Association of Independent Retirees (A.I.R.) Limited
ACN 102 164 385

Super System Review

Phase 1 Governance

October 2009

SUMMARY

The Association of Independent Retirees (A.I.R.) Limited welcomes the Review into the Governance, Efficiency, Structure and Operation of Australia's Superannuation Industry. The Association is the peak body representing the views of fully and partly self-funded retirees with over 12,000 members Australia wide. The Association's policies endeavour to achieve dignity, independence, and freedom of choice for retirees, recognising a diverse range of individual circumstances.

A.I.R. members understand the issues arising in the superannuation system because they are retirees actually applying their assets to manage their retirement income—the ultimate purpose of the system. They understand the issues involved in both the accumulation of assets and also the drawdown of assets for retirement purposes. The superannuation system must accommodate both aspects.

A.I.R. membership is representative of the demographic structure of self-funded retirees. The majority of self-funded retirees are not wealthy; they either receive a part pension, the Commonwealth Seniors Health card, or are just above the eligibility levels for these welfare supports[i]. However, many are fiercely independent individuals who built their retirement assets during their working careers. They wish to continue to control their assets during their retirement. They resist regulation that either regulates or discriminates against them in continuing to manage their affairs.

Australia's superannuation system is predominantly a compulsory fully-funded investment system with all investment and longevity risk carried by individual members. The global crisis has highlighted the high risk of even a conservative approach to investment.

Because of its compulsory nature, Government has a responsibility to ensure that investment risk is minimised through enforcement of a conservative investment strategy by superannuation funds, as agents/trustees for members. It has a responsibility to ensure that superannuation funds are operated in accordance with the highest governance and prudential standards, including accountability and transparency to their members.

Loss of retirement assets through fluctuations in the investment market, or through bad investment, is a very serious matter for retirees deleteriously affecting their health and welfare, consequently imposing added costs on Government.

Summary of Recommendations

Recommendation 1

That Government legislated prudential authorities should have adequate powers to enforce proper prudential management on superannuation funds and should be accountable for the proper use of those powers. That APRA should use the Future Fund investment strategies, and reporting requirements and standards, as a benchmark for all large superannuation funds.

Recommendation 2

That the trust structure for 'large' APRA regulated superannuation funds should be retained and the trust deed strengthened to require:

- trustee meetings consistent with those of public corporations including trustee election by members, restraints on conflict of interest, and trustee performance reporting;
- an annual general meeting, or a suitable mechanism, for allowing members to elect trustees and to provide feedback on information provided to members;
- reporting requirements consistent with the reporting requirements of public companies.

Recommendation 3

That the Government should not use legislation to require superannuation funds to invest in Government sponsored vehicles, but should provide incentive to invest in products that support Government policy.

Recommendation 4

That the terms of reference of APRA should be extended to include:

- a prudential standard -making and quality control power over all forms of investment;
- enforceable powers to support its standard-making and quality control powers;
- power to establish an investment rating service for investment products including a highest grade rating with invested assets guaranteed by Government. Superannuation entities, whether they are large superannuation funds, small APRA regulated funds, or SMSFs should be prohibited from investing in unrated products.

Recommendation 5

That Government/member-representative committees should be formed with appropriate Government Departments and Ministerial offices where member-representative associations exist. That members should be obtained by advertising for interested members with experience where appropriate member-representative associations do not exist.

Recommendation 6

That the terms of reference of APRA should be extended to include:

- responsibility for establishing financial reporting standards for superannuation funds to provide consistency between superannuation funds, and to support the long term nature of superannuation funds.
- power to enforce these standards.

Recommendation 7

That restrictions on investment by SMSFs in business residential and commercial property should be removed to allow a proper balance between the different asset classes and to allow the expertise of trustee/members to be properly utilised.

Recommendation 8

That the terms of reference of APRA should be extended to include:

- a standard-making power to control investment by superannuation funds preventing high risk practices including high-risk investments in hedge funds, asset lending, excessive margin borrowing and margin lending, and short selling. These standards should apply to all superannuation funds.
- power to enforce these standards.

Recommendation 9

That superannuation entities should not be permitted to circumvent APRA requirements by providing a high-risk investment option for members, or a high-risk investment strategy containing such high risk practices.

