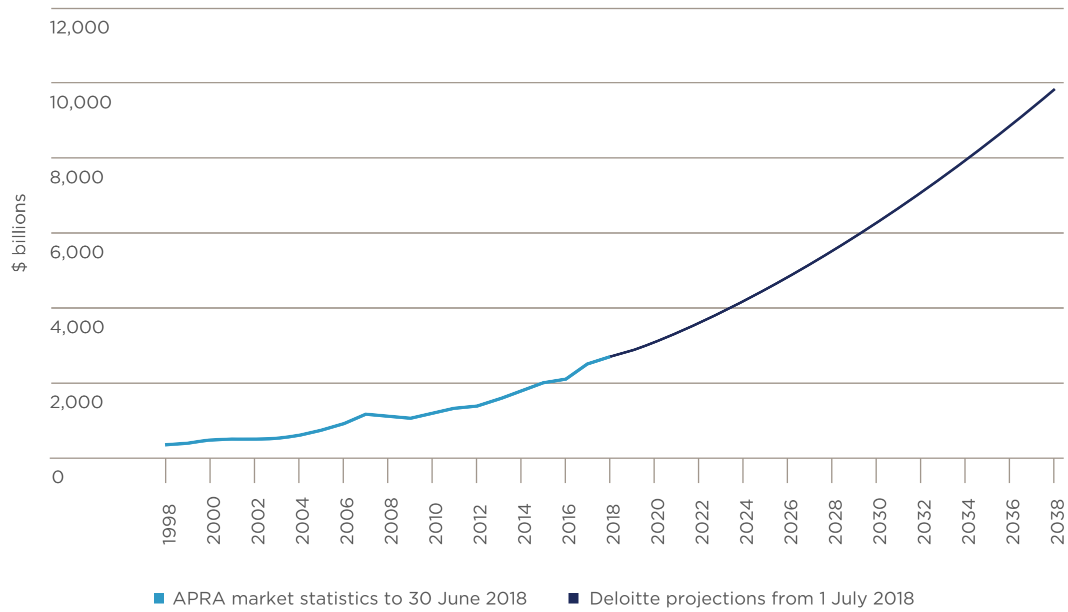
It wasn't until 1992 that a superannuation guarantee scheme was introduced. Under the legislation, employers were required to make contributions on behalf of their employees to a superannuation fund. Initially contributions were three per cent of wages, and that figure has grown over the subsequent decades to a minimum of 9.5 percent currently.

Back then, the size of the superannuation pool was estimated to be around AUD$148 billion (US$95 billion). At the end of last year, that number had risen to AUD$3.0 trillion (US$1.9 trillion). It grew by an annual compound growth rate of more than 10 per cent in US dollar terms over the past decade. Forecasts suggest the pool of superannuation assets will reach AUD$10 trillion over the next two decades[6].

"These projections reflect the legislated increases in the Superannuation Guarantee from 9.5 per cent to 12 per cent by July 2025," says Diane Somerville, principal at Deloitte Actuaries & Consultants in a report released ahead of the COVID-19 pandemic.

"Despite this low interest rate environment, super fund returns continue to be strong," she says. "In spite of short-term volatility, funds have consistently earned robust returns over the medium term, ensuring average balances at retirement have increased. Add to this the fact that many members have received superannuation contributions for a significant proportion of their working lives."

Projected superannuation assets



Source: Deloitte, APRA, 2019

5 https://www.aph.gov.au/About_Parliament/Parliamentary_Departments/Parliamentary_Library/pubs/BN/0910/ChronSuperannuation

6 https://www2.deloitte.com/au/en/pages/media-releases/articles/dynamics-australian-superannuation-system-next-20-years-deloitte-analysis-271119.html

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Essentially, Australia's three-pillar retirement system[7] is designed to address the funding issues associated with an ageing population. Its central pillars are represented in the below graph.

