It is more than 25 years ago that Australia began a rigorous reform of its pension industry. Nick Sherry, a key architect of the reform and the former Australian Minister for Superannuation and Corporate Law, looks back on how the reform unfolded and what other governments can learn from the Australian experience.

A Universal Need
In the mid 1980s, Australia found itself in the same position that most advanced economies were in – and many remain in today: an aging population and an inadequate superannuation system to provide adequate benefits for citizens in their retirement. About 70 percent of the population had only a meager state pension to look forward to.

Australia was one of the first countries to take action and address these problems, using a mix of state pension and employee contribution programs. It began to rebuild the superannuation system with the goal of providing fiscal sustainability, fairness and practicality. The architects of the new plan used compulsory contribution, means testing and prudent asset allocation strategy to reach those goals, putting Australia in a strong position envied by many of its counterparts. Australia now has the fourth largest pension system in the world (behind the US, Japan and UK) although it has a small population of only 22.6 million people.

Brave Steps of Reform
Australia’s reforms created a three-pillar system that ensures everyone has at least a minimum level of superannuation, a superannuation guarantee, to look forward to. The first pillar is the basic state pension, with flat benefits that are means tested and indexed to wage increases. The second pillar is compulsory employer defined contribution superannuation for all employees earning more than $450 a month. The third pillar is voluntary additional contributions.

Achieving sustainability for the state pension system, the first pillar, meant increasing the retirement age for state superannuation to 65 – it will rise further to 67 by 2020 – and adding means testing to determine who really needs pension payments. When a person retires, their private assets and income are assessed, and if they have a high level of assets and income they don’t receive full government pension, thereby making more resources available to those who need them.
Means testing was an unusual approach in Australia, as the pension industry generally shifts the investment outcome risk to the individual, which results in different outcomes depending on fund return, contributions and time in the system. However, this greatly increased the sustainability of the program by making sure that the cost of pension is manageable.

Compulsion, the second pillar, was adopted as a fairness measure because at the time only 30 percent of the workforce – mostly middle/higher income, male, public sector and large private sector employees – were enrolled in a pension scheme. Today, that number has risen to more than 92 percent and fairly reflects the number of low/middle income and female workers.

In 1987 the government introduced compulsory defined pension contributions at 3 percent, which has since increased to 9 percent and is set to rise to 12 percent by 2020.

The third pillar of Australia’s system, voluntary additional contributions, changes with the economic situation. Voluntary additional contributions currently are 2.5 to 3 percent of income, down from 3 to 3.5 percent before the global financial crisis, reflecting the changing financial confidence of members. Addressing unsustainable defined benefit pensions was another key step in the reform. Defined benefit plans around the world are facing hard choices due to an aging population, and the situation was no different in Australia. Australia has seen the majority of defined benefit plans close to new members, a shift that has occurred much more rapidly in Australia than in other markets.

Investment Management
While Australia’s reforms on pension contributions were radical, its approach to how those assets should be managed was no less innovative, and has created one of the greatest strengths of the system. The architects designed an arms-length, independent trust governance to invest the pool of assets via the private sector in a practical approach. The foundation investment principle is the sole purpose test; trustees of the funds must be prudent and act in the best interest of members to provide sound, diverse investments.

Between three and four percent of Australia’s pension investment pool is invested in national infrastructure, from airports and shipping ports to electrical utilities and hospitals. However there is a key difference in Australia: trustees will only invest in infrastructure if the investment promises solid, long-term returns. They won’t invest out of nationalistic obligation, even though Australia’s economic and population growth has created an infrastructure need. The current allocation of superannuation assets is 40% in equities, 23% in fixed income, 11% in property, 14% in alternatives including infrastructure and 12% in cash.

Australia is still making changes to its system, and one of the latest improvements has been the creation of My Super, a low cost, no-frills default investment option. The majority of members chooses the default investment option and leave it to the trustee. However a significant and growing minority do select from a range of investment options such as cash, bonds, infrastructure and equities.

![The Current Allocation of Superannuation Assets](chart.png)

1 APRA yearly superannuation data 2012 and historical series
2 Rainmaker (December 2012)
The Results
Australia's pool of pension investment funds has grown steadily since reforms were introduced. In 1992 assets totaled AUS$150 billion, which tripled to AUS$500 billion by 2002 and currently total AUS$1.5 trillion.¹ This rate of growth of more than 10 percent per year is expected to continue, resulting in $3.5 trillion in assets by 2025 and between AUS$6 to 7 trillion by 2035.²

Most importantly, the percentage of Australians who own a share of that pool has risen to 92 percent from around 30 percent 25 years ago, creating a much fairer superannuation system.

Rising rates of compulsory contribution have been the key driving force behind the growth of assets. However, a growing population, good long-term economic growth and low unemployment also played key roles in making Australia's pension system what it is today. Australia's population is predicted to grow to 36 million in 2050 from 22 million today³, providing momentum for further growth.

Australia's strict approach to compulsion parameters has played an important role in growing the asset pool. Setting the minimum salary threshold as low as $450 a month for contributions to be paid, the inability to opt out, and restrictions on borrowing and limitations on early access were all strict in comparison to similar systems in the UK, US, New Zealand and Hong Kong.

The growth in pension assets has underpinned a drastic expansion in Australia's asset management industry, with promise of further growth in the coming decades. The growth of the industry has not only been driven by reforms and higher contributions, but also by Australia's growing population.

The savings pool now exceeds 100 percent of Australia's GDP, creating the need for an increased amount of overseas investment. The share of overseas equities investment currently has risen to 18 percent of the overall superannuation assets, up from eight percent in 1992. International investments will garner a growing percentage over overall investments via local partnerships in target markets, international funds and other vehicles.

What have We Learned?
Each country and economy is different, and not everything Australia did in its reforms will work in other markets. However, many of the lessons learned can be applied universally, using different tools.

Public opinion can be an important hurdle to cross when introducing such reforms. Taking investment direction out of the government's hands and putting it in the hands of independent trustees helped build confidence in the system and assure members that they were to be the primary benefactors of the reforms. This confidence grew when members received their first investment statements – for many of them it was the first retirement savings statement of their life – and they saw an actual dollar figure resulting from their contributions. While public opinion on the reforms was split about 50/50 when the reforms began, this quickly shifted to majority approval once members began to see their account balances grow.

Making contributions compulsory is necessary for a sustainable and fair pensions system, as it makes everyone a stakeholder and a beneficiary. The goal at the onset of the reforms was to ensure that more Australians saved for their retirement, and compulsion was the easiest way to bring about that change.

A well-designed default investment plan is key to making a universal plan, as many of the new members do not have the skills, education or interest to make their own investment decisions. Investment choice options that are provided need to be well defined, transparent and benchmarked against the default. Whether the member opts to exercise their own choices or take the default, all fees, costs and returns must be transparent.

Creating an investment strategy that best serves the pension plan member and meets long-term financial sustainability goals requires diversification. Assets should be invested into infrastructure, real estate and other alternative assets in addition to more mainstream products such as equities and fixed income in domestic and foreign markets. Most importantly, the Australian experience shows that reforming a pension system, and seeing the positive results of those changes, takes time. Australia's system has had a quarter of a century to grow and develop, with the helpful winds of positive population and economic trends at its back. Today Australia can see that making hard but important decisions has paid off for its future.

³ Australian Prudential Regulatory Authority (APRA) Quarterly Superannuation Statistics and historical data
⁴ Rainmaker (December 2012)
Deloitte (November 2011)
⁵ Australian Bureau of Statistics, Population Forecasts
⁶ Australian Bureau of Statistics Investment Statistics
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