INTRODUCTION AND CONTEXT OF THE SUBMISSION

The Association of Independent Retirees (A.I.R.) Limited welcomes the Review into the Governance, Efficiency, Structure and Operation of Australia's Superannuation Industry. The Association is the peak body representing the views of fully and partly self-funded retirees with over 12,000 members Australia wide. The Association's policies endeavour to achieve dignity, independence, and freedom of choice for retirees, recognising a diverse range of individual circumstances.

A.I.R. members understand the issues arising in the superannuation system because they are retirees actually applying their assets to manage their retirement income—the ultimate purpose of the system. They understand the issues involved in both the accumulation of assets and also the drawdown of assets for retirement purposes. The superannuation system must accommodate both aspects.

The global financial crisis has had an extreme effect on many retirees. This is far from a trivial matter. The proposition that markets will recover in due course may be relevant during the accumulation phase but has little relevance to a retiree with only a relatively short and uncertain span of life remaining. Loss of income arising from reduction in assets has far broader repercussions than simply requiring retirees to 'pull their belts tighter'. A healthy retirement depends fundamentally on maintaining social relationships and activities with a group of peers with similar standards of living and retirement expectations[ii]. Insufficient income to maintain social relationships leads to stress, breakdown in health, and reduced individual quality of life. Insecurity arising from investment trauma also leads to breakdown in health. Reduced personal income leads to greater reliance on age pensions. These pressures ultimately add to the cost to government of health and welfare services

An increasing proportion of retirees have retirement assets in Superannuation.

Introduction of compulsory Superannuation Guarantee explains part of the increase. Prior to the introduction of the Superannuation Guarantee a proportion of retirees had contributions made by employers into corporation/government superannuation schemes. Generally, corporation/government schemes and the compulsory Superannuation Guarantee scheme have not required active participation by members. They have had little need to understand the issues involved in the accumulation of their superannuation assets, and have had little interest in how to manage these assets during their retirement. Many have priorities for retirement activities that do not include the need to actively manage their retirement income; they simply look for financial security. Further, many have little expertise, and do not wish to acquire it to manage their retirement assets.

Because retirees have been accustomed to a third party managing their superannuation, they expect to have confidence that this will continue into retirement. Hence, they expect the superannuation industry to act responsibly and ethically during the accumulation and the drawdown phase. They expect operators to be suitably qualified and of good character. They expect the industry to be regulated and monitored in an efficient and effective manner.

People tend to become more conservative as they age because they find it more difficult to cope with stress. A competent, conservative, and ethical approach to investment by superannuation funds is a primary requirement to try to recover the standing of the industry in the eyes of retirees following major company collapses and the global financial crisis. For example, the community would be shattered if the investment policies of the Future Fund (a superannuation fund for the Federal Government Public Service and associated entities) allowed lending of assets for short selling, or margin lending, or similar high risk practices. Superannuation funds should adopt the same prudential and ethical standards as would be expected of the Future Fund. If this cannot be done voluntarily, then government should regulate the industry sufficiently to achieve it. Unfortunately, press reporting tends to force superannuation funds to increase risk to achieve higher returns because it emphasises competitive short term returns and not secure long term practice. A superannuation fund investment option that allows high risk investment, even if sought by some members, should not be permitted.

A community-wide compulsory superannuation system is a relatively recent phenomenon in Australia, although many corporations and public services have provided superannuation for many years. Consequently, the accumulation phase has attracted most attention. Compared to the amounts being accumulated, the amount being withdrawn as pensions has been relatively small, but is growing rapidly as the number of people retiring with compulsory superannuation increases. Superannuation policies and operations must increasingly recognise the different circumstances that apply during the drawdown phase, when living needs are very different, when the ability to accumulate funds reduces, and when security of assets assumes particular importance. As the Chairman of the Review, Jeremy Collins has stated: “We must also remember that retirement is not a death sentence and certainly should not be seen as a time when all investing (which inherently involves risk-taking) stops[iii].” However, the risk profile changes toward security of assets and management of longevity risk.

