AUSTRALIAN INVESTMENT COUNCIL

3 February 2020

Retirement Income Review Secretariat
The Treasury
Langton Crescent
PARKES ACT 2600

By upload to consultation website

Retirement Income Review Submission

Dear Sir / Madam,

As the voice of private capital in Australia, the Australian Investment Council is pleased to present its submission for the Retirement Income Review.

Private capital investment has played a central role in the growth and expansion of thousands of businesses and represents a multi-billion-dollar contribution to the Australian economy. Our members are the standard-bearers of professional investment and include: private equity (**PE**), venture capital (**VC**) and private credit (**PC**) funds, alongside institutional investors such as superannuation and sovereign wealth funds, as well as leading financial, legal and operational advisers. Our members include both Australian domestic and offshore-based firms.

Private capital fund managers invest billions of dollars into Australian companies every year. For the first time in history, Australian-based PE and VC funds under management reached $30 billion in 2018, testament to the growth in available capital to support investment into businesses across every industry sector of the economy. Fund managers secured an impressive $6.6 billion in new investment commitments in 2018, which means the industry now has a combined total of around $11 billion in equity capital available to be invested in the short-term.

The Australian Investment Council is supportive of policy initiatives and reforms that help to ensure our economy is competitive, innovative and able to support Australia now and into the future. In particular, we encourage reforms that assist Australian businesses to partner with private capital firms and enable private capital firms to help those business grow and expand. Our policy recommendations are aimed at lifting Australia's productivity and supporting investment to drive the development of skills and talent, productive capacity and innovation through technology.

We look forward to participating in any future discussion about the themes set out in this submission as part of the government's work as part of this Retirement Income Review. If you have any questions about specific points made in our submission, please do not hesitate to contact me or Brendon Harper, the Australian Investment Council's Head of Policy and Research, on 02 8243 7000.

Yours sincerely

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Introduction

An efficient retirement system is critical to help Australia meet the human and economic challenges of an ageing population.

This will require:

- Developing and maintaining a superannuation industry that is best in class on a global scale;
- Superannuation members who focus on high performing funds, rather than only fees and costs;
- Enabling the superannuation industry to participate in long-term investment;
- Importing lessons from overseas to identify where Australian superannuation outcomes could be improved.

The Intergenerational Report in 2015 showed as Australia's population continues to age it will be placing increasing pressure on the age pension. However, according to the Association of Superfunds of Australia (**ASFA**) the benefits of a maturing superannuation system are beginning to emerge with 43% of Australians expected to be self-funded in retirement by 2023. This compares to just 22% in 2000.[1] This highlights the need to ensure superannuants are focused on maximising and maintaining returns at, and into, retirement.

To achieve this goal, it is imperative that regulations do not unintentionally inhibit, nudge or motivate suboptimal or inefficient outcomes and that the policy settings encourage long-term investment that will have flow on benefits to the economy and retirement standards of living.

This submission focuses broadly on the following themes:

- Retirement adequacy and the unintended consequence of policy changes;
- Shifting the focus of disclosure settings from fees and costs to retirement outcomes;
- The growing pool of superannuation – asset allocation and the need for diversification;
- Compulsory superannuation; and
- What we can learn from other jurisdictions.

Retirement adequacy and unintended consequence of policy changes

A narrow focus on fees and costs is a lost opportunity

In the same way that a country cannot 'tax its way to prosperity', a pension system cannot 'bargain its way to long-term wealth'.

In response to concerns regarding the performance of some superannuation funds, policy makers and regulators have increased their focus on sector efficiencies and, in particular, inefficiencies. Much of this discussion has been focused on fees and costs, particularly regarding MySuper products. The Council is supportive of initiatives that increase efficiencies, such as consolidation of underperforming funds.

However, a narrow focus on fees and costs and promoting these as the key drivers of superannuation outcomes is misguided and is likely to ultimately lead to lower superannuation balances in retirement. This is because fees and costs are only one part of the performance equation. Superannuation fund performance is the product of both a fund's returns and its costs. Put simply:

Fund performance = returns less expenses

An investment option that is 'low cost' may not be 'high performing' due to having low returns. Policy settings, including commentary by regulators, can encourage or nudge superannuants to myopically focus on a fund's expenses.[2] This could lead to the suboptimal outcome of lost returns.

