



ASFA 2014 National Conference

Melbourne Convention and Exhibition Centre 13 November 2014

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Check against delivery

Today I want to say something about the Future Fund. As you know I am Chairman of the Board of Guardians. Since this is a Superannuation Conference and I have been asked to talk on broader policy issues, I will do that later but those are comments I make on my own behalf as someone closely associated with economic policy in this country over 12 budgets, through major tax reform and structural changes.

First, the Future Fund.

There are many people, including some in the superannuation industry, who think the Future Fund is some kind of superannuation fund. It is not.

The Future Fund has never received a superannuation contribution of 9% (or any other amount) from any Employer on behalf of anyone. It has never received a contribution from a member. In fact it has no members. No individual is entitled to any money from it. It does not manage or operate any superannuation scheme for the Public Service.

Commonwealth Superannuation Corporation

The Commonwealth does manage superannuation schemes through an authority under the Governance of Australian Government Superannuation Schemes Act 2011 (the GAGSS Act). It is called the Commonwealth Superannuation Corporation (CSC). The Corporation has union representatives and independents as Directors. The Chair is Patricia Cross.

Broadly speaking CSC manages three Defined Benefits schemes and one Accumulation scheme. The defined benefit schemes are The Commonwealth Superannuation Scheme (CSS) which closed to new members in 1990. The second is the Public Sector Superannuation Scheme (PSS) which closed to new members in 2005. The third is the

Military Superannuation and Benefits Scheme (Military Super) which is still open. However, the Government announced in the recent Budget it will be closed to new members from 1 July 2016.

The fourth scheme, the Public Sector Superannuation (PSSap) Scheme was established in July 2005 when the PSS scheme was closed. It is an accumulation scheme, and therefore fully funded. According to the 2013 Annual Report, it had around 85,000 contributing members and around \$4.8 billion in assets.

As at 30 June 2013, Military Super had around 56,000 contributing members. It receives member contributions and contributions from the Department of Defence. It has assets around \$4.9 billion.

All of the Commonwealth's superannuation schemes must comply with the Superannuation Industry Supervision Act 1993 (the SIS Act) so that tax paid on net income is assessed at a rate of 15%.

The Future Fund is a Sovereign Wealth Fund.

In 2006, after the Government eliminated debt in net terms, it established the Future Fund to receive and invest Government Budget surpluses. The Future Fund was allocated money from the budget surpluses of 2005, 2006 and 2007. When the third tranche of Telstra shares was sold, the Fund was allocated \$9 billion of shares which it has sold down over time.

Roughly speaking the Future Fund received \$60.5 billion in cash and shares.

There is only one Government that has ever put money into the Future Fund. The Rudd, Gillard, Rudd Governments made no contributions. That is because none ever delivered a surplus. The last surplus in Australia was the 2007-08 Commonwealth Budget delivered in May 2007.

The Fund has grown the \$60.5 billion of capital it received to a total value around \$105 billion as at September this year.

The assets of the Future Fund - the Budget surpluses and the earnings on them - are owned by the Government of Australia. The earnings are included in the Budget.

The Future Fund is a founding member of the International Forum of Sovereign Wealth Funds (IFSWF). The IFSWF defines Sovereign Wealth Funds as: "special purpose investment funds or arrangements owned by the general government. Created by the general government for macro-economic purposes, Sovereign Wealth Funds hold, manage or administer assets to achieve financial objectives and employ a set of investment strategies which include investing in foreign financial assets".

Since the money in the Future Fund is owned by the Government of Australia for the people of Australia, no individual has a claim on it. The Government could, by legislation, draw money out of the Fund for any purpose. The assets of a Superannuation Fund, even a Government Superannuation Fund, cannot be appropriated by the Government without just compensation because it is the property of the members.

Some confusion about the nature of the Future Fund has possibly arisen because The Future Fund Act stipulates certain circumstances under which the Government can draw funds out of it. In particular, after 1 July 2020, the Government can draw down on it to pay an unfunded superannuation liability.