	Pillar 1 Public Age Pension	Pillar 2 Mandatory Private Savings	Pillar 3 Voluntary Retirement Saving
Key facts	**Means-tested, tax-financed age pension**	**Funded by individual DC accounts provided by superannuation funds** **Employers must contribute at least 9.5% of salary into superannuation pa**	**Individuals can contribute voluntarily to their DC accounts, with tax advantages**
Established	1909	1992	1850s
Funding	- General revenue (2.7% GDP) (current taxpayers) - 2006 - Australian Future Fund established to meet future liabilities	Employer contribution	Employer/personal contributions, government co-contribution (if eligible)
Contribution	Non-contributory	Minimum 9.5% of gross salary	Voluntary
Statutory tax rate	Subject to personal income tax with relief through offsets	Flat 15% on contributions & 15% on earnings	Tax of 0% (after-tax contribution) or 15% (before-tax contribution), and 15% on earnings
Potential coverage	For all residents, available to males aged 65 and over and females aged 63.5 and over, subject to means tests (income and assets	Employees aged 18-70 earning at least A$450 per month	Overall tax concessions (since 1915), salary sacrifice, government co-contribution for employees and self-employed on low incomes
Actual coverage	- ~ 68% of persons of eligible age receive some Age Pension - ~56% of age pensioners receive the full rate of Age Pension	- Mandatory and voluntary - superannuation covers over 90% of Australia's workforce: 96% full time employees, 80% part time employees, 73% casual employees and the self-employed	
Administration	Centrelink (Government body)	Individual accounts in privately managed superannuation funds	
Benefit	Flat-rate (no geographical adjustment) income stream payable for life with wage indexation, level of benefit depends on marital status and subject to means tests (income and assets)	Choice of lump sum or income stream, level of benefit depends on contribution rate, salary/wage, investment returns and period in workforce, benefit is preserved to age 55, no early withdrawals	

Source: AMP Capital

7 https://www.charteredaccountantsanz.com/member-services/technical/superannuation/retirement-income-framework

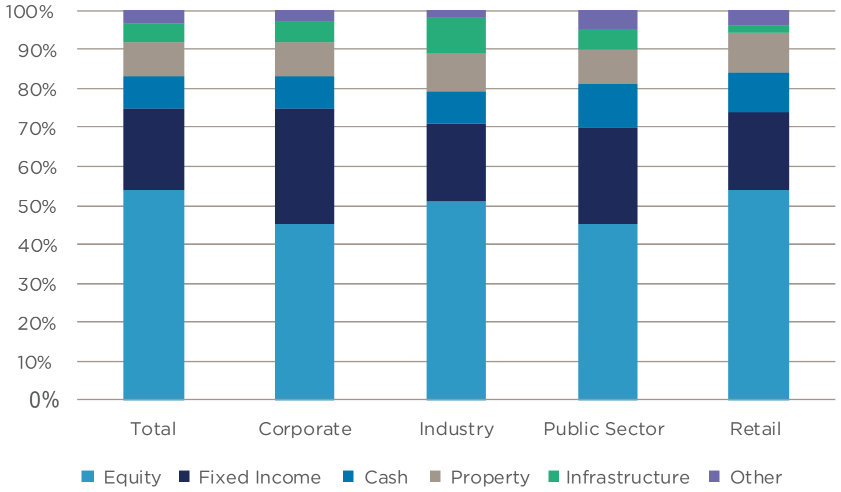
8 https://www.willistowerswatson.com/en-US/news/2019/02/global-dc-pension-assets-exceed-db-assets-for-the-first-time

9 APRA

As of February 2019, Australia was the world's fourth-largest pension funds market and had the highest growth rate of pension fund assets in the world[8].

The Australian system has led the way in defined contribution (DC) funds, as opposed to defined benefit (DB) funds. Around 86 percent of its total pension assets are in DC funds after DB funds were phased out more than 20 years ago[9].

Superannuation allocation estimates, Australia



Source: AMP Capital

The predominance of DC funds is critical to the success of the Australian pension fund model. Fears about unfunded liabilities triggered the government decision to end DB funds. As a result, the onus of retirement savings is on individuals and employers, rather than the federal government.

The pace of growth of pension assets is demonstrated by the level of pension assets to gross domestic product. Ten years it ago in Australia the ratio was 67 percent[10]. Today it's 150.9%[11].

