



## AIST Submission

Review into the governance,  
efficiency, structure and operation of  
Australia's superannuation system

Phase Three: Structure

19 February 2010

## Background

The 'Super System Review', announced by the Government on 29 May 2009, is a review into the governance, efficiency, operation and structure of the current superannuation system in Australia. The Review is split into three segments, with the third being Phase Three: Structure.

The Australian Institute of Superannuation Trustees (AIST) welcomes the opportunity to provide a submission in relation to this third phase of the Review. Specifically, our submission addresses questions posed in the Issues Paper, released on 14 December 2009.

We look forward to being involved in the remainder of the consultation process.

## AIST

AIST is a national not-for-profit organisation whose mission is to promote and protect the interests of Australia's \$450 billion not-for-profit superannuation sector. AIST's membership includes the trustee directors and staff of industry, corporate and public-sector funds, who manage the superannuation accounts of nearly two-thirds of the Australian workforce.

As the principal advocate and peak representative body for the not-for-profit superannuation sector, AIST plays a key role in policy development and is a leading provider of research.

AIST provides professional training, consulting services and support for trustees and fund staff to help them meet the challenges of managing superannuation funds and advancing the interests of their fund members. Each year, AIST hosts the Conference of Major Superannuation Funds (CMSF), in addition to numerous other industry conferences and events.

## About this submission

This submission is divided into three sections. The first section summarises our position in relation to the issues we believe are key factors in improving the structure and operational efficiency of the industry, and our general views on Self Managed Superannuation Funds (SMSFs).

The second section is our response to Part A of the Issues Paper on structural issues, including recommendations to the specific questions posed in the paper.

The third section contains our response to Part B of the Issues Paper on the issues within the SMSF space, including what we believe are the strengths and weaknesses within that sector.

We have submitted our comments and feedback to the *Clearer Super Choices: Matching Governance Solutions* Phase One Preliminary Report, released on 14 December 2009, as a separate document.

## Part One: Executive Summary

In the 20 years since compulsory super was introduced, the superannuation industry has evolved into distinct sectors, each offering different governance structures and products.

This first section of this submission argues that significant structural improvements could be made across all sectors of the industry to optimise the retirement outcomes of working Australians.

As the super system grows, so does the risk of fraud and theft. This submission identifies key issues that leave both the industry and individual members vulnerable to fraud or theft including early release of super, rollovers to SMSFs and other areas of administration.

We argue that broader Tax File Number access for funds and the updating of the ATO register of complying funds (as a priority) would significantly reduce the risk of superannuation fraud.

This submission also deals with the role of insurance in our superannuation system. AIST recognises that Australia has a significant underinsurance problem and that the superannuation industry has an important role to play in addressing this issue. As the not-for-profit superannuation sector has grown, it has demonstrated innovation in default insurance design, a trend we encourage and are confident will continue. The linking of low-cost insurance with compulsory superannuation has significantly boosted insurance levels, particularly among low-income earners and blue collar workers who previously faced exorbitant premiums or difficulties obtaining cover.

We believe existing arrangements in regards to default death and TPD cover are working well; however, we support members being able to opt-out of either or both forms of insurance. While we recognise the need to encourage greater income protection insurance, we do not support Government mandating income protection insurance in default funds.

This submission also deals with the structure of post-retirement superannuation. While we see a role for commission-free annuities in helping manage longevity risk for retirees, we also note the need for retirees to maintain an exposure to growth assets during their retirement.

On the issue of capital requirements and risk reserves for funds, we do not believe further changes to increase capital reserves within trustee companies are required, chiefly because increasing the capital a trustee needs to hold raises the issue of where that capital comes from and who owns it. Not-for-profit funds have limited capacity to raise capital without jeopardising their independence, which is a crucial feature of the overall super system. Moreover, to specify an arbitrary figure for capital reserves does not address the fund's actual risks.

The issue of whether default funds should remain in the industrial award system has been raised repeatedly throughout the Review. In this submission, we reiterate our view that providing default selection within the industrial award system is efficient and cost-effective, both for employers and employees.

The second part of this submission deals with SMSFs. AIST is not directly involved in the SMSF sector; however, we recognise that SMSFs have a place in the modern Australian superannuation system. Given the current size and forecast growth of this sector, we believe the regulation of SMSFs needs to service the Government's overarching policy objectives in relation

to retirement incomes policy. Consequently, we believe that SMSFs need to be brought more closely into the wider superannuation family, so that access to member services, regulatory oversight, and information to policy makers is equivalent to that of APRA-regulated funds. To achieve this closer integration, we propose a number of changes to laws governing SMSFs, including that the regulation of SMSFs be transferred to APRA.

## Key recommendations:

### Insurance

Default funds should be required to provide both TPD and death cover. We also recommend the banning of commissions on default insurance.

We do not believe the tailoring of default insurance to an individual's circumstances would be practical and therefore should not be mandatory. However, we see a role for insurance to be tailored to fund demographics.

While we recognise the need for improved uptake of income protection insurance, we do not support the mandating of income protection as part of default insurance cover.

### Super in the post-retirement phase

We believe that annuities in retirement have an important role to play in addressing longevity risk for retirees. We have previously recommended that the Government could play a role in providing annuities to low-income retirees in the context of an increased Superannuation Guarantee. However we do not support a radical change in investment strategy purely because someone turns 65, as retirement may last up to 30 years.

### Integrity and fraud

We identify that scams involving early release schemes are on the rise and the establishment of dummy accounts is also increasing. We argue that broader use of the TFN as an identifier is required to combat this problem.

We also note the increased incidence of rollover fraud involving SMSFs and recommend that the register of complying super funds be updated so that all funds on the list have complying fund status.

### Participation in the system

**Indigenous issues:** We recommend that super funds take the necessary steps to identify indigenous members and provide them with more relevant educational materials.

We also recommend that legislation be changed so that participants in the Community Development Employment Projects (CDEP) become eligible for the SG.

**Women:** We recommend the removal of the \$450 monthly income earnings threshold for SG; a superannuation component be included in a paid parental leave scheme; and Government support to improve financial literacy among women.

**Older workers:** Given that older workers have not had the benefit of a working lifetime of Superannuation Guarantee, we support raising concessional cap limits for older workers with low account balances to assist them in 'catching up'.

### Other structural issues

**Default funds:** As in our previous submission, we recommend the selection of default funds stays within the industrial award system. We believe this is the most efficient selection process for both members and employers.

**Dispute resolution:** We believe the current Superannuation Complaints Tribunal removes the need for a superannuation court.

**Capital requirements:** We do not support increasing the capital requirements applying to public-offer trustees. However we support custodians' capital reserve requirements being set based on the actual risks they faced

### SMSFs

- We recommend stronger regulation of advisors to SMSFs, be they accountants, stockbrokers, financial planners etc.
- We support a requirement that every SMSF retain an investment advisor and receive an investment report from that advisor on at least an annual basis.
- SMSFs be fully regulated under the same regulations as APRA-regulated funds, and there should be no dilution of superannuation law.
- Transfer all SMSFs to APRA regulation and synchronise reporting with APRA funds, utilising the improved reporting facilities enabled by use of regulated administrators.
- APRA, as the regulator, establish better facilities to validate complying status, so that other funds can rollover funds to SMSFs with confidence.
- Given the reported high costs associated with running small-balance SMSFs, we support a minimum established amount for SMSFs based on the number of members as follows: one member: \$200,000; two members: \$300,000; three members \$400,000; four members \$500,000.

### Scope of the Review

We note that the scoping paper released at the commencement of the Review indicated that Phase Three would include the 'funds management model'. We are disappointed that this area has not been included in the Issues Paper for Phase Three, and we question whether the Review can adequately address the issue of costs and efficiencies in the superannuation system without examining an operational area which would account for roughly half our members' costs.

We recommend that the Panel call for further submissions on this issue.

### **Issues relating to 'choice' architecture**

The issues paper produced by the Review Panel poses a number of questions about super funds in the light of the choice architecture framework. Our chief concerns with the proposed architecture are outlined in a separate policy response document.

## Part Two: Response to Part A

### 8. SUPERANNUATION SECTORS IN LIGHT OF THE CHOICE ARCHITECTURE FRAMEWORK

#### 8.1 Defined Benefit Funds

**Should there be stricter funding standards set out in part 9 of the Superannuation Industry (Supervision) Regulations 1994 (SIS Regulations) so that there is greater protection for members and so that APRA could have a direct role in working with the employer to remedy the deficit?**

All defined benefit funds are subject to actuarial control as detailed under the SIS regulations. All actuaries are subject to appropriate professional standards to ensure that the fund remains in a satisfactory financial position and any actuarial deficit is funded in an appropriate manner. The Institute of Actuaries of Australia has a professional code of conduct that provides an adequate framework to ensure that funds are appropriately monitored.

In addition, the trustee has a legal requirement to act in the interest of all members and this encompasses the need to ensure that members' benefits are protected and secured. Most funds have binding provisions on employers to pay the relevant contribution rate as determined by the trustee and this would be after obtaining advice from the funds' actuary.

The equal representation requirement on the trustee board provides the trustee with the expertise to consider the funding obligation of the employers. We believe that the SIS regulations, the actuarial professional standards, and trust law provide an adequate framework for the ongoing financial management of defined benefit funds.

**Should actuarial reports be required more frequently than every three years? Should a mechanism be provided under the SIS Act with a view to protecting members' benefits against employer sponsor insolvency?**

Actuarial reports are expensive to undertake and we believe the cost may be prohibitive. Under current legislation, actuarial reports are not required more frequently than triennially, except in abnormal circumstances.

In addition, the financial position of any fund is tested on an annual basis when completing financial statements, as this identifies whether the fund remains in a satisfactory financial position. Trustees are required to take appropriate action to address any shortfall and the actuary or auditors would also provide appropriate notice to the regulators as required via legislation. It would then be up to the trustee, in consultation with APRA, to implement an appropriate rectification program.

The trustee has an obligation to ensure that members' benefits are secured and this includes ensuring that defined benefit employer contributions are paid on time and in full. Defined benefit fund trust deeds usually include a requirement for the employer to make contributions within a specified time frame. However, we believe the Panel should consider similar legislation to that applying for after-tax member contributions being remitted within 28 days of the end of the month. This would ensure that any shortfall in contributions due to insolvency would be kept to a minimum.

There will be occasions when the trustee and employer will seek to have actuarial investigations more frequently than every three years. It is not appropriate to be prescriptive with these requirements; the trustee and employer should consider the situation on a case-by-case basis. We note that APRA has power under SISR 9.29(2) to require a trustee to undertake an actuarial investigation.

Insolvency is rarely identified before the actual event. In this context it is difficult to envisage how protection might be accomplished without establishing a separate insurance reserve or pool. In turn, this would create issues of moral hazard. We would support changes to ensure that superannuation contributions are protected in a similar way to other employee entitlements, although it may not be practical to support unfunded liabilities in this way.

