Submission to Review into Governance, Efficiency, Structure and Operation of Australia’s Superannuation System

Phase Three: Structure

Preamble: The Australian superannuation “pie”

Part A: Structural issues

8.1 Defined benefit funds

Are there other examples of legislation in recent years which has resulted in problematic application for defined benefit plans?

8.5 Public Sector

Should the government accept the choice architecture model proposed in the Review’s Phase One – Preliminary Report?

Part B: SMSF issues

17. SMSF governance (and 18.1 economies of scale)

17.2 Trust model

17.2.1 Trustee education

Given the obligations of being a trustee and the minimal barriers to entry, should there be some minimum level of financial and compliance knowledge required? Is there another way of addressing low trustee financial literacy, such as ....

18. SMSF operation and efficiency

18.4 Accounting Standards

Should SMSFs be required to complete general purpose financial statements so that assets are annually marked to market?

Some concluding comments
Submission to Review into Governance, Efficiency, Structure and Operation of Australia’s Superannuation System

Phase Three: Structure

Preamble: The Australian superannuation “pie”

There are approximately $1.2 trillion invested in superannuation assets in Australia according to APRA’s latest figures (as at September 2009). This has grown from a base of $135 billion just prior to the introduction of the Superannuation Guarantee Charge (SGC). Very few industries can boast such a huge annual growth rate that, year after year, is buffered by the SGC. Figuratively speaking, the total amount of superannuation assets in Australia represents a very large “pie” upon which many individuals and companies have come to rely. The main tenet for these individuals and companies offering their services, in the best interests of the member, is largely based on the assumption that the individual member is not informed enough to be able to manage her own superannuation assets.

The Australian superannuation pie will continue to grow and grow in line with employment levels because, unlike other countries including the USA and the UK, superannuation is compulsory in Australia. Not only has the superannuation industry in Australia benefited from a strong and growing Australian economy since 1992 all the way through to the start of the Global Financial Crisis (GFC), it has also benefited from the inbuilt SGC growth mechanism (mentioned above). There are many players who would like to participate in the decisions of how the large Australian superannuation pie is cut up and how it is shared. Naturally, the superannuation member thinks that her piece of the pie belongs to her as (deferred) compensation for employment services rendered. She understands that her not-for-profit superannuation trustee is acting in her best interests by investing her superannuation monies (along with other members’ monies) in Australian equities, overseas equities and unlisted assets. She draws comfort from APRA’s RSE licensing arrangements because this requires the trustees to be highly skilled and discharge their duties in a prudent manner for the benefit of members in retirement.

The financial intermediaries also want a piece of the pie. However, she is aware that prior to the GFC the trustees of her fund were happy to pay large fees to financial intermediaries based on the size of assets under management, and that these payments were disconnected from performance. The member has learnt these facts from reading the financial media post the GFC, and wonders why the trustees did not communicate these important facts to her (Canberra alone can get action on fees, The AFR, 20 October 2009, p.49). This confirms her suspicions: that whenever any industry (or economy) grows year after year in size and at such an encouraging rate, it is inevitable that a cushion of excess
resources will develop to protect vested interests. She also suspects these vested interests have been rewarded with sizeable pieces of the Australian superannuation pie. She wondered why the superannuation fund offered products that benefited the financial intermediaries and not the member. She also wondered why so little innovation had occurred in the product market because her (long term) retirement needs were not being matched by products in the market place.

During the GFC, the member watched as her superannuation balances plummeted (Superfunds set to post worst returns on record, The AFR, 10 June 2009, p. 53). Some superannuation members are lucky because their employer made a promise to them a long time ago that their piece of the superannuation pie will not shrink, even if there is a GFC and the fund makes huge losses (assuming the employer remains solvent and honours the promise). In Australia, these lucky members are very few in number. Unfortunately, the majority of superannuation members in Australia are not “lucky”. This is because these superannuation members bear all the losses incurred on their superannuation assets immediately. This means that if the member runs out of superannuation savings due to bad returns and excessive fees, the government (and ultimately the taxpayer) will underwrite the longevity risk. Even so, these unlucky members were not granted choice of where to invest their superannuation monies until five years ago (thirteen years after compulsory superannuation was introduced in Australia). After pondering the purpose of the superannuation pie, she is reminded that superannuation is for the long term. She turns on ABC radio and hears the Shadow Treasurer for NSW, Mr Mike Baird, talking about long term Waratah Bonds (Infrastructure NSW) that will be government guaranteed as well as serve as a hedge against inflation. She is very interested.