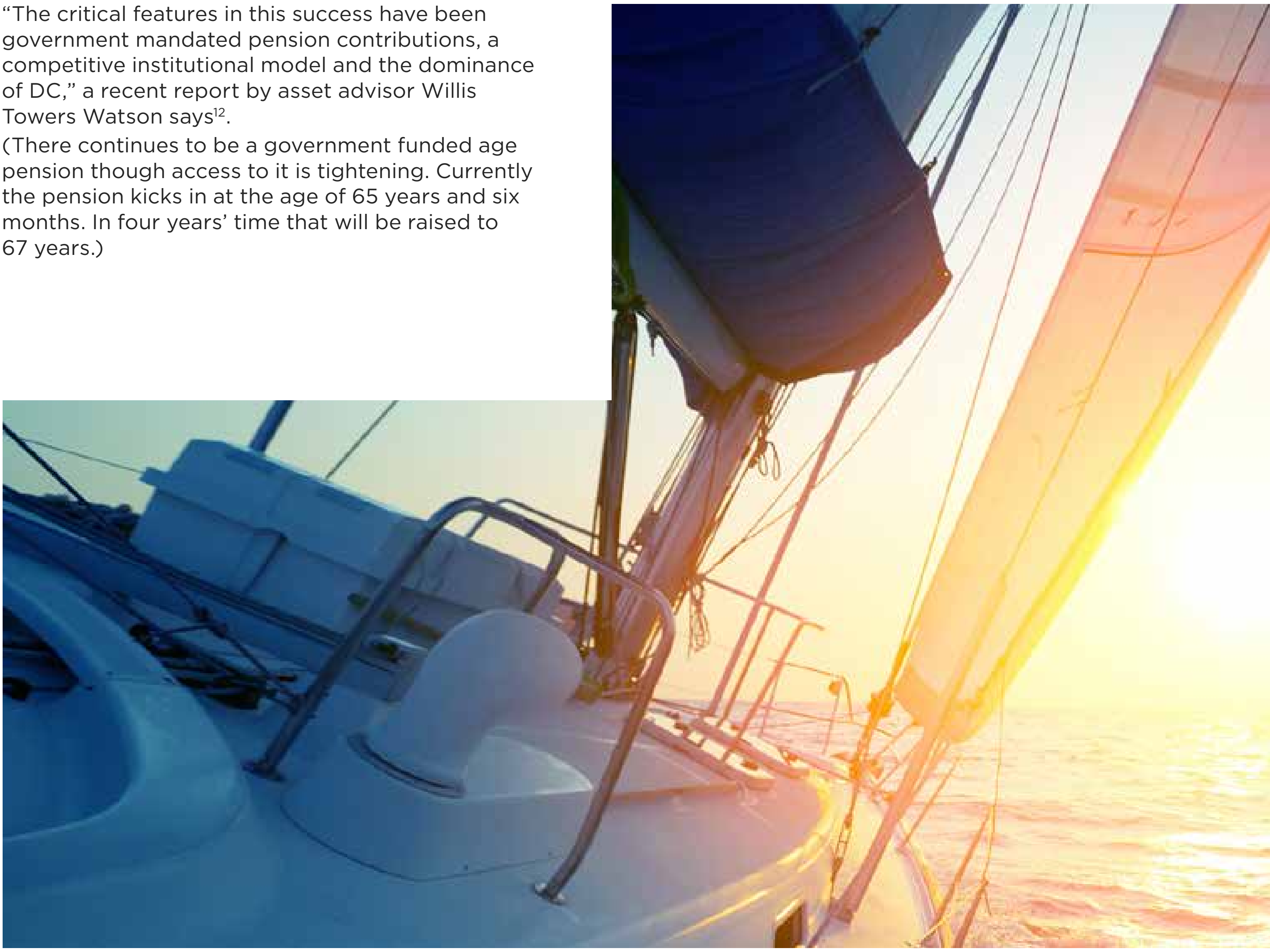
Pension Assets by Market

Market	Total Estimated Assets 2019 (USD bn)	Assets/GDP Ratio (%)
US	29,196	136.20%
Japan	3,386	65.70%
UK	3,451	125.80%
Australia	2,077	150.90%
Canada	1,924	111.20%
Netherlands	1,690	187.30%
Total	41,724	131.00%

Source: WTW, Global Pension Assets Study – 2020

"The critical features in this success have been government mandated pension contributions, a competitive institutional model and the dominance of DC," a recent report by asset advisor Willis Towers Watson says[12].

(There continues to be a government funded age pension though access to it is tightening. Currently the pension kicks in at the age of 65 years and six months. In four years' time that will be raised to 67 years.)



10 https://www.austrade.gov.au/news/economic-analysis/australia-has-the-fourth-largest-pension-fund-assets-in-the-world
11 https://www.thinkingaheadinstitute.org/-/media/TAI/Pdf/Research-Ideas/a_public/GPAS_2020.pdf?modified=20200205113453
12 https://www.willistowerswatson.com/en-US/news/2019/02/global-dc-pension-assets-exceed-db-assets-for-the-first-time

The strong growth in superannuation has led to the development and maturity of a highly skilled and efficient managed funds industry, dominated by retail and union backed industry superannuation funds, and self-managed superannuation funds.

According to the regulator, the Australian Prudential Regulation Authority (APRA), self-managed super funds account for around 28 per cent of assets while retail funds hold 25 percent. Industry funds look after 23 percent of assets. Public sector and corporate funds hold the rest[13].

