

SUPER SYSTEM REVIEW SUBMISSION COVER SHEET

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Governance

Operation & Efficiency

Structure



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

Super System Review

Phase 2 Operation and Efficiency

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.

The Phase 2 Issues paper is notable in concentrating on the accumulation of super funds in an essentially account-based system. Conceptually, the superannuation system should be member-based and not account-based. Although this concept is important in the accumulation phase, it is even more important in the drawdown phase when members come to gather together their accumulated superannuation assets and to use their entitlements over a normally lengthy retirement span.

Australia's superannuation system is predominantly a compulsory fully-funded investment system with all investment and longevity risk carried by individual members. In this respect it is unique amongst other nations. 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 fund trustees on behalf of 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.

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 highly leveraged investing, 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.

Many issues have emerged as experience has been gained in administering the compulsory superannuation system. Some of these have emerged because of fragmentation within the industry. Some have emerged because of a difficult to manage interface between contributors, employers, funds, and the ATO. It is imperative at this stage of development of the system that these issues are considered and major changes made to ensure an efficient future system for both the funds and their costs and also contributors.

This submission sets out recommendations in answer to a number of Issues raised in the Phase 2 Issues paper. The comments and recommendations should be read in the context set out above. Numbers in brackets refer to the individual section in the Issues paper.

Summary of Recommendations

Recommendation 1

That the superannuation fund system be transformed from an account-based system to a member-based system conceptually and administratively. That the following initiatives discussed in the issues paper and supporting a member-based system should be introduced:

- A Review of Information Technology standards and usage with a view to standardising the range of technologies used (6.1, 7.2.2).
- The compulsory use of TFNs to reduce identity issues and to reduce the inconvenience of repeating the identification process each time a person wishes to make changes to their accounts (7.2.2, 7.4.3).
- A requirement on funds to compulsorily consolidate member accounts to move toward a member-based system and to remove the costs of administering multiple accounts (6.4.4).
- Establishment of one single Government Eligible Rollover Fund (ERF) to manage inactive accounts. The ERF should be conducted by the private sector under a competitive tendering protocol (6.4.2). All other ERFs should be closed.
- Development of a central clearing house to improve the efficiency of fund-member transactions and to make it easier for members to consolidate multiple accounts (6.1.1).
- Development of standard forms to support more efficient member/fund transactions (7.2.3).
- Development of a national default fund (6.2.2).

Recommendation 2

To obtain a simple and cost effective system, the conceptual approach and the regulations should be changed to reflect the following:

- Desegregation of assets being accumulated from assets being used to support a pension should only be permitted during the transition to retirement age ranges. At all other times a retiree's fund should be nominated to be in either the accumulation phase or in the drawdown phase.

- The taxation approach to a contribution made into a fund in the drawdown phase should treat the contribution as an asset supporting a pension; such a contribution should be subject to the contribution tax where this is applicable under the regulations.
- That additional contributions intended to add to an existing pension be rolled into the existing pension from the date of the contribution, with all conditions pertaining to the existing pension being retained except that the balance has increased. Consequentially,
 - The restriction on adding capital contributions to an existing pension should be removed by removing Section (a) (ii) of Regulation 1.06.
 - The minimum withdrawal amount in a financial year should not be adjusted to take into account additional contributions in that financial year.
 - Any consequential issues arising from the ability to make capital contributions to an existing pension should be regulated in the appropriate part of the Act.

Recommendation 3

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;
- setting of a default investment strategy as the standard for the industry taking into account international standards;
- setting of Key Performance Indicators and benchmarks that reinforce the desirable investment culture for the industry, including the Future Fund as one benchmark;
- enforceable powers to support achievement of the above.

Recommendation 4

That collection of data should be:

- based on Key Performance Indicators;
- mandatory and collected by a recognised authority such as APRA.

That APRA should proactively encourage the collection of data by private agencies and research houses that supports the agreed investment culture for the industry.

Recommendation 5

That investment executive remuneration should be designed to support the agreed conservative investment culture for the industry.