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[1] Better Retirement Outcomes: a snapshot of account balances in Australia ASFA July 2019

2 Examples include ASIC's Regulatory Guide 97 and APRA's Superannuation 'heatmap'.

Recommendation 1: A narrow focus on fees and costs is a lost opportunity
Government enhances policy settings, including disclosure settings for superannuation funds that encourage members to focus on their net retirement income, rather than fees.

Increasing financial literacy – More dialogue required on superannuation adequacy in retirement

Most Australians don't engage with their superannuation until they are approaching retirement. While entities like ASFA publish guidelines on the amount required for an adequate retirement, this amount is subjective because, by necessity, it is based on assumptions about individual facts and circumstances.

Earlier engagement in superannuation and having the right information to make informed choices on superannuation investments will help provide Australians with sustainable income in retirement.

Recommendation 2: Better information for superannuants
Enhance financial literacy programs and produce more user-friendly material in plain English to help educate and inform superannuation fund members on how to plan for retirement and the choices, risks and outcomes they can prepare for.

The tension between high liquidity and long-term investment

An unintended consequence of policy and regulatory changes in recent years is an increased (and problematic) focus on highly liquid, low-cost investment products in default superannuation funds and the implied need for superannuation funds to increase liquid holdings. Drivers of this include being able to facilitate the quick transfer of member funds between investment (and fund) options and the motivation to reduce headline fees. This has increased the weighting of superannuation funds to certain asset classes over others – such as listed equities and fixed income products.

However, it is questionable whether this strategy supports the objective of maximising long-term retirement outcomes to alleviate the pressure on government spending. Some illiquid assets which require active management, such as private capital, property and infrastructure are not considered 'low-fee' but have consistently delivered superior net returns to low-fee and passive asset classes over the long-term.

The long experience of US pension funds in this asset class provides a strong body of evidence on the consistency of long-term PE returns over multiple economic cycles. US public pension funds that invest in PE show an average return of 13% over five years compared to 10.9% for the S&P500 Index.[3]

Similarly, in Australia, PE and VC funds have provided competitive average returns of 15.2% over five years compared to 8.2% for the S&P/ASX300 index. However, due to the limited investment in private capital by Australian superannuation funds, these gains are increasingly being realised by overseas pension funds and sovereign wealth funds rather than Australian retirees.[4]

[3] American Investment Council Performance Update 2019 Q1
[4] Cambridge Associates Performance Benchmarks Q2 2019

US and Australian PE Performance – 5 years

US Pension Funds PE Investments [1]	13.0%
S&P500 Index Total Return	10.9%
Australian PE and VC Index [1]	15.2%
S&P/ ASX 300 index	8.2%

Sources: American Investment Council Performance Update 2019 Q1; Cambridge Associates Performance Benchmarks Q2 2019

Recommendation 3: Balancing the need for liquidity against long-term investment
The Australian Investment Council recommends consideration be given to balancing the need for low-cost and liquid investments and the benefits, both to superannuants and the nation more broadly, of longer-term investment options.

Australia's superannuation system is different and members are potentially missing out

Australia's superannuation pool is the fourth largest in the world[5] and represents a growing source of potential funding for Australian businesses, both directly and via private capital investment firms. However, there are strong differences in superannuation systems in other jurisdictions. This raises the question as to whether superannuants are missing out on potentially higher retirement balances.

As discussed above, alternative assets provide an opportunity to potentially increase superannuation funds' returns. The allocation of investment capital by superannuation funds into private capital firms has increased over recent years, with investments spanning a range of sectors across the economy. In addition to investing directly with private capital firms, superannuation funds are increasingly co-investing with private capital firms (investing alongside private capital firms). This illustrates Australian superannuation funds increased confidence in the management and performance of local private capital firms, and the strength of the pipeline of investment into great Australian businesses.

Notwithstanding these positive developments, superannuation funds' allocation to alternative assets remains low on a relative basis, at 19% of assets under management **(Figure 1**).[6] Within this 19% allocation, superannuation funds have historically had a bias towards real assets (real estate and infrastructure).