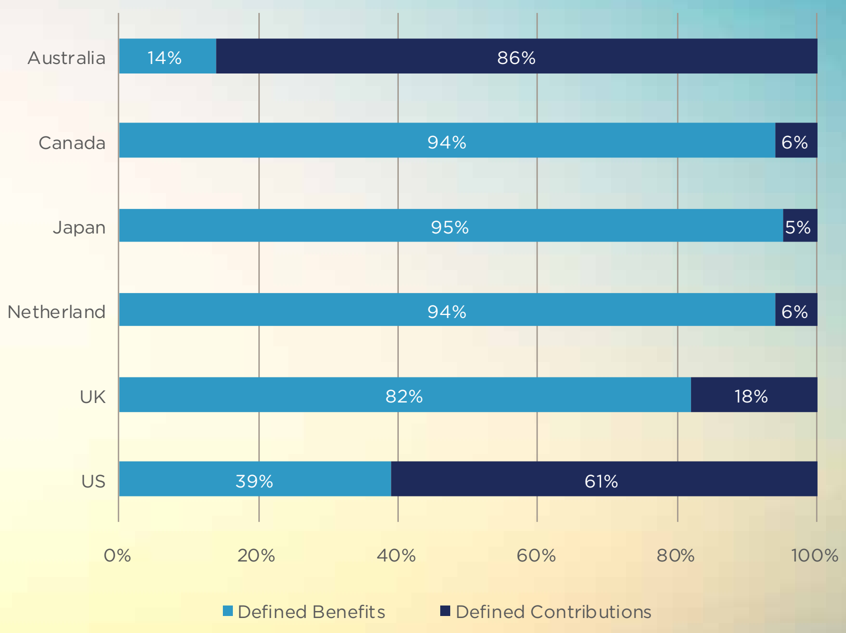
AMP Capital is a leading fund manager with assets under management of A$200 billion[14], serving institutional and retail investors as well as SMSF

Arguably the biggest benefit of Australia's managed funds industry being dominated by superannuation assets is that investors have a much longer time horizon. It means they can look through volatility, even extreme volatility such as financial markets have experienced in recent months. Unless an investor is close to retirement, superannuation is a very long-term investment, says AMP Capital chief economist Dr Shane Oliver.

"As we've seen recently, growth assets like shares have periods of bad short-term performance versus bonds and cash. But they provide superior long-term returns which is essential to grow retirement savings. It makes sense for superannuation to have a high exposure to them," he says. "Our approach is to simply recognise that super and investing in shares is a long-term investment."

The financial performance across the Australian superannuation sector has been strong. The five-year average annualised rate of return during the past five years – a low interest rate environment – was between 6 percent and 9 percent[15]. As at the end of December 51 percent of assets were invested in local and international equities, 31 percent in fixed income and cash investments, and 14 percent in property and infrastructure. Other assets, primarily hedge funds and commodities accounted for 3 percent.

Top Global Pension Assets – DC/DB split (%)



Source: WTW, Global Pension Assets Study - 2020

13 APRA

14 As of 31 December 2019. Represents draw down amount on a fully funded basis.

15 https://www.apra.gov.au/sites/default/files/2020-02/Quarterly%20superannuation%20performance%20statistics%20highlights%20December%202019.pdf

Asset allocation

The Australian system isn't without its faults. A report last year by the country's Productivity Commission said that the super system needed to adapt to better meet the needs of the modern workforce and growing pool of retirees.

One structural flaw, which emerged from the introduction of compulsory superannuation, was the creation of myriad of accounts per person. Most times someone changed jobs, they needed to fill out the paperwork to change superannuation funds. Often they didn't, so would end up in the default fund from their new employer. It meant hundreds of thousands of workers had two or more superannuation accounts and were paying fees in each of them.

The report also shows that some funds achieved high net returns consistently, but others don't. The Productivity Report, APRA's analysis and comments of fund advisors all point to an Australian superannuation system of compulsory contributions that has held the economy in good stead.

Because the size of the asset pool is so large, the federal government is continually working to safeguard the system. As regulator APRA says in a recent report: "While Australians have reason to feel proud of the success of Australia's superannuation system in providing for retirement income, the need for review, refinement and reform continues."[16]

Late last year Federal Treasurer Josh Frydenberg announced a review into the retirement income system – a look at compulsory superannuation 27 years on. It will consider incentives for people to self-fund their retirement and the sustainability of the system. It's about continual improvement of the retirement incomes system.

16 https://www.apra.gov.au/superannuation-australia-a-timeline

Concluding thoughts

The superannuation system in Australia is ever-evolving. For example, in recent months, it has also taken on a temporary new role in supporting Australians. As a result of the COVID-19 crisis, the Australian government has allowed for two lots of $10,000 withdrawals, in this financial year and next, for those suffering from financial hardship. So far, about 1.2 million Australians have applied for early release of their superannuation. Though there are risks in early withdrawal of sacrificing future gains during recovery, this measure is demonstrative of the strength and magnitude of the system.

As a middle power in world economies, Australia can contribute only to a limited extent in global growth. Where it has proven to be a global leader, and an economy worth mirroring, is in establishing a retirement savings system that will last for decades.

To learn more about Australia's experience, please get in touch with us.

Visit Goals-Based Investing for more information on AMP Capital's retirement solutions.