Recommendation 6

That the number of investment options should be significantly reduced.

That despite any pressure from members, member options that use excess borrowing, hedging, short selling, or similar high risk investment techniques should not be permitted.

Recommendation 7

That uniform disclosure of an agreed set of fees and charges should be adopted.

Recommendation 8

That reporting requirements consistent with those of public companies be required from superannuation funds including an Annual Report. That the use of electronic communication be an option for this purpose.

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 Phase 2 Issues paper is notable in concentrating on the accumulation of super funds in an essentially account-based system. Conceptually, the superannuation system should be member-based and not account-based. Although this concept is important in the accumulation phase, it is even more important in the drawdown phase when members come to gather together their accumulated super assets and to use their entitlements over a normally lengthy retirement span.

The superannuation system must accommodate both the accumulation and drawdown phases.

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 expectations¹. 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

Prior to the introduction of the Superannuation Guarantee a proportion of retirees had contributions made by employers into corporation/government superannuation schemes. Generally, these schemes have not required active participation by members or the need to understand the issues involved in the accumulation of their superannuation assets. Most members have had little need to manage these assets during retirement because they receive regular pensions. A similar situation exists under the compulsory Superannuation Guarantee scheme during the accumulation phase but not in the drawdown phase.

Many retirees have priorities for their 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 their assets will continue to be managed properly 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, effective, and conservative 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) permitted lending of assets for short selling, or highly leveraged investing, 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 emphasises competitive short term returns and not secure long term practice, encouraging superannuation funds to increase risk to achieve higher returns. A superannuation fund investment option that allows excessively high risk investment, even if sought by some members, should not be permitted because it runs counter to the desired image of a conservative approach to members' funds.

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 in the compulsory Superannuation Guarantee system, the amount being withdrawn as pensions has been relatively small, but is growing rapidly as the number of members retiring 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.

Many issues have emerged as experience has been gained in administering the compulsory superannuation system. Some of these have emerged because of fragmentation within the industry. Some have emerged because of a difficult to manage interface between contributors, employers, funds, and the ATO. It is imperative at this stage of development of the system that these issues are considered and major changes made to ensure a cost-effective future system for both the superannuation funds and their members.

The financial 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 a number of the Issues raised in the Phase 2 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. Design/Architecture (6.1, 6.2)

The Issues paper notes that one of the biggest inefficiencies for members is having multiple accounts in the accumulation phase (7.1).

Multiple accounts in the accumulation phase are inefficient financially (7.1). Many employees move between a number of employers over their working life and incur multiple accounts. Many casual employees have small amounts in many accounts and do not have the wish to keep careful account of these. Because of the compulsory nature of superannuation, and the fact that the vast majority of employees do not actively choose their fund (6.2), they take little interest in maintaining records of their superannuation entitlements. Inaccuracies in the personal data defining their multiple accounts (7.4.3), and lack of information on employment movements, makes it very difficult to determine their total superannuation entitlement, and location of their multiple accounts.

The present system is account-based rather than member-based. The system has led to the many problems highlighted in the Issues paper. On retirement members are interested in their total entitlement. They do not wish to have to manage across a range of multiple accounts. Most want a single pension from a single source so they can get on with their retirement priorities. Multiple accounts need to be consolidated annually for determining whether a member has breached the maximum contribution limits. Transforming the system conceptually and administratively to a member-based system would remove many of the existing issues identified in the Issues paper.

These issues will steadily become more serious as the system grows, employees become more mobile, additional employment groups are included in the system, more identity issues arise, and more members reach retirement age.

It is appropriate to remove as many of these problems as possible at this relatively early stage in the development of the system by introducing new and improved systems. Present fragmented systems add significantly to inefficiency with resultant added cost. They also add greatly to the inconvenience of members who are required to repeat identity processes as they manage their funds, and who have difficulty in determining their assets and their location. These issues become of particular importance as they approach retirement. The suggestions for greater centralisation and standardisation of processes discussed in the Issues paper are supported.