As you know, all of the Commonwealth Government defined benefit schemes are unfunded. The Government uses general revenue to pay public service pensions in the same way it uses it to pay age pensions. From 1 July 2020 some or all of its public service pension bill could be paid from the earnings of the Future Fund. That would free up general revenue for other purposes such as age pensions. As you know money is fungible.

The Future Fund Act of 2006 established a locked box to save for the benefit of future taxpayers. The Future Fund is a Sovereign Fund which facilitates intergenerational wealth transfer from one generation to the next.

Other Sovereign Wealth Funds (SWFs)

Most people who look at these things agree that the first Sovereign Wealth Fund, was set up by Kuwait in 1953.

That fund was designed to manage the State-owned oil wealth and invest it into financial assets that would outlive the depleting asset – the oil reserves. The depleting asset is still going strong.

Since Kuwait set up its fund, many other countries have followed suit.

The reasons for setting up funds, and the objectives that these funds have, are varied. Often funds will have more than one rationale, but broadly we can think of several different categories.

SWFs, like Kuwait, are long term savings vehicles focussed on turning a depleting asset into perpetual financial assets.

The Abu Dhabi Investment Authority is another example. So too is Norway's sovereign wealth fund which invests the proceeds of Norway's oil reserves into long-term national savings.

Norway's fund is only permitted to invest outside Norway. That is to manage the exchange rate and shield the economy from overheating.

Others funds, you can think of as stabilisation funds. These are typically designed to reduce the impact of external shocks on a country's economy and budget. Examples of stabilisation funds can be found in countries with high levels of exposure to commodity price volatility such as the old Copper Stabilisation Fund in Chile and the Oil Stabilization Fund in Mexico.

A third group of sovereign wealth funds can be described as development funds. These may have a focus on providing support to socio-economic projects by holding and allocating resources to priority areas. The Angolan Sovereign Fund and Iran's National Development Fund are examples in this group.

Finally, you have intergenerational savings funds like the Future Fund. These funds allow countries to save today to meet the costs of tomorrow. In our case we have savings that can be drawn down after 2020 to assist financing the demands of an ageing population.

The Future Fund is the 9th largest SWF in the world.

The only Western Country with a larger fund is Norway. Most other SWFs have been built out of State Owned natural resources. The Future Fund is rare among SWFs since it was built off the back of Budget Surpluses.

Other Pension Funds

Outside the true sovereign funds which are owned by government, there are a range of funds which are state-backed pension plans – the likes of Canada Pension Plan, or Calpers, the California Public Employees' Retirement Plan.

These funds receive contributions from members, invest and make payments back to their members. The money contributed comes from Employees and Employers. In a Sovereign Fund it comes from the State.

China's State Administration of Foreign Exchange or SAFE is another large pool of sovereign capital standing at approximately USD3.8 trillion. While not meeting the definition of sovereign wealth fund, SAFE manages China's foreign exchange reserves including investments not only in US Treasuries but in other asset classes including listed equities globally.

The Future Fund Investment Mandate

Under its Statute, the Future Fund is given an investment mandate which sets the return objective of averaging CPI + 4.5 – 5.5% over the long term.

That was set in May 2006. It has not been changed since. Financial markets were awful in 2008-09. The Future Fund was way behind its objective. In the September quarter of this year, for the first time, it was within its objective. Returns from inception, from May 2006 to September 2014, were 7.3%.

To continue to meet its objective over the long term will be an extraordinary challenge for the Future Fund. In the modern world returns of this nature would be absolutely exceptional. And the Board is tasked with avoiding excessive risk. The Board is building a financial

asset for the Australian Government, and through it, the Australian people.

With no members, the Future Fund does not have different investment options. It does not market financial products, financial advice or insurance products.

The Future Fund has an absolute return objective – which provides it with an absolute clarity of focus.

This means that the Fund works only to maximise risk adjusted returns as required by its mandate. It does not seek to match some market 'benchmark'. It does not measure performance against any peers.

The Future Fund is not trying to manage the currency.

It's not here to support particular industries or sectors.

It is here to grow capital for the Government.

It's here to build a financial asset for future generations of Australians.

These things are important because they drive how we, the Board of Guardians, manage the Fund.