The return to members depends on investment returns less costs. This Inquiry has been established because of the concern that costs are not constrained through competition between superannuation funds. One of the few factors exerting pressure for better investment returns and reduced costs is competition from the SMSF sector, which should be retained and supported.

This submission sets out recommendations in answer to the Issues raised in Section 5 of the Issues paper including SMSFs where appropriate. The comments should be read in the context set out above. Numbers in brackets refer to the individual section in the issues paper.

RESPONSE TO THE ISSUES RAISED

1. General (5.1)

Questions raised in the Issues paper that are addressed in this section concern a) governance issues highlighted by the global financial crisis (5.1.1), b) cost transparency, control of costs through competitiveness, and costs arising from complexity (5.1.2), (costs will be addressed in detail in a submission to Phase 2 of the review but are raised here to put this submission on governance in context), and c) best practice.

The superannuation industry has become a powerful industry in Australia. It has claimed on many occasions that, as it is supported by professionals, it knows best what is in the best interest of members. For example, it has criticised SMSFs because they are not managed by professionals. However, the global financial crisis has shown that superannuation fund professionals, because of their power and pressure for ever-increasing personal and organisational returns, were able to introduce unethical and non-prudential practices to the detriment of their members. The superannuation industry in Australia was as culpable as any investment organisation in this respect. Consequently, there is member and community disenchantment and loss of confidence in superannuation trustees and their professional staff and advisers. Australian superannuation funds ignored the fact that their purpose was to act on behalf of their members conservatively and ethically. Prudential and enforcement authorities either did not have the enforcement power, or chose not to use it under pressure from professional superannuation fund managers[iv].

The argument that professionalism gives the right to introduce financial methodologies and techniques that are beyond scrutiny is no longer tenable. Members and the community expect that Government authorities will have the power to enforce ethical and prudential practices and will use that power. There is already evidence that Government will continue to give in to financial professionals and power groups. The recent announcement that short selling will not be banned, but that relief is given to market makers to hedge risk, is untenable from the point of view of members of superannuation funds. Superannuation funds should not be market makers but should be required to have a conservative strategy for investment[v].

Inflow, outflow, and transfer of member funds between investment categories generally attracts fees. Fees charged are generally publicly available. However, overall costs are covered both by fees and also by internal transfer from investment returns and capital; the latter amounts are not generally publicly available.

Costs arising from factors in the control of fund management include efficiency of investment and administration, staffing, marketing, and intra-industry communication and advocacy. Generally, scale factors would be expected to reduce unit costs of these items, expressed as a percentage of investment returns. However, SMSFs are the only group of superannuation funds where scale factors reduce costs because of the essentially fixed nature of their administrative fees.

Competitive forces have not been successful in achieving unit cost reductions. Member pressure has not been successful because member power is virtually non-existent. The ability to transfer funds to an SMSF has been one of the few competitive factors. Government pressure appears to have been the only other factor influencing superannuation funds to improve efficiency and reduce unit costs.

Costs also arise from factors outside the control of fund management including legislative and regulatory restrictions on investment and inflow and outflow of funds, and reporting costs. Unnecessary or outdated regulations can impose significant costs. One example is that of the definition of a pension[vi], which prohibits the addition of contributions to a pension, forcing either additional pensions to be established or commutation and restructuring of pensions. Another example is the prohibition on ownership of property in SMSFs, which has led to complex and high costs of mechanisms to ensure regulatory compliance.

Government has a responsibility to address both the costs incurred by superannuation funds from their own initiatives, and also the costs arising from Government regulation. These matters will be addressed in detail in the Phase 2 submission.

Best practice is not measured simply by the net investment return to members on their assets. Unfortunately, this measure is newsworthy and is reported by the press as the major key performance indicator. The drive to maximise net investment returns has been demonstrated to lead to practices which run counter to a conservative, prudential and properly regulated investment culture. A better benchmark is required. One benchmark would the Future Fund, a superannuation fund for the Federal public service and Federal entities. There would be considerable community confidence in the investment strategies of that organisation, which if used as a benchmark for all large superannuation funds, would help to overcome the negative community view of the performance of superannuation trustees during the period prior to and during the global financial crisis. The role of APRA includes the setting and reporting of prudential standards, and it would be appropriate for it to set Future Fund investment strategies and performance as a benchmark for all large superannuation funds.