**As employers have a particular interest in defined benefit funds, should trustees of defined benefit funds (or sub-plans) be required to have employer representatives on their boards (assuming that equal representation is not otherwise required for that trustee board)?**

As discussed in our previous submissions to the Review, it is our view that the equal representation model for trustee boards is the most efficient and effective model for managing superannuation and best represents member interests for the following reasons:

- Minimising and managing conflicts of interest: the representative model fosters strong competition within the superannuation system. Representative trustees are not bound by parent companies and are free to act in the best interests of members, rather than shareholders.
- Reducing administration and agency costs to a minimum by maximising economies of scale benefits through the formation of collective vehicles that have been able to deliver superior returns with lower fees to members.
- Ensuring that members' interests are represented and single-mindedly pursued by trustees, as the model allows trustees to solely focus on member interests.
- Ensuring that trustees remain independent of vested interests in the financial sector, and capture the decision-making benefits of diversity and representation. A key competitive advantage of the representative model is, as the name suggests, representation. The nature of this model, whereby there are an equal number of employer and employee representatives, strongly aligns board and member interests. This ensures a mission-driven culture that focuses solely on delivering net benefits to members.
- Ensuring the best possible application of innovation in investment management, and recruitment of the best possible investment managers. The representative model has been innovative in its approach to long-term investments. For example, the not-for-profit sector was an early adopter of alternative investments, which have delivered positive results to members and provided much needed diversification options.
- Meeting the emerging need for national savings to address problems such as climate change and the post-GFC economy: the not-for-profit sector has a 25-year track record of

out-performance of up to 2.4 per cent per annum. Evidently, governance plays a role in performance.<sup>1</sup>

For further information, research and evidence in relation to our reasoning behind the strength of the representative trustee model, please refer to our Phase One submission.

In relation to the policy committee structure, we support the representative trustee model. For defined benefit funds within master trusts, the policy committee structure is intended to provide input into the governance process for employers, although it is not clear that this avenue is adequate for this purpose. Given the highly technical nature of funding questions, and the sensitivity of the fund's relationship with the sponsor, we believe employer representation is required at the trustee level for all defined benefit funds.

**There have been several occasions where defined benefit funds have not been appropriately taken into account when new legislation has been promulgated. The Review is aware that there are problems for defined benefit funds with respect to the 'dollar disclosure' regime in the Corporations Act as well as that Act's requirements for historical fund performance to be provided to members and disclosure more generally (e.g. significant event disclosure). Are there other examples of legislation in recent years which has resulted in problematic application for defined benefit funds?**

There are many different legislative measures that present unique problems for defined benefit funds. In recent years, these have included:

- Surcharge and notional surchargeable contributions;
- Contribution caps;
- Application of co-contributions received by members; and
- Family law splits.

While we acknowledge the preponderance of defined contribution funds in Australia's modern system, defined benefit funds remain important. We would support a requirement on regulators that an actuarial council, possibly the Institute of Actuaries of Australia, be consulted prior to implementation of regulations for defined benefit funds.

## RECOMMENDATIONS

1. Given the strong performance of the equal representative trust model, we recommend that this be the mandatory model for default superannuation and defined benefit funds.
2. The Review Panel provide defined benefit funds with due consideration before final recommendations are made, possibly by mandating regulator liaison with the Institute of Actuaries of Australia.

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<sup>1</sup> Bryan, Dick, Gillian Considine, Roger Ham & Mike Rafferty, *Agents with Too Many Principles? An Analysis of Occupational Superannuation Fund Governance in Australia* (2009), Workplace Research Centre, University of Sydney (for the Australian Institute of Superannuation Trustees).

## 8.2 Small APRA funds

**Why have small APRA Funds (SAFs) proven so much less popular than SMSFs? Why do SAF members choose these vehicles over SMSFs? What are the additional trustee responsibilities in managing SAFs and how are the risk management frameworks in place appropriate for managing the risks of governing multiple SAFs? Do SAFs offer advantages for the retirement income system by comparison with SMSFs or other APRA-regulated funds? Are there structural impediments to their take up? If so, what are they and how could they be removed?**

No response.

## 8.3 Retirement Savings Accounts

**Could RSAs be enhanced by removing the capital guaranteed nature of the product and allowing any prudentially regulated entity to provide an RSA? What would be the advantages and disadvantages of an enhanced version of this product playing a larger part in the superannuation system?**

Retirement savings accounts (RSAs) offered by banks are part of the providing financial institutions' balance sheets, which are subject to banking laws rather than trust and superannuation law. As such, it is difficult to see how removal of the capital guarantee could be provided whilst still ensuring returns on assets are allocated to members on a transparent and equitable basis.

We see risks for members in such a proposal through the application of non-transparent, and potentially unscrupulous, treatment of earnings. In addition, most funds provide 'cash' options that offer similar certainty of capital with transparent returns.

### RECOMMENDATION

1. The capital guarantee remains in place for RSAs.

## 8.4 Approved Deposit Funds

**Do ADFs serve any residual purpose? In the interests of simplification, should this institutional class be closed to new members and the capacity to create new ones removed?**

Approved Deposit Funds were first introduced into the market in 1984 as an approved or appropriate vehicle for receiving superannuation lump sums. Given the evolution of the superannuation industry and the subsequent legislation changes that have occurred, mainstream superannuation funds can now operate in the space previously monopolised by ADFs.

As such, we believe ADFs do not serve any residual purpose and there is no reason for these products to remain open to new members.

## RECOMMENDATION

1. ADFs are closed to new members and the creation of new ADFs should not be permitted.

## 10. INSURANCE AND SUPERANNUATION

### 10.1 Compulsory or voluntary insurance

**Should the minimum level of cover required in a default fund (or a 'universal fund' under the choice architecture model) be tailored to other factors such as family situation and financial circumstances? Should the amount of cover be maintained or indexed, presumably with the cost of cover increasing with age, or should a constant insurance fee be applied with the insured benefit decreasing with age? Should all members be able to opt out of insurance? Should funds be permitted, for example, to offer life insurance as an opt-in default for young, single members? Should commissions be payable on default fund life insurance? If so, why?**

Default insurance arrangements have long been a feature of many superannuation funds, including not-for-profit funds. When many of the current industry funds were established in the 1980's, contributions were very low, and insurance levels were set at a correspondingly modest level. As contribution levels have grown with the introduction of the SG, and member balances have grown, most funds have increased their levels of default cover to provide more useful protection for members. We believe that by the time the minimum levels for eligible default funds were introduced, most funds then operating as defaults would have had insurance arrangements in place exceeding that minimum.

However, default cover is provided to members for whom the trustee has received only basic information, and hence it must be designed with the following in mind:

- The wide variation in the actual personal circumstances of fund entrants;
- The similarities between entrants that may exist by virtue of the fund's occupational focus and demographic profile;
- The levels of cover that can be obtained for that membership in the group life insurance market; and
- The levels of contributions, so that default cover premiums do not unduly erode retirement savings.

We assume the question in the Issues Paper about 'tailoring' default cover refers to default insurance design and the limiting factors noted above. In this context, we respond that trustees are in a position to tailor default insurance to their overall membership's needs, and historical differences between many default funds enable them to do this to their members' benefit. We would also see the minimum specified for eligible default funds as an absolute minimum, and believe that most funds would already have built a more appropriate default structure which exceeds the requirements of that minimum.

However, attempting to tailor default insurance cover to individuals would be difficult to implement, and runs counter to the rationale for default cover – that it provides a basic level of protection for those who are disengaged. To tailor the cover would require obtaining additional

information from members, which, in practice, would be very difficult and costly to acquire given the levels of member disengagement experienced by the superannuation industry. In addition, premiums will rise due to the insurance being tied to individual risk ratings rather than to the group risk rating, resulting in overall cost increases.

We believe member education and engagement is a natural complement to default cover, so that those members for whom the default is not appropriate (including those who have lower or no need for cover) can elect to change their arrangements.

In relation to how insurance cover is priced, that is indexed versus fixed, we believe this is a decision best left to each fund to determine, based on their membership demographics and insurance risk profile as a fund. Risk increases with age hence dollar cover per dollar premium declines for older members and traditional benefit design has assumed that as members' account balances increase over time, the decreasing cover provides a relatively flat level of total protection. However, some funds have found that for their members' risk profile, there is either a distinct sag in the cover levels for members in their 30s and 40s (the age of peak need for cover), or insufficient cover for older members. Consequently, they have determined a cover scale to more effectively complement the assumed growth in account balances, and floated the premium. We believe the absolute minimum specified for eligible default funds should continue to be expressed in the traditional fixed premium basis.

AIST believes super fund members should be able to opt out of insurance to ensure retirement benefits are not eroded unnecessarily. For example, a member may have cover outside of superannuation and therefore should not be forced to double up and hold insurance through their superannuation.

While funds may choose to provide low levels of default cover to young members, due to their generally lesser financial commitments, we do not support a purely opt-in default insurance cover for young members. It would leave many young people without cover and may adversely affect a fund's access to low-cost cover. Were entrants provided with an opt-in arrangement only, young people may not be able to access cover easily when their financial commitments increase in middle age.

In addition, unless younger and generally lower-risk members are included in default cover arrangements, the fund's risk profile would worsen and the associated premiums would increase.

In relation to commissions, they should not be allowable on default insurance. Default cover is provided without bias to all members and is not provided with the help of advice. Thus, there is no justification for paying a commission in relation to default cover as there has been no 'service'. At a wholesale level, we believe a brokerage fee is both appropriate and legitimate for the service provided by the insurance broker. However, this fee should be dollar-based and paid to an independent broker.

Ultimately, the underinsurance issue and the debate surrounding minimum cover are both functions of a deeper issue – lack of financial literacy. The 2008 ANZ Adult Financial Literacy Report found that those with low levels of financial literacy were less likely to hold insurance and struggled to understand what rights and options they have.<sup>2</sup> More needs to be done to educate

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<sup>2</sup> ANZ, Adult Financial Literacy Report (2008).

members about the insurance available through their super and the importance of having the right level of cover to meet their needs. Widespread member disengagement supports, rather than detracts from, the importance of adequate default cover.

**APRA data indicates that the annual cost of life and total and permanent disability (TPD) insurance exceeds \$2.4 billion for APRA regulated funds with more than four members. Should default funds also be required to offer TPD cover in addition to death cover? What are the drivers of a fund's proceeds ratio? Are there ways that death and TPD insurance could be provided more cheaply to members? Are the apparently wide variations in proceeds ratios between fund types explained solely by occupational, socioeconomic and demographic factors?**

AIST has reservations regarding the statistics quoted in the Issues Paper and sourced from APRA. We have been advised that this data does not include any claims reserves for open claims, nor any claims incurred but not yet reported, and that the analysis is therefore restricted to claims-paid data only.

We note that group life insurance premiums from superannuation funds constitute more than 25 per cent of the premium income of life insurance companies in Australia. This indicates that superannuation trustees are in a powerful position to negotiate policies on terms very favourable to their members.

We believe the inclusion of group life insurance within superannuation is one of the silent success stories of the industry and we consider the ability to provide typically underinsured Australians with access to basic cover a significant strength and a key value add. More importantly, trustees' purchasing power in this market means that for most members cover through superannuation is cost effective and need not result in unnecessary erosion of retirement benefits. This is particularly evident in the industry fund sector where data compiled by IFS Insurance Broking (IFS IB) indicates an average 30-year-old male or female could be up to \$311 or \$222 per year better off respectively, whilst a 50-year-old male or female \$1,300 and \$1,036 per annum better off than if they obtained equivalent cover outside of superannuation.