Any benefit/cost analysis of the introduction of new processes should be undertaken taking into account the future growth of the system, likely changes to membership types and work structures, transition from accumulation to drawdown phases, and pension structures and needs in retirement.

Recommendation 1

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- A Review of Information Technology standards and usage with a view to standardising the range of technologies used (6.1, 7.2.2).

- The compulsory use of TFNs to reduce identity issues and to reduce the inconvenience of repeating the identification process each time a person wishes to make changes to their accounts (7.2.2, 7.4.3).
- A requirement on funds to compulsorily consolidate member accounts to move toward a member-based system and to remove the costs of administering multiple accounts (6.4.4).
- Establishment of one single Government Eligible Rollover Fund (ERF) to manage inactive accounts. The ERF should be conducted by the private sector under a competitive tendering protocol (6.4.2). All other ERFs should be closed.
- Development of a central clearing house to improve the efficiency of fund-member transactions and to make it easier for members to consolidate multiple accounts (6.1.1).
- Development of standard forms to support more efficient member/fund transactions (7.2.3).
- Development of a national default fund (6.2.2).

2. Regulation (6.3)

Unnecessary or outdated regulatory burdens add to inefficiency and cost (4.3, 6.3.1).

The emphasis in policy and regulation development in the compulsory super system has been on accumulation of assets. The Issues paper itself appears to focus only on efficiency in the accumulation phase (4.2). A growing proportion of superannuants are drawing down pensions from their superannuation assets. Superannuation funds are still developing new products, and issues continue to be identified as experience is gained. Structures developed to serve the accumulation phase, if not properly designed, can cause difficulties and inefficiencies in the transition stage from the accumulation to the drawdown phase, and in the management of the drawdown phase.

The ability to make contributions during the drawdown phase is a very important principle in the superannuation system. It encourages people over the retirement age to continue to work. It encourages retirees to manage their retirement assets across their retirement life span.

A superannuation fund is identified as being (a) in the accumulation phase, where capital is being accumulated for the future payment of a retirement pension, or (b) in the pension or drawdown phase where the capital is being used for the purpose of paying a pensionⁱⁱ. A retiree taking a pension may make contributions as prescribed in the Act.

The concept of an account-based system, as distinct from a member-based system, has led to a retiree being able to have multiple accounts simultaneously in the drawdown phase while also having multiple accounts in the accumulation phase. The regulations are structured in such a way that this situation becomes mandatory unless costs are incurred by a retiree in consolidating accounts.

To obtain a simple and cost effective system, the conceptual approach and the regulations should be changed to reflect the following:

- Desegregation of assets being accumulated from assets being used to support a pension should only be permitted during the transition to retirement age ranges. At all

other times a retiree's fund should be nominated to be in either the accumulation phase or in the drawdown phase.

- The taxation approach to a contribution made into a fund in the drawdown phase should treat the contribution as an asset supporting a pension. Any such contribution should be subject to the contribution tax where this is applicable under the regulations.
- Consequentially Regulation 1994 - REG 1.06 setting out the definition of a pension should be changed to remove the requirement preventing the capital supporting a pension being added to after the pension has commenced.

Regulation 1994 - REG 1.06 sets out the definition of a pension as follows:

“SUPERANNUATION INDUSTRY (SUPERVISION) REGULATIONS 1994 - REG 1.06

Meaning of pension (Act, s 10)

- (1) A benefit is taken to be a pension for the purposes of the Act if:
 - (a) it is provided under rules of a superannuation fund that:
 - (i) meet the standards of subregulation (9A); and
 - (ii) do not permit the capital supporting the pension to be added to by way of contribution or rollover after the pension has commenced.”

Part (1) (a) (ii) of REG 1.06 (the restriction) prevents the capital supporting a pension being increased after the pension has commenced.

The restriction has led to a high degree of complexity, and substantial increased costs for superannuation funds and members, including SMSFs.

There may have been a need in 1994 for the restriction. However, the justification for retention of the restriction on the grounds that misuse would occurⁱⁱⁱ has never been demonstrated.