We have a strong focus on growing the Fund over the long term and on protecting its capital.

We focus on diversification.

What this means is that we will usually expect the portfolio to perform well when markets are good and to be insulated against the full impact of weaker periods.

Put another way we expect to achieve our long-term returns with lower levels of volatility than many other investors and for the investment returns to be smoother over time.

We think this is important because it responds to our mandated obligation to take acceptable but not excessive levels of risk.

The result of this is that the portfolio looks quite different to the portfolio of a typical superannuation fund. We have generally a lower exposure to

listed equities and a greater exposure to tangible assets like infrastructure and property, as well as private equity and hedge funds.

In many respects the portfolio looks like an endowment fund. It would be similar to, but not the same as, endowments at universities like Yale or Harvard.

The portfolio will look and behave differently to what people might otherwise expect. The emphasis on diversification and use of external investment managers also means that the Fund's organisational structure, business model and costs will not be comparable to many other investors.

But this approach has delivered well so far and is tailored to our mandate.

Other Funds Managed by the Future Fund Board of Guardians

I should also mention that in addition to the original Future Fund, we also manage other pools of money for the Government. These are managed on different investment mandates.

Shortly, we expect to receive the first contribution to the DisabilityCare Australia Fund which has been established to support the National Disability Insurance Scheme. The Building Australia Fund, Education Investment Fund and Health and Hospitals Fund contain over \$9 billion and are due to be replaced, under proposed legislation, with the Asset Recycling Fund and the Medical Research Future Fund. In all there will be four Funds.

The Future Fund Board of Guardians focuses on investing each fund according to its mandate.

The Taxation Position of the Future Fund

As I have said, the Future Fund is owned by the Government. There is no point in the Government taxing itself. It doesn't tax the dividends of its Bank - The Reserve Bank of Australia. It doesn't tax the dividends of its Wealth Fund - the Future Fund.

If it did tax itself it would not get any more. It would have the same amount less the compliance and handling cost of paying money from one

arm of Government, the Sovereign Wealth Fund, to another – Consolidated Revenue.

The tax exemption of the Future Fund is explicitly set out in the Act – section 84A. Where you read comment in the press that the Future Fund has tried to minimize its Australian tax, it is ill-informed.

The Future Fund cannot minimize its Australian tax liability. It has no liability to minimize.

Further, as the Government's Sovereign Fund, the Future Fund is typically entitled to Sovereign Immunity when it invests overseas. In the vast bulk of its investments offshore, the Future Fund's Sovereign Immunity is recognised, just as Australia recognizes the reciprocal rights to Sovereign Immunity when other sovereigns invest in this country.

This is another big difference between the Future Fund and a Superannuation Fund. A Superannuation Fund gets preferential tax rates but not immunity.

Future for Superannuation (personal comments)

So what does the future hold for superannuation?

Well I don't know what David Murray's Financial System Inquiry will recommend nor what the Government will do with those recommendations.

I don't know what the Tax White paper will say. But in my time I have been through a few rounds of Tax Reform. From now on I will offer you some personal views. I am speaking for myself. These are not necessarily the views of the Future Fund Board of Guardians.

The biggest tax reform in the last 100 years in Australia was the introduction of a broad based goods and services tax some 14 years ago in 2000. That tax now raises \$50 billion per annum. As a result most proposals for tax reform these days start with a proposal in relation to GST. Some argue the base should be extended, some argue the rate should be increased. There is no one now arguing that GST should be abolished, or that revenue from GST should be cut.

Those who want to raise more money from the GST do not agree on what should be done with this revenue. Some say that it should be given to the States so they can spend more on health, education etc. If that is all we did then so called 'reform' would just amount to more tax and spend.

Some have argued the revenue raised could be used to abolish other state taxes, for example, Payroll tax. Payroll tax is a value added tax much like the GST itself.

My view has always been that if we increase indirect taxes there should be a trade off with a reduction in direct taxes for example Income Tax and Company Tax. Even if no more tax is collected in net terms, this has the advantage of increasing incentives to work and invest and promotes economic growth.