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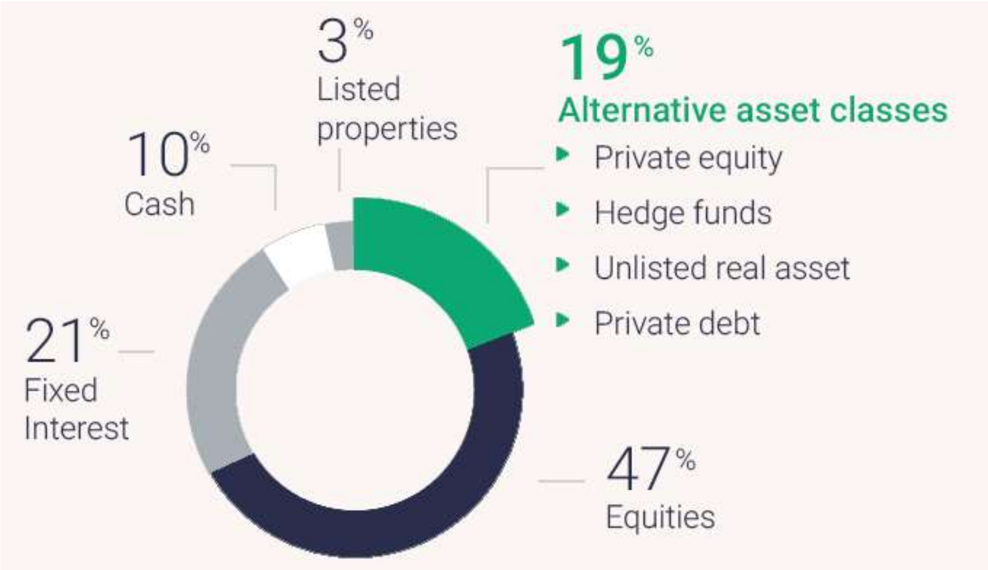
[5] Willis Towers Watson (2019) *Global Pensions Asset Study - 2019*
[6] EY (2019) *Will the rise of private capital tip the balance of investment power?,August*

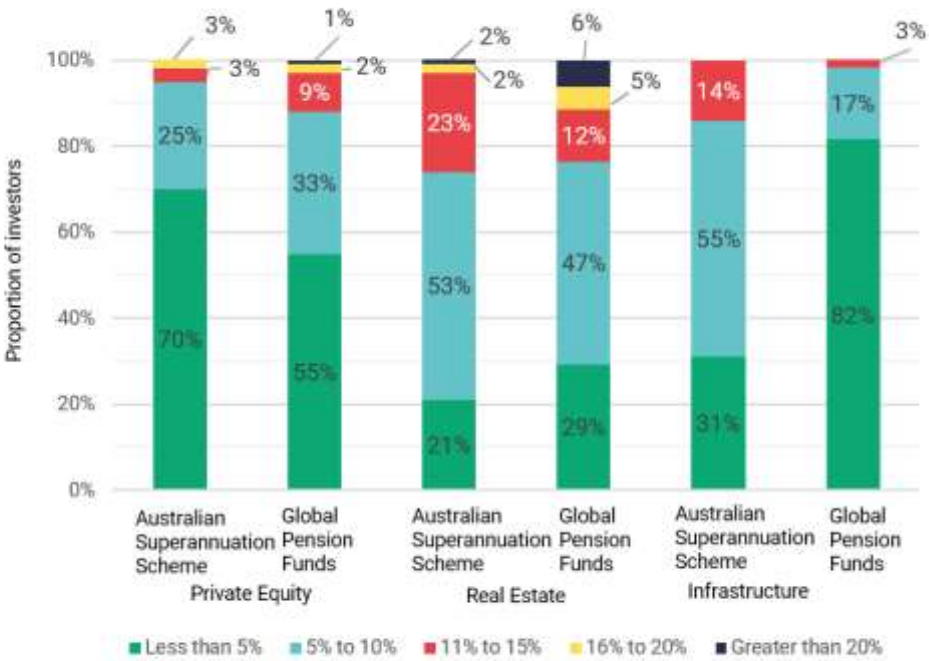
Figure 1: Superannuation Scheme Allocation



Source: EY (2019) *Will the rise of private capital tip the balance of investment power?*, August 2019

However, Australian superannuation funds have significantly less invested in private capital compared to global pension funds **(Figure 2).** While less than one third of Australian superannuation funds have 5% or more of their total assets allocated to private capital; global pension funds have 45% invested. In contrast, 69% of Australian superannuation funds have a 5% or greater allocation to infrastructure, compared to 18% of global pension funds.