Of course, trustees need to exercise their purchasing power, and we see increasing willingness to do so, not only in terms of driving down premiums, but also in improving services and reducing claims processing times. IFS IB has initiated a Claims and Underwriting Re-engineering project (CURE) to drive these outcomes for their client funds.

The ability for members to obtain insurance on a group basis ensures that should a claim be made, they have the trustee of the fund on their side to assist with gaining access to their insurance entitlements. In the retail insurance space, an individual must liaise directly with the insurer and does not have the benefit of fund support. With this in mind, we believe default funds should be required to provide both TPD and death cover.

However, members have different needs for death and TPD at different stages of their lives. For example, young single members with no financial commitments arguably have very little need for death cover but a significant need for TPD. As a general proposition, we believe members should have the option to opt-out of either the TPD or death cover, or both; that is, 'unbundle' their insurance offering. However, we understand that funds covering members in hazardous occupations (for example, police) may not be in a position to offer an opt-out as employers will wish to avoid moral hazard.

## RECOMMENDATIONS

1. Decisions on how to tailor default insurance and how to price the cover should not be mandated or legislated, but left up to the trustee to determine.
2. Commissions are outlawed on default insurance.

### 10.2 Self-insurance

**Is it in members' best financial interests for certain superannuation funds to continue to be allowed to self-insure death and TPD benefits? Should defined contribution funds ever be allowed to self-insure death and TPD benefits? Is there any reason that defined benefit funds (and sub-plans) shouldn't be allowed to self-insure death and TPD benefits so long as actuarial advice is obtained on the funding needed and APRA is satisfied as to the financial strength of the employer? Would this lead to costs savings for employers and members?**

APRA discourages funds from self-insuring due to the associated risks and required reserve structures. The regulator believes the best mechanism for delivering death and disability insurance is through entities established under the Life Insurance Act 1995. We believe this still has a place, particularly in relation to large, defined benefit funds with a government sponsor.

However, where funds self-insure, appropriate documentation and planning is critical, including specifically addressing self-insurance as a risk in the fund's risk management plan. Inclusion in the fund's RMP assists the fund in understanding what potential catastrophic risks will arise that may impact on the fund or employer and its ability to support such an event.

We note that funds, in particular public sector funds, with highly stable memberships are in a position to securely self-insure for death and disability insurance. Ultimately, this benefits members as profits, which would otherwise accrue to the insurer, are reinvested back into the products and result in better insurance, fee reductions, or other product enhancements that would not have otherwise been feasible.

The question of achieving the right balance between internal and external insurance arrangements should be primarily driven by risk management rather than costs. In most circumstances the trustee must make an independent decision as to whether a member is totally and permanently disabled.

In most cases this will accord with their insurer's decision and the claim will be fully paid. However, in some instances the trustee is potentially exposed to an uninsured liability, for which many trustees, even those with insurance policies in place, maintain a reserve. This means trustees must decide upon an appropriate balance between self-insurance through internal reserves or insuring externally. Other insurance options are available, such as reserving with stop-loss or catastrophe insurance. In this context, we believe some level of self-insurance is inevitable, and proper reserving is an appropriate response.

By restructuring their default cover arrangements, trustees may be able to reduce the cost of premiums to their members (for instance by removing death cover from default arrangements for the very young).

## RECOMMENDATIONS

1. The decision to self-insure or not is best left to trustees and should not be legislated.
2. APRA should provide guidance for trustees concerning insurance reserves, and should clarify trustees' positions where a claim is admitted by the trustee, but declined by the insurer.

### 10.3 Income protection

#### **There is a range of views as to whether and to what extent income protection insurance should be embedded in superannuation. What is the right approach here?**

Research conducted in 2008 by AIST and Industry Funds Forum (IFF) showed that 50 per cent of Australians were underinsured for death cover in excess of \$100,000. For TPD, 74 per cent were underinsured by \$100,000 or more, a trend that continued in the level of income protection insurance, with 45 per cent being underinsured by \$1,000 or more a month.

Given this trend, we believe providing default death and TPD insurance within superannuation is essential as it provides a cost effective path for supplying insurance to the masses, and it may be the only life insurance cover an individual has. In addition, some individuals have difficulty paying for insurance premiums from their after tax salary and embedded insurance allows premiums to be paid from pre tax salary or from SG contributions. If this was not possible, it is improbable that these people would obtain and hold cover, let alone adequate levels of cover.

It is our view that both death/TPD and income protection insurances play a key role in ensuring an individual – and their family - is adequately covered in the event of an illness or accident. However, while we support death and TPD being offered on a default basis, there are significant administrative hurdles for many funds in offering default income protection.

The IP benefit is typically salary-linked and most trustees do not maintain accurate records of members' salaries. Under a typical IP policy, cover will be capped at say 75 per cent of salary, and this means trustees can only practicably provide default cover up to 75 per cent of the lowest possible salary.

To offer default income protection would add another layer of cost, as it would require the gathering, recording and updating of salary information with the added complexity that employers are not currently required to pass salary information on to a super fund. We also note that where a member has multiple accounts across a number of funds they are likely to pay multiple income protection premiums without receiving any benefit in the event of a claim – as most insurers would offset the other policy along with work cover entitlements.

In some instances, notably in defined benefit funds, trustees do maintain accurate salary records and the administrative hurdles to default IP can be overcome. In other cases, employers use their corporate fund to provide IP under an industrial arrangement, and in this case the employer is required to provide the relevant details to the trustee.

We also note that the release of the Tax Determination 2007/3 has made embedded insurance easier to administer and more cost-effective for funds. In particular, it has enabled funds to

claim tax deductions for income protection cover costs up to the age of 65, and this has helped ensure members are covered for the full period of time during which they are ill or disabled.

## RECOMMENDATIONS

1. The Government allow trustees to decide whether or not income protection insurance is provided as a default, based on individual fund membership profiles and the administrative arrangements of the fund.

### 10.4 Other pooling ideas

**Given the apparent cost of life and TPD insurance to the superannuation sector as a whole, are there more radical ways to address the need for super fund members to have life insurance? How could super funds create sufficient risk pools to be able to underwrite such insurance themselves?**

As mentioned under 10.1 above, we have reservations regarding the statistics provided in the Issues Paper, and hence we do not accept that a more efficient mechanism for providing basic insurance needs to be found.

## 11. SUPER IN POST-RETIREMENT PHASE

**Should more be done to address financial risk in retirement, rather than just longevity risk? Alternatively, should more be done to ensure that post-retirement assets are not invested too conservatively? Would a similar system in Australia increase the attractiveness of guaranteed annuities for retirees? What else can be done to improve the availability of retirement income stream products in the Australian market (such as indexed annuities and deferred annuities)?**

For allocated pensions, volatility in returns need not necessarily lead to volatility in income. The choice of income to draw remains a choice for the account holder, and provided they are confident their fund will recover from losses they can draw their anticipated income with confidence. Given that various studies cited in the Issues Paper identify that over 60 per cent of benefits will be generated by investment returns in retirement, it is crucial for the adequacy of the overall retirement incomes system that exposure to growth assets is not unduly reduced in retirement. To ensure a greater focus on long-term returns and terminal benefits (including income streams) we believe changes to the disclosure regime are necessary in order to address the risk of overly conservative investments.

We believe that longevity risk is the 'main game' in retirement product design and policy. Management of financial risk and asset allocation is a continuation of the process commenced in the individual's working life, and the same factors apply (time horizon, risk tolerance, disclosure and advice) to those decisions as in working life. We do not support mandated 'step change' in the approach to financial risk at the point of retirement.

We note with interest that it is not clear in the Panel's proposed choice architecture whether universal funds would be able to provide income streams. We believe many members will continue in a default fund throughout their working life, with the expectation that their fund will provide a suitable retirement income stream. Therefore, we support as seamless as possible a transition from working life into retirement, and it is not clear whether this is achievable under the proposed architecture. The inclusion of mandated annuities would also need to be considered by trustees when designing any default portfolio for a retirement income stream.

We support annuities in the context of an increased SG, but we believe their chief role lies in addressing longevity risk.<sup>3</sup> Over-reliance on annuities would reduce the overall asset mix and diminish the outcomes of the system overall.

Mandating annuities would certainly increase the size and diversity of the available products. A major contributor to improving the pricing of annuities would be to eliminate commissions.

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<sup>3</sup> AIST supplementary submission to Australia's Future Tax System Inquiry, November 2009

## 11.1 Collective pension schemes

**Is there room for another model in Australian superannuation, being a model that sits in between the defined benefit model on the one hand and the defined contribution model on the other? Is such a model viable in the face of an ageing population?**

We believe funds can do more in terms of refining product design in accumulation funds, and there is currently significant debate regarding lifecycle funds. However, we do not believe that a return to widespread defined benefit coverage is feasible, given the mandatory nature of the system, Australia's flexible labour force, and the many small businesses that participate in the system.

## 11.2 Pension components of super funds

**Should it be mandatory for trustees to manage pension assets separately from accumulation assets? If not, why not? If yes, what are the specific benefits that would be derived and what additional costs might be incurred? Should there be limits to ensure member level diversification in order for income streams to be paid as required?**

We do not see a valid reason for requiring trustees to manage pension assets separately from other assets. Similar portfolios can be appropriate for both the growth phase and the accumulation phase, and cater efficiently for members of similar risk tolerance.

In addition, the component of pension assets in the asset pool is quite small for many funds and managing these separately from other assets can severely impact the fund in terms of costs and administration complexity. Splitting the portfolio to manage pension assets separately would dilute the scale efficiencies the Review Panel is seeking and, ultimately, would increase costs to members.

We support the construction of retirement-focussed investment options, where trustees combine their existing assets and managers to provide more income-oriented products for retirees. We also support robust processes for allocating investment returns in which the different tax treatment of pension assets is taken into account and earnings are allocated to various members in an equitable manner (relating to their taxation status).

Individuals are free to spread their assets across different options or funds, and this is often a rational response to perceived performance expectations in different asset classes in different funds. Requiring diversification would cut across an individual's right to adopt such a strategy. However, we support safeguards around diversification and we believe suitability gates, as outlined in the Phase One Preliminary Report, are an appropriate mechanism for achieving this.

In addition, when transitioning to the pension phase, we strongly support member education and advice, as we recognise that this is an important financial decision for the individual concerned and, therefore, receiving appropriate and non-conflicted advice is critical.

## RECOMMENDATIONS

1. The Government does not mandate trustees to manage pension assets separately from accumulation assets.
2. 'Suitability gates', as outlined in the Phase One Preliminary Report, are investigated with a view to providing safeguards surrounding diversification.

## 12. THE INTEGRITY OF THE SUPERANNUATION SYSTEM

### 12.1 Security of super

**What, if any, additional measures should be adopted to enhance the security of superannuation funds? What is a suitable definition of fund failure? Do we need a super guarantee corporation or other statutory insurance to cover a fund failure?**

In the context of superannuation, 'security' can be thought of in several ways:

- Security of the funds under management in terms of investment and liquidity;
- Security of the data and personal information held by each fund; and
- Security in terms of fund operations and long-term viability.