Recommendation 1

That Government legislated prudential authorities should have adequate powers to enforce proper prudential management on superannuation funds and should be accountable for the proper use of those powers. That APRA should use the Future Fund investment strategies, and reporting requirements and standards, as a benchmark for all large superannuation funds.

2. Trustees (5.2)

Questions raised in the Issues paper addressed in this section relate to Trustees: to appointment, performance, and accountability.

The superannuation trust model (5.1.3) is one that holds in trust the assets of a large number of individual owners—members. The failings of the trust model, arising principally from the culture of the superannuation industry, include lack of transparency and accountability, at least to the level of public company accountability, and reporting (5.4.1). The failings include:

- Lack of input by members into the appointment of trustees, and lack of reporting on performance measures of trustees, conflicts of interest, and similar matters of good governance to allow members to judge the worth of trustees (5.2). Improvement of competitiveness between superannuation funds requires that trustees do not have trusteeship of a number of superannuation funds, or non-executive or executive positions in outsourcing organisations.
- Lack of an Annual General Meeting or more appropriate mechanism for election of trustees, for members to question trustees, and for trustees to receive feedback from members (5.4.1).
- Lack of declaration of substantive issues affecting the performance of a fund such as outsourcing (5.2). In this context, A.I.R. supports Recommendations 4 and 6 of the 2007 PJC Inquiry as set out in Section 5.3.5.

A.I.R. supports retention of the trust model and believes that the issues identified in the Issues Paper and summarised above can be addressed by modification to the Trust Deed of superannuation funds to require these matters to be addressed.

The trust model for SMSFs contains a number of disadvantages that will be addressed in the Phase 3 submission but are summarised below:

- Unnecessary restriction on the number of members and trustees, which inhibits the ability for all interested family members to be members of the trust. This issue was raised in the Senate Committee Review into the Superannuation Industry in 2007[vii]. The consensus report supported change but it was not supported by the Labor Minority Report.
- High administrative complexity causing errors, including those arising from the need for all assets to be owned by all trustees.
- Complexity of the corporate trustee/trustee model, which removes ownership complexity but adds complexity and cost through registration by ASIC and regulation by the ATO.

The advantage of the SMSF model is that it is transparent and accountable to all members because they are the trustees. The model is clearly impractical for large superannuation funds.

Recommendation 2

That the trust structure for ‘large’[viii] APRA regulated superannuation funds should be retained and the trust deed strengthened to require:

- trustee meetings consistent with those of public corporations including trustee election by members, restraints on conflict of interest, and trustee performance reporting;
- an annual general meeting, or a suitable mechanism, for allowing members to elect trustees and to provide feedback on information provided to members;
- reporting requirements consistent with the reporting requirements of public companies.

3. Government and Regulatory (5.3)

Questions raised in the Issues paper addressed in this section relate to Government policies on use of superannuation funds, and APRA regulation, including appropriate accounting and disclosure requirements.

The Australian compulsory superannuation system is based on a fully-funded accumulation type model, unlike most major European countries, which have a heavy reliance on defined benefit unfunded systems[ix]. Accordingly, members (as distinct from superannuation funds) bear the full investment risk. Unlike many European countries the Australian Government has designed the system so that the Government is not required to bear any investment risk. Therefore, it is unreasonable to suggest that Government should be able to influence, by legislation or regulation, investment in Government prescribed investments, whether they meet Government objectives of the types set out in Section 5.1.3 of the Issues Paper, or not.

The argument that Government concessionally taxes superannuation and therefore has the right to interfere in investment decision-making for its own policy purposes is totally rejected by A.I.R. members. The purpose of concessional tax on accumulation and drawdown of funds for use in retirement is to encourage people to save for their own retirement, not solely as a direct benefit to people in retirement but primarily as a means of easing the future burden on the public purse. Regulation to restrict superannuation funds from investing in appropriate or high risk investments is very different to regulation requiring investment for Government policy purposes. It is potentially disastrous for government to proscribe investment decision-making other than to limit unethical and excessive risk practices.