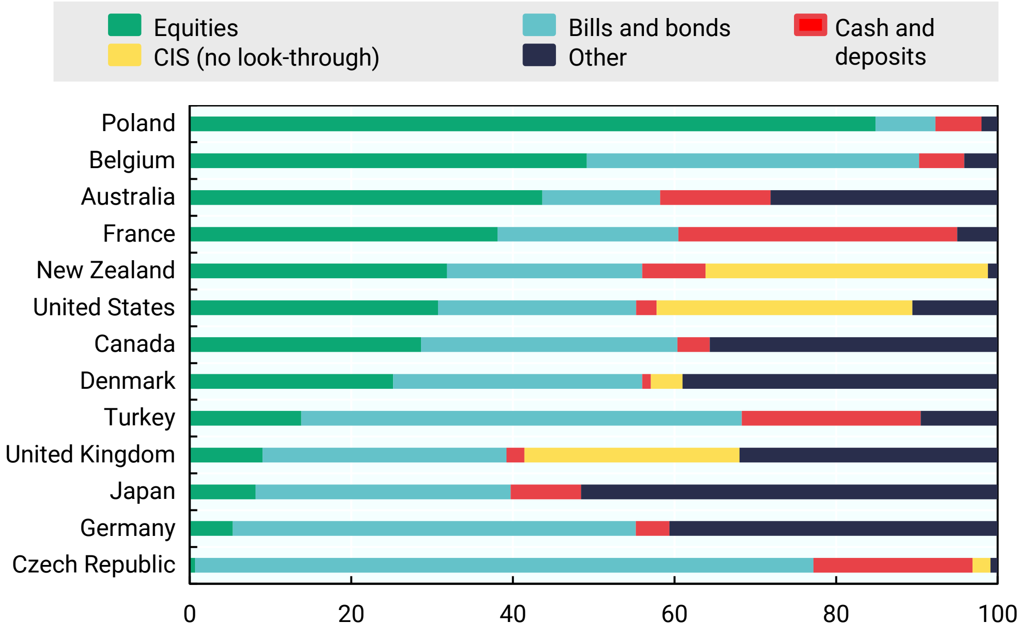
Figure 2: Current Allocations to Alternative Assets by Asset Class:
Australian Superannuation Schemes vs Global Pension Funds (as a % of Total Assets)



Source: Preqin (2018) *Australia' Superannuation Funds in Alternatives*, November

Also, out of line with most developed pension funds is Australian superannuation funds' 44% allocation to equities. (**Figure 3**).[7] This is especially true among developed countries with countries such as Germany, the UK, Canada and the US which retrospectively allocate 5.4%, 9.0%, 28.7% and 30.7% of assets under management to equities. This indicates that there is potential for Australia's superannuation funds to increase their allocation to alternative assets and in particular to private capital. However, there are some structural challenges in doing so.

Figure 3: Allocation of assets in funded and private pension plans in selected asset classes and investment vehicles, 2018 or latest year available



Source: OECD Global Pension Statistics.

One of the structural challenges stems from the increasing size of Australian superannuation funds. With larger balance sheets, the scale of investing into Australian startups and growth businesses can be rendered uneconomic and inefficient. This issue of 'increasingly big funds needing to write increasingly big cheques' will only be amplified with consolidation in the superannuation sector. While the fact that superannuation funds have increased participation in providing capital to Australian businesses, directly and via private capital funds, is a positive step forward, it is unlikely to meet the nation's entire growth capital demands over the long-term. As a result, offshore institutional investors will continue to play a major role in funding Australian businesses.

A number of technical and regulatory barriers also exist to superannuation funds increasing their allocation to alternative assets, such as rigidity of the new disclosure of fees and costs regime embedded in ASIC's Regulatory Guide 97. This issue, along with others, constitute important issues that government and regulators can address to help unlock the capacity of our domestic superannuation funds to allocate larger amounts of capital to support the growth of businesses in the unlisted sector of our economy. While outside

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[7] *OECD (2019) Pension Markets in Focus 2019, October*

the scope of this submission, the Australian Investment Council is able to provide further detail and insights to assist the government with future deliberations on this issue.