It is our view that funds already address these issues in their risk management processes, risk management strategies, risk management plans, liquidity management policies, investment diversification, compliance with stringent licensing requirements, and the use of experts through outsourcing. As such, we do not believe it is necessary for any additional measures or requirements to be introduced.

However, we recognise that regardless of how sufficiently security risks are managed, there are always improvements to be made. The initiatives that could be introduced to enhance the current framework are:

- Legislative relief to simplify collective investment through vehicles such as pooled superannuation trusts;
- Broader Tax File Number (TFN) use across the industry, including use as a primary identifier; and
- Tighter regulation of the SMSF sector, including the requirement for minimum establishment deposits and regulation by APRA.

In addition, we believe that the establishment of a national fund or even several mega funds will increase the impact of a fund failure. Therefore, we do not support mandated consolidation as it is important that strong levels of competition exist in the market driven by many market participants.

We do not believe a definition of 'fund failure' is required, nor do we perceive it necessary to establish a superannuation guarantee corporation, statutory insurance scheme or a national fund.

### RECOMMENDATIONS

1. The Government commits to altering the relevant legislation to simplify the use of collective investment vehicles by multiple funds.
2. Broader TFN access is required for funds and use of the TFN as the primary identifier associated with superannuation should be progressed.

3. Tighter regulation of the SMSF sector, including the requirement for minimum establishment deposits and regulatory overview by APRA.

## 12.2 Impact of superannuation fraud and theft

### What are the areas of greatest vulnerability of superannuation funds to fraud or theft?

Consultation with our members has identified the following aspects of the superannuation industry as being most vulnerable to fraud or theft:

- **Early-release schemes:** We note that ASIC has been active in the space of illegal early-release schemes, and we are aware that whilst the regulator is making ground, the number of reported cases regarding early-release fraud continues to grow. These scams hurt the member in two ways: firstly, if the criminals do manage to obtain the superannuation monies, the exorbitant fees charged significantly reduce the amount paid to the member. Secondly, it removes the money from the superannuation industry and depending on the amount, can have a major impact on the benefit the member receives at retirement.
- **Identification theft and establishment of 'dummy' accounts:** As the pool of superannuation monies continues to grow, so too does the target placed on the sector by criminals. This target, coupled with the level of member apathy and disengagement present in the sector is a dangerous combination when assessing the risk of fraud or theft faced by a fund. We believe the likelihood of identity fraud could be reduced by broader use of the TFN, as discussed at length in our response to the Phase Two Issues Paper.
- **Rollovers to SMSFs:** We are aware of many cases where members are encouraged to roll over their superannuation accounts from mainstream funds to SMSFs where they are then provided with a cheque for the amount of their balance less a sizeable fee. When processing this rollover, we believe a key step for the super fund is to check the ATO's Complying Funds Register. This is a particular concern given the register is not as accurate as it could be in relation to the status of listed SMSFs. It is possible for an SMSF to be listed on the register prior to receiving 'complying' status. In addition, the ATO institutional structure is not particularly robust in relation to identifying fraudulent SMSFs. We believe the ATO register of complying funds should be overhauled to ensure SMSFs cannot appear on the register before they have received complying fund status.
- **Lack of legal and regulatory knowledge held by staff performing member administration tasks:** Our consultation process has identified that there is a need to ensure information is effectively disseminated through a superannuation fund. For example, legislative changes should be passed on to contact centre staff to ensure all fund employees are aware of what the current law is. For this reason, we support continual staff training and development. Specifically, we believe standards regarding frequency of RG146 refresher courses are required across the industry.
- **The investment instruction process carried out between funds and custodians:** This is a critical issue and needs to be comprehensively addressed within the risk management program of each fund. We believe greater focus on potential fraud in this area in risk management programs would initiate a process where custodians were required by their client funds to demonstrate they had robust processes in place. This in turn would encourage custodians to continually develop better systems. We also support regulatory attention to this matter as part of the prudential review, and this may assist funds to identify any shortcomings in their instruction and custodial processes.

Trustees have an obligation under the SIS Act to prudently manage their fund and this involves safeguarding members' monies, where reasonably possible, from losses arising as a result of theft or fraud. Whilst we recognise that it is impossible to eliminate early release schemes, rollovers to dummy accounts, and SMSF-based fraud, it is possible to have a strong and robust control process in place and we actively encourage our members to diligently plan and prepare for these scenarios within their risk management framework.

### **How is the industry best protected from systemic risk arising from a loss of confidence in the security of retirement savings?**

A loss of confidence in relation to the security of retirement savings could significantly impact funds and, ultimately, retirement savings. To manage and mitigate this risk requires attention at both an industry and fund level. This is achieved via effective use of risk mitigation strategies, business planning with consideration for consumer confidence, risk management plans and strategies, liquidity policies and other controls funds have in place.

However, a key driver of consumer confidence is understanding and knowledge. If members constantly feel as though the system's rules keep changing, sentiment is certain to fall. For this reason, we believe wherever possible, reviews and legislative changes must be kept to a minimum.

## **RECOMMENDATIONS**

1. Broader TFN access is required for funds and this would assist to minimise the issues associated with identity theft and fraud.
2. APRA provide more regulatory attention and guidance to funds in relation to the custodial process.
3. The ATO register of complying superannuation funds be updated to ensure all funds on the register have obtained complying fund status and to ensure that an SMSF cannot be included on the list before this status has been confirmed.

### **12.3 Use of superannuation for criminal purposes**

#### **Should rollovers to SMSFs be designated services for the purpose of the AML/CTF Act? What mechanisms could be established to inhibit the repatriation of criminally obtained funds from overseas into an Australian SMSF under the guise of extraordinary foreign investment returns?**

For the purposes of the AML/CTF Act, rollovers to SMSFs should be designated services, as evidence shows they carry a risk of exposure to fraud and potential money laundering or terrorism financing. As such, these transactions should be identified as designated services to ensure enhanced tracking and analysis of these amounts.

Furthermore, we note that the AML/CTF regulatory program has placed an added burden on funds and the additional reporting required is quite broad in nature, particularly when compared to the actual AML/CTF activities themselves. As such, any additional AML/CTF requirements should be considered in terms of value added for reporting and work required. Whilst requiring SMSF rollovers to be included as designated services would bring additional attention to early

release schemes it is unlikely this would assist with identifying criminally linked transactions from overseas sources. It is our view that administration of SMSFs through licensed administrators and tighter regulatory requirements for these funds would assist in minimising money laundering activities.

In addition, as previously mentioned in this submission, tighter control of the superannuation complying fund register maintained by the ATO would provide considerable assistance in this area.

## **RECOMMENDATIONS**

1. The ATO register of complying superannuation funds be updated to ensure all funds on the register have obtained complying fund status and to ensure that an SMSF cannot be included on the list before this status has been confirmed.
2. SMSF rollovers should be classified as designated services for the purpose of the AML/CTF Act.
3. As discussed in our Phase One submission, we support APRA having regulatory responsibility for the SMSF sector.

## 13. PARTICIPATION IN THE SYSTEM

### 13.1 Indigenous Australians

#### **Are there ways in which the superannuation system could better accommodate the needs of indigenous Australians?**

We acknowledge that indigenous Australians are not well-served by the superannuation system, particularly as many live in remote communities or do not earn enough to be eligible for employer contributions. Historically, indigenous Australians have faced challenges that have resulted in a reduced life expectancy in comparison to other ethnic groups in Australia – indigenous Australian men have an average life expectancy of 59 years.<sup>4</sup> Many members of indigenous communities will not reach preservation age, and therefore would not ever be able to access their super, should they have any.

Currently, insurance arrangements are unsuitable for many indigenous members as they do not take into consideration the different lifestyles and family arrangements of indigenous people. We believe funds could and should collect more detailed information when members first submit an application to join the fund so that they can provide more culturally appropriate insurance arrangements to indigenous members. This could simply be a tick box stating whether a member is of Aboriginal or Torres Strait Islander descent, as is currently present on many application forms in other industries.

Current arrangements require prospective members to provide certain documents to certify their identity. Often, this is impossible for some indigenous people as they may not have access to 'proof of identity' documents. In our Phase Two submission we proposed that members be required to quote a TFN or satisfy a 100-point ID check. However, we acknowledge that different arrangements may be necessary, such as those Centrelink have in place, for verification of identity of Aboriginal and Torres Strait Islander people.

We note that government programs, such as Community Development Employment Projects (CDEP), have assisted indigenous job-seekers in attaining skills for employment. Participants in the CDEP program complete jobs within their community and are remunerated for their efforts. However, CDEP organisations are exempt from contributing superannuation to participants in the CDEP program. Participants who commenced post-July 1 2009 receive income support payments, while those who participated in the program before this date received a wage. Neither the participants nor the CDEP organisations meet the definitions of an employee or employer under superannuation legislation, which therefore renders participants ineligible for the Superannuation Guarantee.

Indigenous Australians face both language and cultural barriers to participation in the superannuation system. English is not the first language for some indigenous people, which makes communication with financial institutions difficult. We note that ASIC has made attempts to provide information about superannuation to indigenous communities in simple formats; for example, *Super and us mob*. However, these documents are written in English and are therefore targeted at particular members of indigenous communities who read and understand English.

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<sup>4</sup> Australian Bureau of Statistics, *The Health and Welfare of Australia's Aboriginal and Torres Strait Islander Peoples*

Language barriers have also contributed to extremely low levels of financial literacy in indigenous communities, especially amongst young people.<sup>5</sup> Financial education is virtually non-existent, particularly in remote communities, and knowledge of superannuation and retirement planning has therefore progressed very little since its introduction.

Finally, family and financial arrangements in indigenous communities are, generally, very different to those of the majority of Australians. For example, large groups of people often live together, rather than living as the traditional 'family unit', and they often pool money together as opposed to having individual savings.

## RECOMMENDATIONS

1. The Government remove any regulatory impediments preventing funds from collecting information in relation to whether an individual is of Aboriginal or Torres Strait Islander descent.
2. The CDEP income payments should be included as salary or wages for the purposes of the Superannuation Guarantee (Administration) Act 1992.

### 13.2 Women

**Excluding issues of adequacy resulting from broken workforce participation and lower average incomes (which fall within the scope of the Henry review) are there specific issues which disadvantage women in their interaction with the superannuation industry? If so, how could these be addressed? Are there other clearly identifiable groups for whom specific provision could and should be made within super?**

As we have argued in our submission to the Henry Review, we support removing the \$450 threshold for the superannuation guarantee. We strongly believe paid parental leave should include superannuation, and we recommend a review of the ATO's definition of ordinary time earnings (OTE) to achieve this. In the absence of a super component to paid parental leave, we have supported a one-off superannuation 'baby bonus' payment. We note the Productivity Commission's recommendation that the Government implement a paid parental leave scheme that includes a superannuation component.