However, A.I.R. strongly supports positive discrimination by Government, either directly or indirectly, to encourage superannuation funds to invest in products, including infrastructure, supported by Government policy. An example of direct encouragement could be development of Infrastructure bonds with an interest premium: an example of indirect encouragement is subsidy to renewable energy industries that indirectly increases their attractiveness as investment products.

Lack of adequate control of the quality of investment products (5.3.2) has reduced the confidence of superannuation fund members in the security of their assets. It is also a cause of serious concern to trustees of SMSFs and to people who have their retirement assets invested outside superannuation, in many cases because they have been unable to access superannuation. Enforcement of prudential standards for investment products has rested with ASIC and the ASX. Although recent changes transferring some regulatory responsibilities from the ASX to ASIC has improved regulatory control, ASICs role has been one of ensuring standards are met, including standards for prospectuses for new issues and products. It has not pro-actively provided information of value to investors in making decisions on investments in terms of their risk/return profiles.

There have been many notable examples of organisations that have established and marketed products of an unacceptable prudential standard despite the alleged control exerted by ASIC to prevent this. Examples include Allco Finance, Babcock and Brown, ABC Learning, Opes Prime and Storm Financial. Many retirees, whether their investments are held in superannuation funds, SMSFs, or outside superannuation, have been heavily affected by investment in such products. Better definition of the respective responsibilities of ASIC and APRA is required to ensure that investment products are adequately controlled. Responsibility for this should rest with an authority in such a way that the Government will guarantee identified low-risk high-security products.

As discussed in Section 5.1, there is no longer any case for greater flexibility in investment practices for large superannuation funds compared to small APRA regulated superannuation funds and SMSFs. Limitations on lending and borrowing, and restrictions on investment should be consistent across all types of superannuation funds. Such limitations should be public to provide accountability to members and to act as advice for people investing for retirement or managing their assets in retirement outside superannuation.

A.I.R. has proposed that an authority should be set up to establish an information system for investors which might be along the lines of a tier-grading system for investment types and products[x]. The information system would operate in a similar way to the investment rating agency services presently in place for financial securities but would apply to all investment products. The highest tier grading would have the lowest risk/return profile with the invested assets guaranteed in the event of default. Superannuation funds of all types would be prohibited from investing in non-rated investments. A.I.R. believes that it would be more appropriate to have such a system operated independently of ASIC to provide confidence to investors. It proposes that an authority as part of APRA should be formed for this purpose. It therefore proposes that APRA's powers should be extended beyond its present prudential powers to meet this need, including enforcement powers.

APRA's mission is "To establish and enforce prudential standards and practices designed to ensure that, under all reasonable circumstances, financial promises made by institutions we supervise are met within a stable, efficient and competitive financial system." A.I.R. believes that (a) the institutions supervised by APRA should be extended beyond financial institutions to all corporations, and (b) the low-enforcement and consultative approach used by APRA should be strengthened to provide an open, transparent and accountable superannuation system. It believes that APRA should have a prudential standard-making power and a power to give directions to superannuation funds in the matters raised in this submission including:

- enforcement of the trustee governance requirements set out in Recommendation 1 of this submission,
- enforcement of the financial reporting requirements set out in Recommendation 5 of this submission,
- enforcement of a conservative investment strategy by superannuation funds as set out in Recommendation 7 of this submission,
- formation of an authority as part of APRA to establish an investment rating service for all investments including a highest grade rating with investments guaranteed by Government, and that all superannuation entities should be prohibited from investing in non-rated investments.

Recommendation 3

That the Government should not use legislation to require superannuation funds to invest in Government sponsored vehicles, but should provide incentive to invest in products that support Government policy.

Recommendation 4

That the terms of reference of APRA should be extended to include:

- a prudential standard -making and quality control power over all forms of investment;
- enforceable powers to support its standard-making and quality control powers;
- power to establish an investment rating service for investment products including a highest grade rating with invested assets guaranteed by Government. Superannuation entities, whether they are large superannuation funds, small APRA regulated funds, or SMSFs should be prohibited from investing in unrated products.

4. Accountability to Members (5.4)

Questions raised in the Issues paper addressed in this section relate to accountability of superannuation funds to members and member representation.