Radical changes to superannuation were introduced in July 2007. Some of these changes reducing the need for the restriction are:

- Removal of the RBL requirements. The restriction may have been necessary for the recording and administration of the RBL system.
- Removal of complying pensions, and earnings from the capital supporting those pensions, from assessable income. The proportion of concessional, non-concessional, and tax free amounts in the capital of the fund supporting the pension/s is no longer required in determining complying pensions and earnings from the capital supporting those pensions.

In the light of the changes introduced in July 2007, the benefit to government of the restriction weighed against the cost, increased complexity, and inefficiency for superannuation funds, trustees, and retirees does not appear to be justified. The restriction is inconsistent with expressed government policy to simplify the administration of superannuation funds.

Because of Regulation 1.06, a retiree with a pension who wishes to make further contributions has three options,

- (1) Commence an additional pension immediately following the contribution.
- (2) Roll back the original pension and commence a new pension with the total amount.

(3) Have the contribution placed into an accumulation component of the fund.

Each option adds to fees charged and costs of administration in superannuation funds. The lack of a supportable rationale for contributors to have to go through the administrative complexity of adopting one option over another, and the fee charged by superannuation funds to make a contribution, leads to disenchantment and confusion with the system. In the case of an SMSF, each option adds to complexity in understanding the requirements of the Act for the member and the trustee and the risk of breaching the Regulation.

The complexity and cost arising from each of the three options is discussed below.

(1) Commencement of an additional pension immediately following the contribution.

If the additional pension is commenced immediately following the contribution then the fund remains fully in the pension phase and no tax is payable on the additional pension or the earnings from the contribution. The minimum withdrawal requirements apply to the additional pension.

Over time an individual retiree may accumulate a number of pensions. The retiree will then receive a number of pension statements. The superannuation fund will administer the individual retiree's capital and pensions as though the retiree is a number of individuals with no connection between them other than a common name and address; not as a client retiree who has a superannuation fund in the pension phase and receives a pension.

Many retirees wish to have the least possible involvement with their pension and pension fund—they have other interests and priorities and simply wish to have a reliable income. The concept of separate income streams, as now defined by the government, may well meet the needs of the government but it does not meet the needs and expectations of a large number of retirees.

If the superannuation capital is held in a superannuation fund, including an SMSF which is administered externally, the outcome is:

- High fees because each time a new contribution is made for the purpose of receiving a pension the retiree is required to pay the full fees applying to commencement of an initial pension. In the case of an SMSF administered externally a monthly/quarterly administration fee is likely to apply to each pension.
- A frustrating and complex situation for a retiree who wants to be treated as a client with a single retirement pension.
- A complex set of accounts adding to the administrative burden of the superannuation fund with associated higher costs.

If the superannuation capital is held in an SMSF administered by the trustee, the trustee is required to accept the contribution from a member provided it meets the requirements of the Act. A new pension needs to be established for each contribution. The SMSF must prepare accounts and statements for each individual pension.

The capital supporting each pension can be either segregated or desegregated. If the capital is segregated the accounts of the fund must provide the details of the segregated investments. Without an artificial device, there can be no proof of segregation because all assets of the fund must be held in the name of the trustee, for example: if a number of pension assets contain BHP shares all shares must be held in one name, that of the trustee. In addition, an actuarial certificate may be required.

The outcome is:

- A frustrating and complex situation for a retiree who wants to be treated as a client with a simple retirement pension.
- A frustrating and complex administration process to maintain the integrity of the accounts of the fund.
- A complex process that may involve a number of financial institutions to segregate the assets.
- Additional workload on the trustee who receives no payment for the work.
- Additional accounting fees for the majority of SMSFs because they use an accountant to complete their accounts and regulatory returns.
- Additional independent audit fees.
- Possible actuarial fees because of the greater complexity of the fund.
- The likelihood of omissions and errors because of the complexity of the rules, regulations, and options, which need to be understood by the trustee, the trustee's accountant, and the independent auditor.