Women have a longer life expectancy than men. Currently, female life expectancy is 83.7 years compared to 79 years for males. Women therefore spend more time in retirement than men, and require more retirement savings. Currently, women are more reliant on the Age Pension in retirement, accounting for at least 58 per cent of age pensioners, due to their inadequate retirement savings and longer lifetimes. However, the Age Pension provides only 70 per cent of the income needed to maintain a "modest and adequate" standard of living in retirement.<sup>6</sup>

Lower marriage rates and higher divorce rates have complicated retirement savings for many women – more women are reliant on solely their own superannuation, which is often inadequate due to broken workforce participation and lower incomes. In many cases, women seek custody

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<sup>5</sup> National Indigenous Consumer Strategy, <http://nics.org.au/financial-management-banking/>

<sup>6</sup> Rice Warner Actuaries, *Touchstone* newsletter, October 2004

of their children during divorce settlements and often trade-off access to super in order to keep the family home so that they have some sense of security and stability.

Low income earners have little incentive to salary sacrifice – for those who earn under \$35,000 (often women), there are no tax incentives as there are for higher income earners. Women earn, on average, 15 per cent less than men, and therefore receive less superannuation. In order to encourage low income earners to save for retirement, we encourage the Government to enhance the co-contribution scheme, and encourage a rebate of the 15 per cent contributions tax for all low income earners.

Low levels of financial literacy amongst women, particularly young or indigenous women, also disadvantages women in their interaction with the superannuation industry. We encourage super funds to promote financial education and literacy through marketing campaigns specifically targeted at women. We also highlight the need to encourage women to top-up their super later in their careers, particularly if they have spent significant periods out of the workforce.

In AIST's supplementary submission to the Henry Review, we recommended the introduction of a system of transitional concessional caps, whereby an individual can apply for an increased concessional cap in the basis that their current savings are inadequate.<sup>7</sup> This is particularly relevant for women in their 40s and 50s, with low balances, who are trying to 'catch up'.

## **RECOMMENDATIONS**

1. The Government include superannuation in the paid parental leave scheme.
2. Legislation is amended to remove the \$450 monthly earnings threshold currently required for SG eligibility.
3. More Government support is provided to women in relation to building financial literacy levels.

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<sup>7</sup> AIST supplementary submission to Australia's Future Tax System Inquiry, November 2009

## 14. OTHER STRUCTURE ISSUES

### 14.1 Allocation of members to default funds: role of industrial awards

**Is the industrial relations mechanism the best way to allocate employees to a default superannuation fund? If not, what other mechanisms might be adopted to improve outcomes for members?**

As discussed in our Phase Two submission, superannuation is a bulk service system that must cater appropriately to the masses. Providing default fund selection within the award structure is an efficient and cost effective mechanism for successfully completing this process.

The introduction of choice of fund was designed to provide and promote employee fund selection and member engagement in relation to their superannuation account. However, it has become evident that the implementation of fund choice has not provided the anticipated levels of system efficiency or member engagement. As such, member apathy towards superannuation is still a major issue and, for this reason, we believe default fund selection is critical and the use of the industrial relations system protects employees who fail to exercise an informed choice. We believe that, where individuals fail to make a choice, the choice should be made by their representative, through the industrial relations process.

Altering this process will increase both system inefficiency and costs, as the inclusion of superannuation within an award provides automation to the fund selection process, removing the necessity for employers to research funds, make a selection and then regularly review the chosen fund. In addition, it removes the issue of employers being provided with inducements in return for default fund selection, an outcome that does not promote the best interest of members.

Given that superannuation is, effectively, deferred wages, it is appropriate that there be a structured process in place to ensure default fund selection is robust and default funds operate to maximise retirement savings without the use of expensive bells and whistles. To facilitate this, we support the use of awards and industrial relations tools. However, funds eligible for nomination as a default fund should meet certain enhanced minimum operating standards, including operating on a low-cost basis, minimum insurance cover, compliance with electronic commerce protocols, no payment of commissions to any financial intermediary, and have a representative trustee structure.

Where an employer is not covered by an award, they should still be guided by the award system when selecting the default fund.

There is a need for improved policing of compliance with award requirements and default fund criteria and we support further investigation into this matter.

## RECOMMENDATIONS

1. Industrial parties select eligible default funds for inclusion in awards and EBAs. Where multiple funds are permitted in an industrial instrument, the employer may choose between them.

Where there is no applicable industrial instrument, or a fund is not nominated in the industrial instruments, employers should be guided by the relevant award.

2. That Government, through the fair work ombudsman, effectively police employer compliance with these rules.

## 14.2 Dispute resolution

**Would there be value in the creation of a specialist superannuation court under Commonwealth legislation?**

**Possible roles for such a court could include:**

- **consideration of trustee proposals to facilitate mergers of funds where complex member rights issues were involved;**
- **legacy product rationalisations;**
- **power to give directions to trustees seeking determination of complex issues; and**
- **resolution of disputes with regulators.**

Currently, the SCT forms the function of a 'superannuation court', allowing members to pursue complaints via an external body, thereby removing the need for a superannuation court created under Commonwealth legislation.

In addition, the SCT is able to provide extensive conciliation services and a low cost avenue for members to pursue their complaints and grievances. Neither of these outcomes would be possible if a court structure was established.

In relation to the dot points identified in the Issues Paper, we note none of these are complaints nor are they issues that we would expect to be common. Therefore, there may be merit in providing an arena for pursuing these issues outside of the SCT structure for a limited time. For example, interpretative decisions or determinations could be provided by APRA, similar to how the ATO currently operates, to provide assistance and direction to funds in relation to mergers and successor fund transfers. This would allow trustees to receive guidance in relation to complex matters and issues without incurring the costs associated with taking the matter to court. Often, trustees are reluctant to spend members' money on court fees, and having a regulator providing formalised guidance would remove this issue.

For example, a fund could write to APRA seeking clarification in relation to a complex issue and APRA could provide a specific written determination or decision based on the information provided. This would remove the need to develop a costly Commonwealth-based court structure, which is likely to be required for only a short period of time.

## RECOMMENDATION

1. The Government investigates the role APRA can play in relation to providing interpretative decisions to funds regarding issues such as mergers and successor fund transfers.

### 14.3 Risk-sharing

**Currently, the investment risk in the accumulation phase of superannuation rests mostly with the individual. Should the Government assume some of this risk, given that it largely underwrites both investment risk and longevity risk in retirement by way of the age pension? Should the Government provide some additional certainty to alleviate individual anxiety in volatile financial markets? How could this be offered without representing an undue burden on the Budget? Should the structure of superannuation include some defined benefit features, rather than solely an accumulation approach? Who could underwrite the defined benefit component? Could default funds be required or encouraged to incorporate an investment fluctuation reserve into their default investment option, so as to allow a more aggressive investment approach without a commensurate increase in volatility? How might they address free-riding, where individuals select a fund after its investment reserve had been built up? How costly would it be to administer a scheme whereby entitlement to share in reserve distributions vested progressively over a period of, say, five years?**

Currently, the Government carries investment risk in the accumulation phase, as poor outcomes will decrease the assets offsetting the Age Pension, resulting in higher payments of the Pension. Volatility only affects those close to retirement who aim to remove all their benefits from the superannuation system upon retirement.

For the majority of workers who are some years from retirement, volatility should not be a risk that the Government needs to remove from the system. In our submission to Phase Two of the Review, we argued for a disclosure regime that firmly focuses member attention on long-term outcomes, rather than short-term accumulations. Adoption of this or a similar regime would be an excellent way to address anxiety among members without changing the growth-oriented asset allocation, which delivers results over the long-term.

Whilst we recognise the advantages for individuals in defined benefit arrangements, and the risk-sharing opportunities presented by them, defined benefits raise the question of who underwrites the benefit. We do not believe widespread adoption of traditional defined benefit schemes, where employers underwrite benefits, is feasible in today's flexible labour markets where employers are trying to reduce, not increase, business risk.

The use of investment fluctuation reserves inevitably raises questions over equity when members leave the fund having contributed to the reserve, or join the fund, having not contributed to it. We do not believe reserving can be equitably implemented where choice of fund and member investment choice are major policy features of the system. Whatever product development approaches are taken, we believe funds should pursue a well-resourced, positive member engagement program, from ages 45 and up.

A system of progressive vesting of a reserve would be expensive to administer, particularly as it is more likely to be offered as a choice rather than default product, and take-up might be modest, resulting in a low number of accounts against which costs can be defrayed.

## RECOMMENDATIONS

1. The Government pursue a disclosure regime focusing attention on end benefits, rather than annual returns.

### 14.4 Capital requirements

**Given the important societal role that superannuation plays and the significant operational risks that all trustees must manage, as a matter of protection for members, should capital be required for all trustees of super funds other than SMSFs? If so, what sort of risk factors ought to be considered in setting capital requirements? What amount of capital should be required? Should a public offer trustee without capital of its own be able to continue to rely on an approved guarantee or the fact that its custodian may have the \$5 million capital backing? Should a custodian be required to have the minimum capital requirement in its own right, rather than being able to continue to rely on an approved guarantee?**

We believe operational risks can be adequately managed within a framework of professional insurances, and risk sharing with operational partners (for example, administrators). We recommend operational risk reserves be held within all funds. Requiring trustees to accumulate specific capital reserves raises the issue of who owns that capital. While this may not be an issue for retail funds sponsored by a large institution, not-for-profit funds have limited capacity to raise capital without jeopardising their independence, which is a crucial feature of the overall superannuation system.

We believe operational risk reserves should be allocated within the fund, within the context of the specific operational risks the fund faces. This would not only avoid the arbitrariness of the current defined dollar figure, but would allow funds to re-allocate reserves in the event that the trustee-developed systems, processes or structures to more effectively manage operational risks.

We do not believe further changes are required to the capital requirements applying to public offer trustees. We note that the approved guarantee or net tangible asset limits are arbitrarily set without reference to the actual risks in question, and that many large industry funds currently hold operational risk reserves well in excess of \$5 million.

The \$5 million figure applied to custodians is also arbitrary, and given the concentration of very large players in the custody space, it is even more inadequate. We believe custodians' capital reserve requirements should be set by reference to the actual risks they face.

## RECOMMENDATION

1. We support custodians' capital reserve requirements be set based on the actual risks they face.

## 14.5 Source of permanent capital

Would it assist super funds to be able to create a listed entity or entities which could hold longer-horizon assets, such as infrastructure, providing permanent capital for such investments?

Under such a model, the constitution of the entity could require that the founding fund(s) must retain (say) a 50 per cent stake in the listed entity for an extended period. The advantages would be:

- some of the apparent difficulties with infrastructure ownership, such as illiquidity and difficulty with regular valuation, could be ameliorated while retaining exposure to assets that match the fund's 'liability' profile;
- the availability of transparent valuation and price signals by the market, thereby overcoming unit pricing and arbitrage problems that affect such assets if held directly by a super fund;
- investors wanting to trade actively in the entity could do so outside superannuation because the entity would not, itself, be a superannuation fund;
- SMSFs would be able to gain easier exposure to infrastructure and other illiquid assets by acquiring an interest in the entity;
- the entity would be subject to the continuous disclosure, governance and other disciplines of Australian Securities Exchange (ASX) listing; and
- there would be an incentive on the part of analysts and rating agencies to rate the entity; a feature not currently applying to super funds.
- Are there impediments to this sort of structure under current settings? What other issues arise?
- We do not see any legislative or regulatory impediments to super funds creating listed infrastructure vehicles on the terms suggested in the Issues Paper. In fact, there are a number of such vehicles already available to funds. However, investment into underlying infrastructure assets has typically been through unlisted vehicles, as these allow funds to capture an illiquidity premium as long-term investors. We do not believe liquidity or valuation issues pose real barriers to prudent participation in infrastructure assets.