The Chairman of the Review, Jeremy Cooper has stated that: "Consumers in super also seem to be under-represented. There are roughly 11 million people in super, but there is not one single body that just represents members and advocates their issues. Do we need something like an Australian shareholders' association for super?"[xi]

The advocacy powers of the superannuation industry overpower, by orders of magnitude, similar powers available to members. Fund administrations include high costs to conduct powerful representative associations advocating their sectional interests. These costs are taken 'off-the-top' of members' assets. Associations or groups representing members do not have this luxury and do not have the resources to research and explain the views of members.

The suggestion implicit in Section 5.4.1 (that a representative body could provide representation for all superannuation members) is simplistic. Superannuation fund members are not a homogeneous group. They include:

1 People below retirement age who form two distinct groups:
   - 1.1 those who see super guarantee as a means of compulsory saving by an external system. Many do not perceive that they have ownership of the funds and lack interest in issues affecting the management of their funds.
   - 1.2 those who take an interest in accumulation of their retirement assets. Many in this group will invest outside superannuation as well as accumulating assets within the superannuation system.

2 Retirees with quite different interests drawing down their superannuation funds. The different interest groups include:

2.1 An increasing number of retirees who have had super guarantee savings made for them. Because they perceive these funds to be at arms length from them, they are not interested in managing them, do not have the skills, and do not wish to understand and bear the investment and longevity risks. They believe that it is the Government's problem to manage these risks because the Government required them to allocate some of their funds for superannuation purposes. They simply desire to receive a sufficient and secure income to provide their needs in retirement. They are not interested in whether their income is from super guarantee savings or from a government pension. Statistics show that over 90% of retirees fall into this category.

2.2 A group of people who have built their savings wholly or partly outside superannuation. This group includes self-employed people not covered by the super guarantee system.

2.3 A group of retirees who have accepted the responsibility to build their retirement savings either within or outside superannuation. This group can be split into at least three subgroups:

  2.3.1 A subgroup that wish to receive a secure income over their retirement span and do not wish to be involved in managing investment and longevity risk. They look for market-linked and complying annuity type products that can give them a reasonable income from their assets and reasonable flexibility to manage unforeseen costs. Satisfactory products that meet these requirements do not exist.

  2.3.2 A subgroup that are comfortable with having their assets managed for them by professionals, but with flexibility to make some decisions about asset management and the level of their pensions.

  2.3.3 A subgroup that actively manage their assets and income and develop the expertise to do this.

It is unreasonable to expect that one group/association can represent this diversity of interest among members. The great majority of members would not be interested in subscribing to a single group/association, or indeed a group that more closely represented their particular group interests. Nevertheless, there is a need for the Government to receive advice from members of superannuation funds, as owners of the assets, to counter one-sided industry advice. It is an oxymoron to expect that the power of the superannuation industries' advocacy capability can be matched by the power of members' advocacy, even if member advocacy associations were funded by Government.

There are no superannuation fund members on Government committees providing advice. In a similar manner to the attitude of the superannuation industry itself, the Government has assumed that superannuation industry professionals know best. Unless the Government changes its approach, supporting the establishment of member-representative associations is a waste of time.

A.I.R. represents retirees primarily in groups 2.2 and 2.3. It cannot attract resources at a level sufficient to pay for the research necessary to compete with industry associations. As an example of communication with Government, A.I.R. has been fortunate to meet with the SMSF Segment, Superannuation, Australian Tax Office on a one-on-one and regular basis over the past four years to provide the views of SMSF trustee members, to receive information for dissemination to its members, and to assist the SMSF Segment in its activities. The SMSF Segment proposed these meetings on a member association/ATO basis because the similar committee involving superannuation fund professionals was too large to give the member association reasonable input.

A.I.R. supports extension of this model to meet the needs of the different groups identified above with superannuation using representatives from the appropriate retiree associations representing the interests of the groups listed in 2 above within a Government culture that values such input.

Members listed in 1 above in the accumulation phase do not have a representative association. A.I.R. does not support the formation and funding of appropriate groups, unless formed voluntarily. It is of the view that it would be better for government to identify individuals who have expertise from their interest in superannuation and to include them in government/member Committees. Many areas of representation with Government use representative committees or boards established by Government. Where a representative association is not available, or appropriate from the Government's point of view, public advertisement for members is commonly used. A.I.R. believes that this would be an appropriate model for communication between members accumulating superannuation funds and the Government.