Recommendation 4: Explore options to better support Australian businesses
Government and regulators support the capacity of our domestic superannuation funds to allocate larger amounts of capital to support the growth of businesses in the unlisted business sector of our economy.

Compulsory Superannuation

The Superannuation Guarantee (SG) rate has been legislated to increase to 12% by 2025. However, we note that there has been considerable debate amongst some stakeholders on whether or not this should proceed.

Having certainty and confidence in the superannuation system is critical for the Australian community. Public debate often overshadows the fact that superannuation investment belongs to the 15 million Australians who invest their money with a professionally-managed and governed superannuation fund, and trust that that fund will provide them with the best possible financial outcome when they retire.

The age pension will continue to play a role for those Australians who are most in need. However, a continued commitment to increase the SG rate to 12% by 2025 with no further delays is the foundation for maintaining confidence in the system and for helping Australians self-fund their retirement.

As life expectancy continues to increase, ensuring the right policy settings are in place will be critically important. One area that will need consideration will be retirement income products that support late life health and accommodation requirements.

What we can learn from other jurisdictions – Patient Capital

Patient capital refers to medium- and long-term capital funding for business and infrastructure. It is a necessary part of the capital and financing mix for economies, including for emerging and growing businesses. This form of capital provides companies with the requisite time and investment to allow them to innovate and grow. There is an opportunity to increase returns for superannuation funds while providing patient capital.

Overseas examples of patient capital are provided below and the Australian Investment Council is available to discuss this topic in more detail.

Patient Capital in the UK

In 2016, the UK government launched a Patient Capital Review to identify potential barriers to accessing finance for starting and growing businesses. The UK Treasury estimated there was a “patient capital gap” of around £4 billion per year which was resulting in fewer UK companies realising their full potential, when compared to the USA. A comprehensive action plan was implemented to unlock more than £20 billion of finance to support the growth of small, innovative businesses. It aimed to buoy the economy through increased investment into high-growth, innovative firms. A further initiative was announced in the UK Budget in 2018 for regulatory reforms and a commitment to make UK pension funds a major source of patient capital for growing and innovative firms within their domestic market.

Canada and New Zealand

Canada and New Zealand have also realised the potential of private capital investment as a means to boost their economies. A review of the long-term growth prospects for the Canadian economy led to Canada’s leading banks and insurance companies forming the Canadian Business Growth Fund. This was to provide

Canada with an independent, private sector fund that focused exclusively on the financing gap facing Canadian growth companies. The fund made an initial capital commitment of $545 million, with plans to increase its commitment to $1 billion in future years. This fund has served as a model for the Australian Government's announcement of a plan to establish a Business Growth Fund in our own market.

More recently, in its June 2019 Budget, the NZ Government announced a new NZ $300 million, 15-year venture capital fund which aims to boost private investment in New Zealand's early stage companies. The New Zealand Superannuation Fund will administer the fund, with the New Zealand Venture Investment Fund investing through underlying managers targeting local growth businesses in the $2 million to $15 million annual turnover range. The aim is to reduce the pressure on this sector to sell their businesses prematurely to overseas buyers.

Australia

Australia should not shy away from conducting a similar review and learning from the UK experience in setting a forward-looking strategy to increase the pool of patient capital that can become available to high growth businesses over the next few years.

Long-term patient capital investment needs to be a priority for policy makers. It can provide a boost to Australia's fastest growing businesses, and with it, bring jobs and economic growth. It is timely to consider long-term patient capital as a viable policy option. As Australia's $2.9 trillion superannuation industry continues to grow, private capital – including private equity, venture capital and private credit – are investment streams being explored by super funds as they seek to diversify their portfolios and generate better returns.

Recommendation 5: Develop a Long-Term Patient Capital Strategy
Government works with industry to develop a long-term Patient Capital Strategy, drawing on international experience, which clearly sets out how private and long-term patient capital can play a key role in supporting the expansion of Australian businesses, drive stronger economic and employment growth, and deliver better retirement outcomes for all Australians.