Listed infrastructure vehicles do represent an opportunity for SMSFs to access infrastructure investment, and we also see a niche for infrastructure bonds in providing alternative sources of fixed-interest investment for SMSFs.

## 14.6 Legacy products

**To what extent are they a problem in superannuation? What measures can be taken to facilitate elimination of legacy products (and movement of legacy members) without material disadvantage, in circumstances where a successor fund transfer might not be available?**

We note the view expressed by the Product Rationalisation Project Panel of the Treasury that "The successor fund transfer process is generally appropriate for the superannuation industry due to the fiduciary duty imposed on superannuation trustees."<sup>8</sup> The successor fund process effectively incorporates protections for beneficiaries of the kind identified as being necessary to any analogous process introduced for managed investment schemes and life insurance products. Given these protections are in place, are operable, and are necessary to deliver

<sup>8</sup> The Treasury, *Product Rationalisation of Managed Investment Schemes and Life Insurance Products: Proposals Paper*, December 2009

consumer protection, we do not believe there is any scope for introducing parallel product rationalisation processes in superannuation law.

Whilst some providers of high cost, retail-based legacy products complain about administration expenditure, the often exorbitant fees collected from members provide an incentive for the provider to continue the product as is without investigating equitable ways of winding these products up.

## 14.7 Innovation

**For example, is there any reason why super funds shouldn't be able to compete in the 'reverse mortgage' market (as this seems peculiarly compatible with the retirement income function of super funds)? Are there any specific impediments at present to super fund trustees developing new product offerings? If so, what are they?**

Whilst the reverse mortgage market may seem appropriately aligned with the retirement income function of superannuation funds, we would caution against funds being able to move into this space. To facilitate the introduction of these products being offered by funds, alteration of the sole purpose test is required, and we are concerned that unintended consequences may result from any easing or relaxation of the test.

In addition, superannuation fund trustees do not have access to shareholders who can provide capital to fund new initiatives and ideas. As such, any money set aside for product implementation would need to be carefully considered.

Historically, funds have tried to be innovative with their product offerings and have attempted to introduce products and services that compliment superannuation based offerings and assist their members. For example, we are aware of some of our members introducing discounted health insurance, home loans and managed-fund products through strategic alliances with other organisations. We are also aware of funds looking to establish alliances with organisations to facilitate the provision of guaranteed income products to assist members with longevity risk.

We encourage our members to add value to their product offerings where it is cost effective and beneficial to do so. However, it is difficult to innovate when average account balances are low. We expect product development to progress over time as the number of members receiving whole-of-working-life SG contributions increase and thus, average account balances grow. We also believe funds will begin to investigate product offerings that enable members to pay for high care or low care health facilities.

## Part Three: Response to Part B

### 17. SMSF GOVERNANCE

AIST is not directly involved in the SMSF sector. However we recognise the importance of that sector to the overall superannuation system, and we strongly believe the regulation of SMSFs needs to service the Government's overarching policy objectives in relation to retirement incomes policy.

Accordingly, we have not addressed all the questions in Part B of the Issues Paper, but we have expressed our views more generally in the following section, and then addressed some of the specific questions on which we have knowledge.

#### **Overview of AIST's position on SMSFs**

AIST recognises that SMSFs have a place in the modern Australian superannuation system. We believe it is a natural outcome of the choice philosophy that many Australians will want to manage their own superannuation, and turn their back on both major institutions that offer superannuation to the general public, and their employer's default fund. We note that the architecture outlined in the Phase One Preliminary Report positions SMSFs at the extreme on the spectrum of choice or member engagement.

However, AIST's view is that this do-it-yourself philosophy cannot exempt SMSFs from the policy objectives the Government has assigned to superannuation, nor from the rules and regulations designed to support those objectives. There is a strong sense among SMSF members/trustees that 'it's my money and I can do as I want'. Proponents of this view resent regulation as an unwarranted government intrusion. We reject this view, and respond that the tax incentives SMSFs enjoy requires them to be administered in accordance with superannuation law.

We also believe that SMSFs, as a large and important sector in the superannuation industry, should be subject to the same level of public and academic scrutiny as APRA-regulated funds. The statistics and other information available on SMSFs through the reporting and statistics collection activities of the ATO are inferior to those presented by APRA, and we advocate for more regular, detailed reporting and disclosure to facilitate better research and policy formation.

There is a presumption that SMSF members/trustees are fully informed and rational investors who are comfortable and equipped to 'do it themselves'. Given that the choice architecture presumes that increasing levels of choice reflect necessary increases in investor sophistication, it underscores this myth. Our view is that if SMSF members/trustees have chosen to 'do it themselves', this should not remove them completely from the protections implicit in superannuation law.

We believe there are three key reasons behind choosing to manage one's own superannuation that the Review needs to consider closely in its examination of submissions. The three areas are as follows:

- Firstly, SMSF growth may be driven not by a positive urge to manage your own super as much as a negative urge to avoid involvement with the financial sector. This may simply be a deep-seated and potentially irrational distrust of the financial sector, or it may be a well-reasoned response to the costs involved in investing large sums through commercial funds. To the extent these issues are related to APRA-regulated funds rather than SMSFs themselves, many of the changes we have advocated in Phases One and Two of the Review address these perceptions.
- Secondly, many SMSF trustees enter the SMSF sector as a result of advice from a tax advisor, without due consideration of investment strategy, or how to execute that investment strategy. We see improved regulation of advisers in the SMSF sector as a key element in ensuring those setting up SMSFs are properly equipped for the task they face.
- Thirdly, since most SMSF costs are fixed for large sums invested, SMSFs can be very cost-effective, especially when compared to retail funds. However, this can be a two-edged sword, with smaller SMSFs experiencing large costs as a proportion of assets under management. We believe costs are not always allocated and accounted for transparently within SMSFs and we support bringing the member disclosure regime for SMSFs fully in line with APRA-regulated funds.

A major purpose of the Review is to drive efficiency and we believe, because efficiencies in many areas can only be achieved with whole-of-industry coverage, SMSFs should be subject to the same requirements as APRA-regulated funds with respect to electronic commerce.

### 17.1 Trust model

**Is the trust model appropriate for SMSFs? Does it still deliver the best outcomes for trustees, members and the broader community? Are the current membership requirements in the SIS Act, requiring trustees to be members and all members to be trustees, still appropriate for**

**SMSFs? Does the trust model work effectively for single member SMSFs?**

The requirement that all members are trustees and vice versa imposes a self interest motivation among the trustees. However, were members permitted who were not also trustees, the trustees would effectively be assuming a position of trust in respect of that person. For this reason we believe the requirement should remain in place.

### 17.2 SMSF trustees

**Should their responsibilities be less onerous than for trustees of APRA-regulated superannuation funds? If so, which of their current responsibilities should be changed? Does it remain appropriate to prohibit individuals in an employer/employee relationship from being members of the same**

**SMSF except when they are relatives?**

In our view, it is appropriate to prohibit individuals in an employment relationship (other than relatives) from being members of the same SMSF. Such a relationship would allow an employer to

exert pressure on his employees to join his own SMSF, and the employee is unlikely to be able to act in an appropriately independent governance role as a trustee.

### 17.2.1 Trustee education

**Given the obligations of being a trustee and the minimal barriers to entry, should there be some minimum level of financial and compliance knowledge required? Is there another way of addressing the issue of low trustee financial literacy, such as a mandated limitation on the products in which SMSFs, or some sub-set of SMSFs, are permitted to invest? Should trustees of SMSFs require some minimum level of training? Should SMSF members undergo some ongoing level of formal education and training or accreditation to become better educated on their trustee obligations and how to invest? If mandatory education is not required for SMSF trustees (as ATO questionnaire data might suggest is the case — see below), should voluntary training be encouraged? If so, how would this best be achieved? Should the ATO have the powers to impose training or accreditation requirements on SMSF trustees where they have breached SIS Act requirements?**

We believe there should be some minimum level of financial and compliance knowledge for SMSF trustees. However, given the narrower legal obligations and smaller sums involved in SMSFs, the hurdle would be lower than for APRA-regulated trustees. We also acknowledge that educating and verifying the knowledge of over 700,000 SMSF trustees would be a daunting logistical challenge that would have to be considered when formulating a standard.

We believe education and/or knowledge standards should be supplemented with a more robust professional advice framework. While APRA-regulated trustees come to their roles as part of their professional lives, many SMSF trustees are advised to establish an SMSF by a tax advisor. As such, they often lack the skills and resources to engage and coordinate the various professional advisers needed to effectively run their fund. The decision making capacity of SMSF trustees would be greatly enhanced by a trusted front-line professional who could administer their fund, coordinate the reporting and filing, and answer simple queries.

We also support a requirement that SMSF trustees engage and receive advice at least annually from a licensed investment advisor. We believe this is a more effective measure to improve investment practice than limiting the universe of investments.

We support minimum knowledge requirements, and this would require training in some instances. As noted above, the logistics of such an exercise are daunting, and the only practical options are training through existing SMSF adviser networks and internet-based training products. Were existing advisers to undertake training, the case for regulation of those advisers would be strengthened to ensure that the training provided is both academically rigorous and free from conflicts in relation to the services provided by the adviser.

Given we advocate for better support networks for SMSF trustees, mandatory knowledge standards, and no watering down of prudential regulation, we believe breaches need a stronger response than simple imposition of additional training. We support administrative penalties for minor first offences, with more punitive measures for more serious or subsequent breaches. The penultimate remedy should be for the regulator to require an SMSF in breach to be wound up and its assets transferred to APRA-regulated funds.

## RECOMMENDATIONS

1. That SMSF trustees receive advice from licensed investment advisers at least annually.
2. Trustees of SMSFs must meet minimum knowledge requirements.

### 17.3 Complexity

**Do the current compliance requirements for SMSFs impede an individual's choice to manage their superannuation given the perceived complexity in operating an SMSF? If so, how could this be improved? Alternatively, given the complexities of managing a person's retirement savings, do the perceived complexities amount to a useful barrier of entry to the sector? Is the complexity facing SMSFs any greater than super funds generally? If so, can you suggest any simplifications?**

We do not believe compliance or regulatory requirements should be watered down because they are perceived as too complex. To an extent, complexity is an unavoidable consequence of appropriate regulation, and we would suggest that individuals who are discouraged from operating an SMSF because of the inherent complexity are probably not suited to do so.

#### 17.4.1 Regulation

**Should there be separate Acts for ATO-regulated funds and APRA-regulated funds?**

We believe the policy objectives are the same for all funds, and therefore it is natural for the same body of law to govern all funds. We support APRA regulation of SMSFs, hence we do not see a case for segregation of legislation on the basis of regulator responsibility.