Superannuation Taxation

Because superannuation funds are vehicles for long term savings by individuals they enjoy tax advantages. Where an employer pays wages into a superannuation fund, rather than direct to the employee, it is taxed at 15% rather than the marginal income tax rate. There is a surcharge for people earning over \$300,000. There are also contribution limits. But I'm trying to keep this simple. The Treasury estimates the value of this concessional tax treatment at around \$16 billion.

In addition the earnings in a superannuation fund are not taxed at marginal income tax rates. They are taxed at 15%. The Treasury estimates this concession to also be worth \$16 billion to the industry.

I think both of these concessions can be justified on the grounds that they are assisting people to save for their retirement and when you bear in mind that the Government will get substantial benefits back when, later in life, it claws back the Age Pension, it is not such a bad deal to the Government. Any assessment of the true cost of these concessions must take into account the savings on the Age Pension that will be delivered back to the Government as a result of private superannuation.

Let us bear in mind that for most people, occupational superannuation will not free them from the pension. What it will do is deliver a sum which will be taken into account under an income test and turn them from full pensioners into part pensioners. Remember that under the

income test 50% of their deemed income from superannuation will be clawed back out of the pension. In other words the State will put in effective marginal tax rate (EMTR) of 50% on people with superannuation (above the threshold) which will go a long way to clawing back the two tax concessions they have enjoyed during the accumulation phase of their superannuation.

Most of you will have forgotten, but I well remember because I introduced it, the refund of excess imputation credits. This was part of the tax reform introduced along with GST that took effect from 1 July 2000. What it meant was that individuals, superannuation funds and charities were entitled to claim back any imputation credit which was above their own marginal rate. For Australians who are on the 30% tax rate there is no credit. But Charities that have a zero tax rate can get back the 30% tax in addition to any franked dividend they receive from a company. Superannuation funds can claim back 15% which is the tax paid by the company over and above their own marginal tax rate. This has been enormously valuable to superannuation funds and has allowed them to set off a large portion of their tax liability.

In his Financial System Inquiry Interim Report, David Murray, said: - "The case for retaining dividend imputation is less clear than it was in the past." He went on to say, "The dividend imputation system creates a bias for individuals and institutional investors, including superannuation funds to invest in domestic equities. As such, dividend imputation may be affecting the development of the domestic corporate bond market."

What he meant by this was because superannuation funds have a low tax rate, and they can get a refund of excess imputation credits, the after tax returns from dividends are enhanced. He compares them favourably to the tax position of investing in debt. Unsurprisingly instead of recommending the advantageous tax treatment of equities be extended to debt, he suggests the less friendly terms for debt be extended to equity.

One way of increasing tax on superannuation funds, without increasing the tax rate, would be to deny or restrict their access to the refund of excess imputation credits. I doubt a recommendation in this regard will come out of the FSI, but it is likely to be under consideration in the Tax White Paper.

If I were running a superannuation fund, and I have gone to great lengths to explain to you today that I am not, I would be showing a great deal of interest in proposals in this regard.

There are large Australian companies, with overseas shareholders, who are also getting ambivalent about the dividend imputation scheme. This is because franking credits and refunds of excess franking credits are only available to Australian residents including superannuation funds. Overseas investors cannot claim these credits and therefore do not value them. Some companies say that it biases investment decisions in favour of investing in this country, rather than overseas. There would be some support for changing the dividend imputation scheme amongst some of the large corporates, or at least acquiescing to a change. This should give Australian resident investors even more reason to get interested in this area.

The SG Rate

One thing I should mention in closing because I am sure it will come up in our discussion. This industry, of course, supports an increase in the super guarantee from 9½% to 12%. Why would any sane person not support a legislated increase in their stream of revenue? Personally I would love to get a legislated revenue stream into the Future Fund. But I think it is much more important for Funds to concentrate on delivering the best return for their existing contributions. If they do exceptionally well they might even convince members to make voluntarily contributions to the fund. There are lots of tax incentives to do so.

The argument for increasing the SG rate is a self-satisfied and self-interested one. The best way the industry can advance its cause is by delivering benefits. After all that is productivity - maximising the level of output from any given level of input.

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