For the reasons explained above, it is unreasonable to expect that the great majority of people, whether accumulating or drawing down assets, will be interested in education to improve their understanding of superannuation.

Recommendation 5

That Government/member-representative committees should be formed with appropriate Government Departments and Ministerial offices where member-representative associations exist. That members should be obtained by advertising for interested members with experience where appropriate member-representative associations do not exist.

5. Operational (5.5)

Questions raised in the Issues paper addressed in this section relate to the appropriate Investment time horizon (5.5.1), a perceived tilt towards investment in equities (5.5.2), and regulation of leverage of assets.

Investment Time Horizon (5.5.1)

While APRA and the ATO (for SMSFs) reports on a number of aspects of the performance of superannuation funds, press reporting tends to be focused on the competitive investment return between large superannuation funds, judged to be the main area of interest to members. Even though longer-horizon statistics are presented, the focus of interest is perceived to be on short-term investment returns. Consequently, superannuation funds tend to be influenced to operate using short-term policies, including short-term investment and timing of write-downs and other financial devices for presenting the best short-term picture. This approach is in stark contrast to the opportunity and need in superannuation to invest funds over the long term to reduce investment risk.

APRA should have a responsibility to work with the industry and the Australian Accounting Standards Board to set standards for reporting that provide consistency between superannuation funds, and support the long-term investment nature of the superannuation funds. This responsibility goes beyond Recommendation 4 of the 2007 PJC Inquiry.

Recommendation 6

That the terms of reference of APRA should be extended to include:

- responsibility for establishing financial reporting standards for superannuation funds to provide consistency between superannuation funds, and to support the long term nature of superannuation funds.
- power to enforce these standards.

Tilt toward Equities (5.5.2)

Some years ago (before the economic crisis) there was much industry activity and press reporting from parties interested in criticising the activities of sections of the superannuation industry, in particular SMSFs. The criticism was that investment strategies in SMSFs were too conservative and superannuation funds had an excessive proportion of assets in bank accounts and fixed interest products. How the wheel has turned! Now the criticism of SMSFs is that there is an excessive focus on Australian equities.

Many young people building their retirement assets outside superannuation commence by purchasing investment property, residential or commercial. They feel more confident about this type of investment because they see it as a longer-term more secure type of investment than equities. They are also encouraged by the ability to negatively gear the property. They lack the experience and the time to gain experience in equities but they perceive a better return and capital gain from property than investment in fixed interest securities. Their understanding of investment in property increases with the length of time they invest. Yet, if they wish to continue an active interest in their financial affairs through superannuation through an SMSF, they are denied the ability to continue to use their expertise in directly investing in property without the need for expensive strategies to avoid the intent of the regulations. They must risk inexperience and invest in equities. The result is that experience built up through property is lost and continued management of their personal retirement assets must be built on inexperience in an investment class. The superannuation limitation on direct investment in property is discriminatory, distorting, and bad law because it can be circumvented.

A.I.R. strongly believes that the issue raised in Section 5.5.2 (that there is a tilt toward equities in superannuation funds) is not an issue about a high proportion of investment in equities but is about the exclusion of a major investment sector from superannuation, that of direct investment in property. Distortion in investment has emerged as an issue because of the size of assets now held in SMSFs.

A.I.R. believes that the prohibition on investment in property, was a control mechanism to ensure that the sole-purpose test is not breached. However, the prohibition has had a major distorting effect on superannuation investment. Instalment Warrants were introduced by stealth and are often argued to be a method of investing in property. However, they are a totally different form of investment to that experienced by people who have direct investment in property. Investment in property is now possible if complex accounting and legal documentation is set up at high fees—a totally different situation to that pertaining in normal direct investment in property. These approaches are mechanisms for circumventing the intent of the legislation. The demand to be able to invest in residential and non-residential property is clearly demonstrated from the ATO SMSF Statistical Report for June 2009 which shows investment (as a percentage of total investment) in residential and non-residential property at 13.7% compared with Australian listed shares at 27.7% and cash and term deposits at 30.1%[xii]. These figures demonstrate that the regulations are wrong in principle and are bad law. Further, they demonstrate that there is no bias toward Australian equities or any other form of investment.