## RECOMMENDATION

1. Regulation of SMSFs to be managed by APRA.

#### 17.4.2 Role of the ATO and other regulators

**Are the ATO's regulatory powers strong enough, or appropriate, in the SMSF sector? Should the Commissioner of Taxation be able to issue directions to SMSFs (for example, to rectify contraventions)? Should the ATO have a prudential role similar to APRA? Is the ATO the appropriate regulator for SMSFs? And if so, does the ATO have any conflicts in fulfilling this role? If not, who would be the appropriate regulator? The regulatory arrangements for SMSFs come under the SIS Act and there are no provisions in this Act for the use of agents or intermediaries as there are for other aspects of the ATO's dealings (such as tax agents). Could the current regulatory regime be improved by the introduction of similar arrangements for SMSF administrators, auditors and others? Given the current widespread use of service providers with delegated powers in both the SMSF and APRA-regulated sectors, what advantage would accrue from such a change? Would it be in the interest of SMSF members to legislate that responsibility for some actions rested with parties other than the trustee or is the current structure where trustees are ultimately responsible for their actions the right setting?**

**APRA is responsible for the regulation of SAFs, while the ATO is responsible for the regulation of SMSFs. Is this segregation efficient and appropriate? Could efficiencies be achieved if the ATO**

## were responsible for SAF reporting and data collection activities, and APRA and ASIC continue to regulate approved trustees of SAFs?

We believe that all SMSFs should be administered by a licensed superannuation administrator (LSA). The fund's LSA would act as the key record keeper and reporting entity, and could also act as the trustees' front line adviser. We support transfer of regulatory responsibility for SMSFs from the ATO to APRA, and we believe LSAs would be able to file compliance reports to APRA on behalf of all funds under their management creating efficiencies, permitting better regulatory oversight, permitting more regular and more comprehensive publication of industry statistics, and providing better support to SMSF trustees. We envisage that participants in a number of industry sectors might be positioned to act as LSAs, creating a competitive tension between different business models and driving down costs.

We do not support the current exemption for tax advisers from the AFSL licensing provisions where the adviser establishes an SMSF. It is unacceptable for tax agents to advise their clients to establish an SMSF for tax reasons, and then leave them 'high and dry' without investment advice to effectively manage their fund. We support a requirement that every SMSF retain an investment advisor, and receive an investment report from that adviser on at least an annual basis. LSAs would provide a natural platform to provide administration, tax and investment advice to SMSF trustees. LSAs would effectively become the intermediary referred to in the Issues Paper, being authorised to lodge regulatory documents, as well as tax documents.

We do not support permitting the delegation of responsibility. While we believe stronger advice and support networks are essential, SMSF trustees should remain ultimately responsible for their decisions, consistent with the self-management philosophy identified in the Phase One Preliminary Report.

### RECOMMENDATION

1. The Government introduce a system of licensed superannuation administrators (LSAs) and all SMSFs be required to use an LSA.

#### 17.4.5 Compliance coverage

**Given the significant portion of retirement benefits under the control of an ever-increasing number of SMSF trustees, what level of oversight is required? In 2009, over 3 per cent of the SMSF population was affected by some type of ATO compliance activity. Should this be higher? Given the community interest in the efficient operation of SMSFs, should the supervisory levy, currently set at \$150, be increased to, say \$500, to match the level applying to SAFs to fund higher levels of regulatory oversight?**

We support more rigorous oversight of SMSFs. Given the number of entities, efficiencies in data collection and analysis would be required. Licensing of LSAs and more comprehensive data requirements would create larger, more sophisticated groups that could provide better datasets to APRA. APRA, in turn, would be able to apply systems developed in its broader regulatory role on a larger scale to effectively identify SMSFs requiring direct intervention.

### 18.3 Data

**Could more comparable questions be incorporated into the ATO and the APRA annual returns to enable better comparisons to be made, such as in the classification of asset classes and operating and performance figures?**

**SMSF annual returns must be lodged within 11 months of financial year-end, while APRA-regulated funds must file their returns within four months. For SMSF data to be meaningful, how quickly does it need to be reported? Would a shorter timeframe be achievable or appropriate?**

**The Review recently released a publication titled 'A statistical Summary of self-managed superannuation funds'. What other data or research on SMSFs is required and who should provide this? Is the ATO or APRA the most appropriate entity to collect and provide data in the marketplace, or should other market participants (non-government) be collecting and publishing data?**

We support full transfer of SMSF regulation to APRA, and the synchronisation of SMSF reporting requirements with those for APRA-regulated funds. This would include the data items, and the timing of returns.

We believe the data currently published in respect of SMSFs by the ATO is inferior to that published by APRA, and synchronisation of reporting would enable publication of comparable statistics. In our Phase Two submission, we indicated that a full research set of statistics should be developed and published by APRA to support ongoing research and policy development. We believe this should incorporate SMSFs as well.

### RECOMMENDATION

1. That SMSF reporting be synchronised with reporting for APRA-regulated funds.

### 18.5 SMSF costs

**Are SMSF trustees aware of the cost of operating their SMSF and do they understand the cost of alternative structures? What is the best method of comparing the cost of running an SMSF with the cost of other options? Is there appropriate disclosure of costs by service providers or through other avenues? Perceptions also exist that cross subsidisation is occurring within accounting practices, which obscures the true costs of running SMSFs — is this true in your experience? Are establishment and ongoing compliance and maintenance requirements inefficient for SMSF trustees? If so, in what areas, and what could be changed or improved?**

In our submission to Phase Two of the Review we advanced the concept of investment objective benchmarking, under which all funds are required to formulate a quantified investment objective, incorporating costs. Such a metric, if extended to SMSFs, would provide the most concise and understandable means of comparing SMSF costs with other funds. Implementation would require SMSFs to establish an investment strategy and objective. We see this as a role in which the SMSF trustee would look to their investment adviser for support.

We believe better disclosure of costs is required. All costs associated with the fund should be brought to account on the fund's statements, and incorporated in the fund's investment performance calculation.

We do not support watering down prudential regulation to cut costs. A fully informed analysis of the costs of running an SMSF should be part of the decision to establish one. However, we envisage that our proposal to use LSAs would improve efficiencies in the areas of compliance and audit.

## 19.2 Asset allocation

**Some SMSF members do not access professional asset allocation and investment advice. As at 30 June 2008, 59 per cent of SMSF assets were held in Australian listed shares and cash and term deposits. Overall, 20 per cent of SMSFs had all their investments in a single asset class. SMSFs in pension phase also show very similar asset allocations to SMSFs in accumulation phase. Is this optimal for SMSF members given the different liquidity requirements of the two phases? If not, what could be done about it?**

**What can be done to improve the access of SMSF members to quality information and advice? Would it assist SMSF members if there was more information available to help them understand asset allocation, diversification and other investment concepts? If so, how could this be delivered?**

**SMSFs have been over-represented among the creditors to several high profile corporate failures such as Westpoint, while the balance of the superannuation industry had very little exposure. Does this reflect a particular vulnerability for SMSFs in the face of commission-driven marketing by financial advisers? Does it reflect a structural weakness in SMSF operations or simply the different risk appetite of SMSF investors?**

Asset allocation decisions would be a primary focus of the advice received from the adviser, and this advice would be framed in the context of the trustee's risk tolerance and time horizon. With respect to liquidity, we note that the Statistics Report states that approximately two-thirds of SMSF assets are held in either listed securities or cash and term deposits. While liquidity may be an issue for individual funds, these statistics indicate it should not be a problem overall.

We believe all SMSFs should retain a professional investment adviser, should establish a written investment strategy (presumably with assistance from that adviser), and should receive a written investment report from their adviser at least annually. Trustees would remain free to make their own decisions, and to disregard that advice, but the provision of advice would provide a more robust framework within which decisions are made, and within which regulators could identify and follow-up instances of clearly imprudent decision making.

In our previous submissions to the Review we advocated strongly for the introduction of a best interests standard for financial advice. Whether or not this standard is adopted in respect of the current financial planning sector, we believe that the advisers mandatorily used by SMSFs should be required to work to that standard to avoid exposure to failures such as Westpoint. The old adage that financial products are sold, not bought, is particularly applicable to SMSFs. We doubt

that an appetite for Westpoint-type investments would exist in the SMSF sector in the absence of commission-driven financial advisers.

## RECOMMENDATION

1. All SMSFs must retain a professional investment adviser, establish a written investment strategy, and be provided with a written investment report from their adviser at least annually.

### 19.3.1 SMSF assets

**Should SMSF investments be restricted to what might be regarded as 'financial assets', such as listed equities and managed funds? This could make valuing, auditing and regulating SMSFs much simpler and potentially less costly. It would also be easier to assess whether an SMSF was investing in non-complying assets. On the other hand, why should SMSFs be restricted when a wider range of investments is available through APRA-regulated funds?**

**Concerns have also been expressed about the ability of SMSFs to invest in assets such as artwork and collectibles. As at 30 June 2008, approximately 1.6 per cent of SMSFs invested in these assets, representing 0.1 per cent of total SMSF assets. Should SMSFs be permitted to continue investing in these assets or should they be phased out over time?**

The asset allocation of the sector indicates fairly modest investment in non-financial assets overall. Of course, individual funds may have direct investments in large, single, non-financial assets such as real property, and it is these instances that need to be addressed through robust regulatory oversight.

We support a 'user pays' approach to auditing and administration of SMSFs. LSAs might be able to provide cheaper administration, advice, and audit services where funds are invested in financial assets only. Conversely, auditors should charge higher fees for funds invested in non-financial assets. The requirement to use an adviser would bring trustees' attention to issues such as diversification and valuation, and would also ensure use of non-financial assets occurred within a properly considered investment strategy.

We do not believe SMSFs should be prohibited from investing in artworks, but they should be required to demonstrate that the investment is both consistent with their investment strategy, and is held on an arms-length basis. A ceiling allocation, say 5 per cent or 10 per cent of the fund's portfolio, to non-financial assets, or more specifically to artworks and collectibles, may be an option.

### 19.3.2 Leverage

**Should leverage which places at risk an amount greater than the initial capital investment be permitted in SMSFs? If so, are the current exceptions to the borrowing prohibition suitable or have the most recent changes, which have allowed for instalment warrant arrangements for assets other than shares, gone too far?**

We believe leverage can be a dangerous practice, particularly in the hands of amateur investors. Hence the borrowing prohibition in SIS is appropriate and should remain for all funds. However, some exposure to leverage is unavoidable as it is common for listed companies to run significant levels of debt, effectively gearing their equity investments. Equally, APRA-regulated funds sometimes establish investment vehicles through which equity investments are geared (for example, unlisted infrastructure).

The current exemptions from the prohibition encapsulated in section 67(4A) of SIS are a practical accommodation of these realities, incorporating suitable safeguards. In the interests of maintaining a level playing field, we do not support further restrictions on SMSFs, but we do believe that investment advisers have a key role in ensuring that instalment warrants are used prudently in their clients' portfolios.