Part A: Structural issues

Working through all of the concerns of the superannuation industry to develop a new system for managing the superannuation assets of Australians and quelling turf struggles is not an easy task. It is inevitable that tensions will surface. To this extent, the efforts of The Review into Governance, Efficiency, Structure and Operation of Australia’s Superannuation System (the Review) are commendable. The new choice architecture discriminates between funds on the basis of member engagement: disconnected, universal, choice and self-managed. The choice architecture focuses less on the form of the superannuation fund and more on the substance of the arrangements with members. The statement of principles in the Preliminary Report (that is, simplicity, efficiency, equity and adequacy (to members)) is also important because it offers a framework to
guide future directions, policies and developments for the superannuation industry so that socially desirable outcomes result. The Review released a Preliminary Report stating (p. 1) that the Review’s overarching focus is “achieving an outcome that is in the best interests of members and which maximises retirement incomes for Australians”. In order to do this, the Preliminary Report (p. 2) states that, aside from the 110 formal submissions received for Part One: Governance, over 100 meetings were conducted with “industry associations, superannuation funds, financial institutions, academics, lawyers and other interested parties” in Australia and overseas. However, one notable omission is the mention of any direct discussions with (engaged) members, whose best interests the Review is claiming to represent. Nonetheless, the Review offers the industry an opportunity for introspection so that its organisation and activities can be poised to better protect the future of Australia’s superannuation system.

Specific points addressed by this submission are as follows:

8.1 Defined benefit funds

*Are there other examples of legislation in recent years which has resulted in problematic application for defined benefit plans?*

**Choice of fund legislation and DBPs**

The nature of the retirement promise between the employee/member and the employer varies. The structure of the fund/plan sets up expectations concerning how the risks are shared between the employer and the employee/member. For example, defined benefit and defined contribution plans (DCP) differ in the way they define the retirement benefit and the placement of risk. In the defined benefit plan (DBP), the retirement benefit is calculated by reference to a formula (usually based on length of service and / or salary) while for the DCP, the retirement benefit is determined by reference to accumulated contributions plus investment earnings of the fund. This means that for a DCP, the contribution is defined but the benefits will vary depending upon the investment strategy of the fund. On the other hand, for the DBP, the benefit is defined and the contributions
from the employers vary. To ensure that these retirement benefits are “defined” and that the substance of the retirement benefit is (ultimately) honoured by the employer (so that the employee receives the “defined” retirement benefit promised to her/him), it is essential that the employer “guarantee” these defined benefits by a preparedness to top up the contributions as needed.

It is only fair, therefore, that because the DCP member assumes the risks (or the falls and rises) attached to her/his retirement benefit, she/he should have a say with respect to how the DCP assets are allocated. This is the foundation of the choice of investment/choice of fund legislation. In the Phase Three Issues Paper, the Review (p. 3) defines the choice member and comments that trustees, although bound by reasonable due diligence on investment and insurance options offered, should have limited liability for choices made by individual members.

Unlike the USA and the UK, the DB obligation is not regulatory backed in Australia. This means that, in the absence of the employer making good the defined benefit promise, the member’s retirement benefit will evaporate. In other words, if the employer refuses to honour the economic substance of the DBP arrangement by refusing to make good any DBP deficits, then the DBP is nothing more than a DCP. From this perspective, the DBP member is worse off than the DCP member because the DCP member understood from the outset that she was assuming the investment risk (and was able to plan their retirement savings accordingly). In the meantime, the jilted DBP member has been (probably) denied choice of fund and heavily penalised due to insufficient employer contributions.

Another issue concerns the definition of the DBP. The definition appearing in the glossary (p. 63) of APRA’s 10 year review of “Celebrating 10 years of Superannuation Data Collection 1996-2006” is as follows:

**Defined benefit funds** are superannuation entities where all members have defined benefits. In defined benefit funds, the member’s benefit is calculated based on a formula specified in the trust deed. Usually the member’s final
benefit depends on years of service with an employer (or years of membership of the fund) and level of salary near retirement.