(2) Commuting the original pension and commencing a new pension with the total amount.

A retiree may maintain a single pension by commuting the original pension and commencing a new pension with the total amount. The fund will need to establish a set of accounts for the original pension at the date of consolidation to allow the individual pension to be cancelled and a new consolidated pension established. An actuarial certificate may be required incurring additional fees.

If the contribution occurs at the end of a financial year, there should be no additional cost of preparing the accounts. However, there will be the full cost and complexity of establishing a new pension.

A retiree might reasonably expect that a number of contributions could be made in a particular year, depending on when finances become available. These would need to be consolidated into a new pension each time a contribution is made. This would involve a new set of accounts for the fund at the date of each contribution, cancellation of the existing pension, and commencement of a new pension.

A retiree would not understand the need for such complexity and associated fees. A retiree would rightly expect that making a contribution, as allowed under the superannuation Act, should be essentially as simple as depositing to a bank account—the need for some additional requirements because of the nature of the contribution is acknowledged, but these should be simple. The retiree would perceive the high additional fees charged by a superannuation fund, or an SMSF, which is administered externally, as unjustified and should not be expected to understand that government regulation defining a pension forces an unnecessarily complex and costly process.

Where contributions arise from employment, a retiree would naturally expect that the contributions would be added to the assets of the fund and, if the retiree has declared the fund to be in the drawdown phase, used for the purpose of paying the pension.

If the superannuation capital is held in an SMSF administered by the trustee the consequences of segregation of assets does not arise because all funds would be immediately allocated to the new pension.

The outcome of commuting an existing pension, adding a contribution, and commencing a new pension is:

- A frustrating and complex administration process to close an existing pension and commence a new pension.
- High fees for funds held in superannuation funds, or SMSFs administered externally, because each time a new contribution is made for the purpose of receiving a pension the retiree is required to pay the fees applying to the commencement of an initial pension and the closure of an existing pension.
- Additional workload on the trustee of an SMSF who receives no payment for the work.
- Additional accounting fees for the majority of SMSFs because they use an accountant to complete their accounts and regulatory returns.
- Additional independent audit fees and actuarial fees for an SMSF because of the greater complexity of the accounts of the fund.
- The likelihood of omissions and errors because of the complexity of the rules, regulations, and options, which need to be understood by both the trustee and the trustee's accountant and independent auditor.

(3) Accumulation of the contribution

Earnings from a superannuation contribution which is accumulated and not used for the payment of a pension will attract income tax until such time as it is used for the purpose of paying a pension.

The complexity of segregating assets in an SMSF, as described above, often leads to contributions held in an SMSF being desegregated with all other assets of the fund for simplicity; segregating assets is a time consuming and complex task.

When additional contributions are eventually used to pay a pension, the exempt portion of fund assets must be calculated. The formula for calculating the proportion of exempt assets is not related to the timing of contributions but directly to the proportion of the different classes of asset. There can be a significant distortion in using the formula with exempt assets being used to pay income tax unfairly.

The outcome of commencing an accumulation component of a fund in the pension phase is:

- Additional fees where an accumulation component is added to a fund in the pension phase where the assets of the fund are held in a superannuation fund or SMSF administered externally.
- Additional accounting complexity in an SMSF when an accumulation component is added to a member's account when the member's account is in the pension phase.
- Additional workload on the trustee of an SMSF who receives no payment for the work.
- Additional accounting fees for the majority of SMSFs because they use an accountant to complete their accounts and regulatory returns.
- Additional independent audit and actuarial fees for an SMSF because of the greater complexity of the accounts of the fund.
- The likelihood of omissions and errors because of the complexity of the rules, regulations, and options, which need to be understood by both the trustee and the trustee's accountant and independent auditor.

Summary of the consequences of the restriction

The effect of removing the restriction on contributing capital to an existing pension against the present requirement is summarised in the Table below. Assumptions are:

- the contribution is intended to be used immediately to support a pension;
- certain types of contribution, such as employer contributions are not included, and
- the retiree does not wish to receive a new pension.