These matters will be expanded in the Phase 3 submission focused on SMSFs. However, to avoid any distortion in investment A.I.R. believes that restrictions on SMSFs investing directly in residential and commercial property should be removed, subject to such investments conforming to other regulations.

Recommendation 7

That restrictions on direct investment by SMSFs in business residential and commercial property should be removed to allow a proper balance between the different asset classes and to allow the expertise of trustee/members to be properly utilised.

Leverage (5.5.4)

The economic crisis has highlighted investment practices that include excessive leverage as being high-risk and/or unethical. The common examples are lending without adequate ability to repay debt, excessive margin borrowing and lending, short selling without ownership of assets to support the transaction, and improper use of derivatives and hedge funds. Proponents of such practices have argued that they make the market more competitive and hence more efficient. They argue that excessive use of such instruments will be corrected by market failure. Clearly, the collapse of this model through market failure has demonstrated that these types of investment are not corrected by market discipline!

Recognising that investment in superannuation should be driven by relatively conservative practices to conserve members' assets and not driven by short-term high risk returns, then the faulty practices identified from the economic crisis should not be permitted in superannuation funds. Regulation should be introduced to prohibit such practices and to ensure proper reporting to identify such practices. APRA should be given the power to control such activities, including the ability to dismiss trustees.

For the reasons stated elsewhere in this submission, the same standards should apply to all superannuation funds, including large and small APRA regulated funds and SMSFs.

To ensure that a conservative, ethical and prudential culture is built into all superannuation funds, superannuation funds of any type should be prevented from adopting a high-risk option within a fund, or a high-risk investment strategy.

Recommendation 8

That the terms of reference of APRA should be extended to include:

- a standard-making power to control investment by superannuation funds preventing high risk practices including high-risk investments in hedge funds, asset lending, excessive margin borrowing and margin lending, and short selling. These standards should apply to all superannuation funds.
- power to enforce these standards.

Recommendation 9

That superannuation entities should not be permitted to circumvent APRA requirements by providing a high-risk investment option for members or a high-risk investment strategy containing such high risk practices.

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[i] 87% of people over 65 paying income tax in 2005/2006 paid less than 30 cents in the dollar (a taxable income of less than %75,000. Personal Tax Statistics 2005-2006 as at 1 October 2006, Treasury 00117625_2006PER11

[ii] Vaillant G., *A Rewarding Life*. The Australian Financial Review, 21 August 2009, Review p 1

[iii] Collins J., *Observations on Retirement.* 18 June 2009, http://www.supersystemreview.gov.au/content/html/speeches/downloads/20090618_ASFA_Observations_on_Retirement.pdf

[iv] Adele Ferguson, Our Regulatory Shield still needs more work. The Weekend Australian 12-13 September 2009.

[v] ASIC ASIC provides hedging relief to market makers. AD09-182. http://www.asic.gov.au/asic/asic.nsf/byheadline/AD09-182+ASIC+provides+hedging+relief+to+market+makers?openDocument

[vi] Meaning of pension (Act, s 10) Superannuation Industry (Supervision) Regulations 1994 - Reg 1.06

[vii] Parliamentary Joint Committee on Corporations and Financial Services *The Structure and Operation of the Superannuation Industry* August 2007<http://www.aph.gov.au/senate/committee/corporations_ctte/completed_inquiries/2004-07/superannuation/report/index.htm>

[viii] 'Small' APRA regulated funds would need to be excluded from some elements of the Recommendation.

[ix] Heat R. *Europe's Burden*. The Australian Financial Review, 21 August 2009, Review p 7

[x] Submission to the Henry Tax Review in response to the Consultation paper, February 2009.

[xi] Collins J., *Observations on Retirement.* 18 June 2009, http://www.supersystemreview.gov.au/content/html/speeches/downloads/20090618_ASFA_Observations_on_Retirement.pdf

[xii] ATO, Self-managed super fund statistical report - June 2009, http://www.ato.gov.au/superfunds/content.asp?doc=/content/00214157.htm&page=8&H8