### **19.3.3 In-house assets and dealing with related parties**

**Should the in-house asset investment concessions, allowing trustees limited investment in related parties, continue within SMSFs? Are there benefits to the superannuation system or the broader economy in allowing SMSFs to partially finance trustee's related businesses?**

We do not support any further watering down of the in-house asset rules, particularly in permitting trustees to use their fund's assets to finance their own business. The typical financing route for small business, through the banking sector, involves an independent and qualified review of the businesses' prospects, and helps prevent the dissipation of assets in non-viable business ventures. Where there is evidence that banks and other sources of capital for small business are not responding to reasonable financing requests, those issues need to be dealt with within the context of the banking and venture capital industries.

### **19.4 Investment strategies**

**Currently, investment strategies do not need to be in writing and can vary greatly in quality and detail. For many SMSFs, investment strategies are a 'tick the box' exercise. Is there benefit to be gained in seeking to increase the regulatory burden here or should it be presumed that self-interest will prevail to see the appropriate investment strategies undertaken?**

We believe all SMSFs should establish a written investment strategy, presumably with assistance from their investment adviser. This strategy should incorporate a quantifiable investment objective, to support investment objective benchmarking. While trustees would be free to execute their strategy as they please, they should be required to calculate their fund's performance, and monitor this against their objective.

Self-interest is an appropriate motivating factor, but a hubristic approach to investing, in which trustees do not consider the ramifications of their strategy, is likely to result from the common conjunction of self-interest and misplaced self-belief.

#### **20.1.1 Accountants' licence exemption**

**Currently, accountants are able to establish and provide background advice about SMSFs, but not about financial products (that is, the investments to be made by the SMSF) without an**

Australian financial services licence. This means SMSFs can be created without any connection with a licensed adviser and hence no source of investment advice. Should all SMSFs be required to use at least one key service provider licensed by ASIC? Is the existing accountants' exemption appropriate and should it be maintained, or should it be broadened as per the recommendation by the Parliamentary Joint Committee on Corporations and Financial Services (PJC) report?

#### **PJC Recommendation 31**

**8.61** The committee recommends that the accountants' exemption be broadened in keeping with its previous recommendation 1 to amend subregulation 7.1.29A. This would enable accountants to advise clients on the structure of any superannuation fund, rather than being limited to advising on the structure of self-managed funds only.

We believe it is unacceptable for a tax adviser to recommend a client establish an SMSF, and then for the client to be able to do so without obtaining and retaining investment advice. While we support the exemption in relation to tax matters, when that advice is to establish an SMSF, the adviser must either provide investment advice (for which he must be licensed) or the trustee must obtain advice from a licensed adviser on establishing the fund.

#### **20.2.1 Timing**

The interaction of approved auditors with trustees often occurs months after the end of the financial year being audited (due to SMSF lodgement dates). Potentially, a contravention could occur between seven and 22 months before an audit takes place. Should this time period be reduced or should administrators, who could have more active involvement with SMSFs, play a greater role?

The frequency of SMSF audits has been questioned on a number of occasions. The PJC59 recommended that audits be less frequent.

#### **PJC Recommendation 30**

**8.45** The committee recommends that SMSFs run by qualified accountants be audited annually for three years from their commencement and, subject to no irregularities, thereafter every five years. SMSFs found to be non-compliant are to be audited annually for three further years.

Should the requirement for annual audits be retained or should they be less frequent? Would this have any impact on cost, given that approved auditors would, under the PJC recommendation, need to review multiple years at a time instead of a single year? In other words, after the eighth year, presumably the auditor would have to reconcile the preceding five unaudited years in order to carry out the five-year audit.

We do not support less frequent audits for SMSFs. As stated above, we believe the key to both reducing costs and improving compliance lies in a closer and more effective relationship between fund administrators and auditors.

#### **20.2.3 Independence**

**Given the key role auditors play, how independent should auditors be from those who administer SMSFs, prepare their financial accounts or annual returns, or provide financial advice? Do the current independence standards provide sufficient guidance or protection for members and other stakeholders?**

Under our proposal for LSAs, it is likely that the firm operating the LSA will provide a package of services to the SMSF trustee. We believe it is appropriate for LSAs to prepare financial accounts and compliance reports for the funds under their administration, but that the audit should be conducted independently.

We envisage that the LSA would put to tender the audit of all its funds, and the trustees could either accept the audit firm bundled as part of the package, or select an alternative arrangement negotiated themselves. The commercial incentives of the LSA will be to make the audit process as automated and trouble-free as possible, hence we see auditor independence being more, rather than less, important in this context.

#### **20.2.5 SMSF establishment**

**Would the SMSF system benefit by having an approved auditor verify that a fund was appropriately established before it could be registered with the ATO? Would there be value in having an approved auditor attest that the fund's deed satisfied the SIS requirements, that all members were trustees or trustee directors, and that none of the members was a disqualified person? Would this reduce the number of new illegal early release schemes?**

We see value in tighter regulation of the establishment of SMSFs, but this should be accomplished through regulation of LSAs, rather than through involvement of an auditor. LSAs could be nominated in law as the only party able to register an SMSF with the regulator, and as part of their license, they would be required to ensure those registrations met specified requirements, including SIS compliance, and the appointment of an investment adviser.

#### **RECOMMENDATION**

1. LSAs be the only party eligible to register an SMSF with the regulator.

#### **20.3 Advisers**

**Should competency standards be increased (ie beyond ASIC Regulatory Guide 146 standards) for financial advisers who provide advice to SMSF members?**

The justification for this would be that an SMSF is a special vehicle and not directly prudentially regulated. Under such a proposal, if an adviser wanted to provide advice to an SMSF, they would need to have a higher standard of training and be licensed accordingly. This could increase the cost of SMSF advice, but the average SMSF has substantial assets and therefore could afford to pay for higher quality advice. The question then arises whether remuneration for advice to SMSFs (that is paid for out of the fund) should be restricted to a fee-for-service model (subject to the sole purpose test). That way, the true cost of the advice could be determined at the time it is given and it would be more likely to be in the best interests of the members. Is there justification for a different charging model for advice to SMSF members?

We believe investment advice for SMSFs should be mandatory, and should be provided strictly on a best-interests basis. Advisers would be remunerated on a fee-for-service basis from the fund, perhaps as part of the fee paid to the LSA administering the fund. We envisage that these advisers might come from a variety of different backgrounds, including stockbroking, financial planning, funds management, or an APRA-regulated fund.

To minimise the disruption to existing commercial relationships, the competency standard would need to accommodate this broad range of existing practitioners, but with RG146 as a minimum. For new entrants, we would see a higher standard than RG146 as necessary.

## RECOMMENDATION

1. SMSFs must retain a professional investment adviser and receive advice at least annually.

### 21.4 Number of members

**Currently, SMSFs can have no more than four members. The data show that about 90 per cent of funds have only one or two members. It is not clear whether or not the current limit has a causal effect on this outcome. What purpose does the current limit serve? Is four members the right number? Why not seven or ten? An alternative view is that SMSFs should be limited to one member. If SMSFs are truly a matter of personal choice and personal responsibility for financial wellbeing in retirement, why have any pooling? If the membership limit were to be increased, should other conditions such as family relationships be imposed on fund membership?**

We acknowledge the logic that personal choice and personal responsibility seem to indicate a 'no pooling' policy with single-member funds. However, it is natural that couples will want to run their fund together and, particularly as they age, dual responsibility may provide safeguards as one partner's faculties begin to decline. It is also natural that couples may invite their adult children to participate in their fund and this provides governance benefits within the tightly-shared interests of a family unit. However, we do not see a convincing case for extending the allowable membership beyond 4 members. On balance we support continuation of the present limit of 4 members.

### 21.6 Minimum monetary balance

**A common belief is that an SMSF needs to have at least \$200,000 in assets to be cost competitive with APRA-regulated funds. From the 2004 to 2008 financial years, the proportion of SMSFs with \$200,000 or less in assets, decreased from 42 per cent to 26 per cent. Over the three years ended 30 June 2008, the average performance of SMSFs with \$200,000 or less in assets was significantly less than those of larger SMSFs and potentially other superannuation funds. Expenses for SMSFs with \$200,000 or less in assets appears to be increasing over the three years to 30 June 2008, which is in contrast with the overall SMSF population. Table 6 on page 27 shows that SMSFs with a fund size of less than \$200,000 had proportionately higher average operating expense ratios in 2008 of between 6.42 per cent for funds below \$50,000 and 2.85 per cent for funds between \$100,000 and \$200,000. In light of these figures, is there any justification to mandate a minimum balance for establishing an SMSF, perhaps by imposing controls on the persons authorised to establish SMSFs? If so, what is the appropriate level and why? Alternatively, can this issue be addressed through education and the publication of better data?**

We support a minimum establishment amount. It would be a condition of an LSA applying to the regulator for registration of an SMSF that they have verified the trustees have access to the funds, either by way of roll-over from another fund, or through lump-sum contributions. The trustees would be required to make a statement that they will make the contributions within a specified timeframe following registration. The regulator would be able to determine from returns that the contributions have in fact been made in the fund's first year of operation.

We propose that a scale be adopted for minimum establishment funds, depending on the number of members:

1 member: \$200,000

2 members: \$300,000

3 members: \$400,000

4 members \$500,000

We do not believe education and data publication are viable alternatives to a mandatory minimum establishment deposit.

## RECOMMENDATION

1. SMSFs be required to demonstrate, on registration, that members meet minimum establishment amounts.

### 22.4 Super Fund Lookup

**Can 'Super Fund Lookup' be expanded to provide member details to enable APRA-regulated funds to verify that a requested rollover is to an SMSF of which the transferring member is a trustee? If available, should this information only be provided on a confidential basis so that the general public cannot access the member details? Would verification of bank account details, such as a bank audit confirmation by the recipient institution, act as a significant deterrent to would-be offenders?**

Verifying the status of SMSFs on receipt of a roll-over request is a major headache for administrators of APRA-regulated funds. We support giving all funds and their administrators access to basic member details of SMSFs to assist verification.

Clearly, confidentiality of member data is paramount. In our Phase Two submission we proposed that administrators of APRA-regulated funds be registered or licensed, and we propose that access to this information only be provided to RSE licensees or their registered or licensed administrators.

### 22.6 Life insurance default

**The SIS Act does not require an SMSF to offer death or disability insurance to its members. Does there need to be an insurance default in the SMSF sector, for example similar to the minimum**

**insurance cover required for default funds? How could this be achieved? Would compulsory death or disability insurance be inconsistent with the self-managed character of an SMSF? Could the extra scale and reduced distribution costs that such a default could deliver enable the super industry as a whole to strike a better bargain on insurance? How many SMSFs currently have life insurance for one or more of their members?**

In most APRA-regulated funds, even where there is default cover, members usually have the option to remove that cover if they choose. Given that default cover can be seen as a response to the likely underinsurance of disengaged members, it may not be necessary to offer default cover through SMSFs as trustees are by definition engaged. However, insurance should form part of the advice package that is provided through an LSA, or licensed investment adviser. Assuming that financial planners would be the principle providers of those services, it is likely that insurance would form part of their advice.