Effect of the restriction on adding capital to an existing pension	Effect of removing the restriction on adding capital to an existing pension
<i>New pension established</i> —new set of accounts; full fees; multiple pensions; multiple statements. Inflexible—limited number of contributions annually because of cost. Complex regulations—difficult to understand; likelihood of errors; reinforces need to use an accountant in SMSFs.	<i>Existing pension retained</i> —existing account; lower fees possible; single statement; one simple pension. Flexible—multiple contributions annually; incentive to work and contribute. Simpler regulations; easier to understand and apply.
<i>Contribution consolidated with existing pension</i> —new set of accounts; commutation of existing pension; full fees for new accounts; fees for commutation. Inflexible—limited number of contributions annually because of cost. Complex regulations—difficult to understand; likelihood of errors; reinforces need to use an accountant in SMSFs.	<i>Consolidation is automatic and simple.</i>

Possible rationales for the restriction

Minimum withdrawal requirements

Minimum withdrawal requirements for pensions are based on the assets in the fund at the beginning of a financial year, or at the time of commencing a pension if commenced in a financial year.

The ATO has adopted the default option that contributions are defined as contributions to the accumulation phase and tax is payable on the earnings of the contribution in the financial year that the contribution is made^{iv}. Where the fund data demonstrates that the contribution was used to form a new pension or that commutation of the existing pension and commencement of a new pension occurred then the tax treatment for the contribution as an asset in the drawdown phase is accepted.

When assets decline in value during a financial year, effective minimum withdrawal percentages increase. This problem has been clearly demonstrated with the recent decline in superannuation assets, which has led to modification of the regulations for the 2008/2009 and 2009/2010 financial years.

Under the present regulation a member may choose either to commence an additional pension or commute the existing pension and commence a new pension using the existing assets plus the contribution. If the assets of the existing pension have declined in value, then the minimum withdrawal requirement will be reduced by electing to commute the existing pension. Where the assets of the existing pension have increased then the minimum withdrawal requirement may be reduced by electing to commence an additional pension at least during the remainder of the financial year. The choice only has an effect during the financial year in which the contribution is made.

Hence, the present regulation can lead to a net minimum withdrawal amount that is less than the sum of the minimum withdrawal amount applying to the existing pension at the time of the contribution plus that applying to the contribution.

A regulation allowing the addition of a contribution to an existing pension gives rise to the issue of how to determine the resultant minimum withdrawal value.

A simple approach, supported by A.I.R., is to assume that the contribution is made to the existing pension as the default option and require no change to the minimum withdrawal amount previously determined during that financial year.

This simple approach has the following advantages:

- It removes all the complexity and cost associated with application of the present regulation.
- It removes the need for a member to withdraw a percentage of the contribution within a few months (a maximum of twelve months) of making the contribution.

The simple approach has the following disadvantages:

- It removes the choice of a member to optimise the minimum withdrawal amount during the financial year that the contribution is made.
- It may lead to a reduction in the minimum withdrawal amount, but only for the financial year in which the contribution is made.

Employer Contributions Tax

Additional contributions from employment, either at the superannuation guarantee level or as voluntary contributions, attract contributions tax at the rate of 15%. This tax is separate from the tax liability of the earnings on assets, which also attracts tax at the rate of 15% when the assets are held in the accumulation phase. In the drawdown phase, provided the requirements of the regulations are met, there is no tax liability on earnings on assets in the fund or on the pension paid. Furthermore, earnings from employment above the age of 75 do not attract employer contributions tax except under certain special circumstances.

There is a clear distinction between the contributions tax and the superannuation tax liability of a member's assets. Accordingly, the contributions tax liability is not a ground for preventing additional contributions being added to assets used for the payment of a pension, even though the earnings from the contribution do not attract tax.

Determination of concessional, non-concessional and tax free amounts

The proportion of concessional, non-concessional and tax free amounts may need to be calculated to determine tax liability on:

- pensions that commenced before 1 July 2007;

- pensions paid during the transition phase
- death benefits;
- a fund becoming non-complying;

Pensions commenced before 1 July 2007 and pensions paid during the transition phase are special cases. It is unreasonable to apply the restriction to all pensions because of these special cases.

For other cases it would be reasonable to calculate the proportions at a time when a member's statement is normally required. However, this should not be used as a justification by the tax department to consider the contribution as being in the accumulation phase, and hence assessable, until such time as the calculation is made.

The effect of the restriction is to remove the incentive for funds to establish a method of calculating the proportions, which would cater for contributions into an existing pension. Removal of the restriction would provide an incentive to improve administrative matters of this kind and would prevent funds from sheltering behind the restriction as a means of avoiding fee collusion.

It is possible, but unlikely that a calculation would be required in between the normal calculation period because of special circumstances, such as the death of a retiree.

Term Type Pensions

There is demand for term type pensions where the retiree's investment and longevity risk is reduced. However, they are unpopular. When the restriction was incorporated into the regulations there may have been reason to limit additional contributions in term type pensions. However, removing the restriction may well encourage development of products with greater attraction to retirees improving the attractiveness of term type pensions.

Summary

The effects of the restriction preventing contributions to be added to an existing pension can be summarised as:

- complexity in superannuation regulations;
- complexity in administration;
- unnecessarily high fees;
- multiple pension accounts forced on a retiree wishing to have a simple pension;
- lack of incentive on superannuation funds to improve efficiency and reduce costs; and
- increased likelihood of errors and inefficiency in administration in superannuation funds and SMSFs.

There is evidence, through ATO audits, of breaches in the requirements for SMSFs that are due to lack of understanding of the complexity of the present requirements, not only by trustees, but also by their accountants. In some cases the ATO auditors themselves have shown a lack of understanding of the regulations pertaining to contributions in the drawdown phase. The complexity of the present arrangements is also highlighted by the fact that some professional accountants are unable to understand and apply the regulations.

There does not appear to be any significant rationale or advantage in maintaining the restriction now that the 2007 changes to superannuation have been introduced. To the contrary, it appears to be a significant impediment to low fees and inefficiency of superannuation for retirees and trustees.

Recommendation 2

To obtain a simple and cost effective system, the conceptual approach and the regulations should be changed to reflect the following:

- Desegregation of assets being accumulated from assets being used to support a pension should only be permitted during the transition to retirement age ranges. At all other times a retiree's fund should be nominated to be in either the accumulation phase or in the drawdown phase.
- The taxation approach to a contribution made into a fund in the drawdown phase should treat the contribution as an asset supporting a pension; such a contribution should be subject to the contribution tax where this is applicable under the regulations.
- That additional contributions intended to add to an existing pension be rolled into the existing pension from the date of the contribution, with all conditions pertaining to the existing pension being retained except that the balance has increased.
Consequentially,
 - The restriction on adding capital contributions to an existing pension should be removed by removing Section (a) (ii) of Regulation 1.06.
 - The minimum withdrawal amount in a financial year should not be adjusted to take into account additional contributions in that financial year.
 - Any consequential issues arising from the ability to make capital contributions to an existing pension should be regulated in the appropriate part of the Act.

1. Performance Data (8.1)

The super system, the subject of this review, is concerned with the predominantly compulsory fully-funded system. All investment risk is carried by individual members, the funds acting as agents/trustees.

Government established the compulsory system to reduce the impact on its budget of the increasing proportion of future retirees. Consequentially, it has a responsibility to define a risk/return model which meets its policy objective of optimising the return on individual's assets to minimise the cost to Government of retirees' pensions (4.1). It has not done so but has relied on trustees' fiduciary duty to act in the best financial interests of its members.

The recent global financial crisis has highlighted the danger of excessively high-risk investment strategies to the stability of the global financial system and the long term security of assets. It has demonstrated that an investment strategy based on a conservative risk/return model should be adopted for superannuation funds. Furthermore, members of such funds reasonably demand that such a strategy should be adopted

The Issues paper shows that a common 'balanced' risk/return strategy is based on a 70/30 growth/defensive strategy (6.2). When compared with most nations' pension investment strategies this would be regarded as a very high risk/return strategy.^v

Most research into superannuation returns is focused on the need to measure comparative risk/return strategies. There is little research focused on measurement methods that encourage and support defined investment strategies.

Key Performance Indicators (KPI) for the industry should be designed to encourage managers to operate within the culture of a conservative investment strategy. Incentive payments for investment managers should also be consistent with this culture (8.1.4).

In the A.I.R. Phase 1 submission it was argued that an important KPI would be to benchmark funds against a conservative Australian superannuation fund and suggested that the Future Fund would be such a model. However, it is noted that public sector investment fees are significantly lower than private sector fees (7.5). Nevertheless, the Future Fund does represent a benchmark that would be neutral in its impact on the predilection of managers to take excess risks.

Development of KPIs based on a 'balanced' default fund model for the purposes of comparison of investment performance would be another effective benchmark. It would also encourage funds to adopt such a standard as their own default model. This model could be subject to review from time to time in accordance with international movements and with information gained by APRA.

The collection of data on investment returns for individual investment options is not supported (8.1.3). AIR believes that the best approach is to base KPIs around a 'balanced' default model. The need to rate funds in a way that encourages conservative investment strategies is emphasised.

Investment-manager executive remuneration should be designed to support a conservative culture in investment. Incentives that are based on group performance are likely to achieve this result better than incentives based on individual performance.

Collection of data should be based on data that supports KPIs. Provision of such data by funds should be mandatory and collected by a recognised authority, such as APRA (8.1.1). APRA should proactively encourage the collection of data by private agencies and research houses (8.2.10) that supports the agreed investment approach for all funds.

Despite any pressure from members, member options that use excess borrowing, hedging, short selling, or similar high risk investment techniques should not be permitted. In addition, the number of investment options should be reduced significantly (6.2.5).

Recommendation 3

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;
- setting of a default investment strategy as the standard for the industry taking into account international standards;
- setting of Key Performance Indicators and benchmarks that reinforce the desirable investment culture for the industry, including the Future Fund as one benchmark;
- enforceable powers to support achievement of the above.

Recommendation 4

That collection of data should be:

- based on Key Performance Indicators;
- mandatory and collected by a recognised authority such as APRA.

That APRA should proactively encourage the collection of data by private agencies and research houses that supports the agreed investment culture for the industry.

Recommendation 5

That investment executive remuneration should be designed to support the agreed conservative investment culture for the industry.

Recommendation 6

That the number of investment options should be significantly reduced.

That despite any pressure from members, member options that use excess borrowing, hedging, short selling, or similar high risk investment techniques should not be permitted.

2. Information to Members (8.2)

Uniform disclosure of fees and charges is supported. The suggested four levels of charges are also supported (8.2.3). It would be difficult to control the proposal that other fees and charges be prohibited. The likely outcome is that such fees and charges would be hidden in the four prescribed amounts.

In its Phase 1 submission A.I.R. argued that information such as remuneration of directors, trustees and executives should be made available as a means of improving accountability. It also supported the need for an Annual Report, which could include the remuneration data. It would support the provision of the Annual Report and other communication through the organisation website as is the practice for public companies (8.2.7, 8.2.8, 8.2.9).

Recommendation 7

That uniform disclosure of an agreed set of fees and charges should be adopted.

Recommendation 8

That reporting requirements consistent with those of public companies be required from superannuation funds including an Annual Report. That the use of electronic communication be an option for this purpose.

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

ⁱⁱ A pension is now defined as a number of income streams but the term “pension” is used throughout this paper.

ⁱⁱⁱ Senator the Hon Nick Sherry, Correspondence to A.I.R. Retirement Incomes Research Group dated 12 May 2009.

^{iv} Confidential information on the approach taken by ATO Auditors is available on request to the author.

^v OECD (2009) Pensions at a Glance: Retirement Income Systems in OECD Countries.