Defined contribution funds are defined by APRA as:

Accumulation funds are superannuation entities where all members receive benefits based on defined contributions (accumulated benefits). The assets of the fund are invested and any earnings (or losses) are credited (or debited) to the member’s account less any charges such as administration fees and insurance premiums. Members bear the full effect of fluctuation in investment earnings.

The definition of the DBP by APRA is at odds with the definition of DBP appearing in the regulatory backed accounting standard AASB 119 (para. 7) as follows:

Defined benefit plans are post-employment benefit plans other than defined contribution plans.

Defined contribution plans are post-employment benefit plans under which an entity pays fixed contributions into a separate entity (a fund) and will have no legal or constructive obligation to pay further contributions if the fund does not hold sufficient assets to pay all employee benefits relating to employee service in the current and prior periods.

Where

Employee benefits are all forms of consideration given by an entity in exchange for service rendered by employees.

We have the unusual situation where the accounting standards require the economic substance of the DB arrangement to be recognised by employers in their general purpose financial accounts, yet the prudential regulator’s definition addresses the legal form of the arrangement only. The APRA definition for a DBP is insufficient because the definition does not include the main defining quality of the DBP, that is, the employer assumes the investment risk. The accounting standards, since 1 January 2005 require reporting entities to recognise any DBP deficits on their balance sheets. While this is a step in the right direction, the meaning of this accounting liability is compromised if the employer has no intention of honouring the DB obligation because there is no statutory duty to do so in Australia. This means that superannuation funds can (and do) call themselves a DBP
when in reality (and according to the trust deed) they are not, and at the same time deny members choice of fund. In these circumstances, it is only fair that the employee/member should be able to plan for their retirement and the choice of fund legislation should equally apply.

Some solutions include: change the APRA definition of a DBP, require DBP to reproduce in their annual report to members the relevant clause in the trust deed that offers the defined benefit guarantee, impose strict funding requirements for DBP plus annual actuarial reviews (although annual reviews are already required if the fund offers pensions), and allow choice of fund for all superannuation plans, including DBP. The upshot is that employers should not make promises they have no intention of keeping and should not call a DCP a DBP when it is not. There is a worldwide trend away from DBP towards DCP.

8.5 Public Sector

*Should the government accept the choice architecture model proposed in the Review’s Phase One – Preliminary Report?*

For the reasons outlined above, the choice architecture model should be applied across all sectors, including the public sector. I am puzzled about how the disconnection between choice and the public sector (including DBP) can be justified. For example, referring to the statement of principles in the Preliminary Report, applying choice to all superannuation funds including the public sector satisfies all four principles, being simplicity, efficiency, equity and adequacy. It is also interesting to note that APRA’s definition of the DBP (see above) would not work under the choice architecture proposed by the Review. That is, it is inconsistent with the choice architecture because if a member accepts the investment risk they should have choice of fund. Denying members of public sector funds access to the choice legislation begs the question of the nature of post retirement employee benefits: are they really employee benefits (according to the definition in AASB 119 para. 7) or do they belong to the employer?
Part B: SMSF issues

Within the superannuation industry, there is a tension emerging: between that of encouraging the creation of very large “mega” superannuation funds (that will yield incredible political power), versus that of a dispersed (but more competitive) superannuation industry. At the most basic level, this represents a “turf war”. The very large superannuation funds maintain that their members derive economies of scale. Economies of scale requires the per unit input cost to decrease with the rise in scale or expansion. However, the information produced by the large funds would make it extremely difficult for a member to verify this claim. Equally, it is also possible for diseconomies of scale to occur in the mega superannuation funds as huge sums of money can be siphoned off for services that do not offer any real value to members, and due to the lack of meaningful disclosures, the members are none the wiser (Canberra alone can get action on fees, The AFR, 20 October 2009, p.49). In addition, the political power of the individual member is not only fragmented but heavily diluted.

The issues relating to SMSFs that I would like to comment on are as follows:

17. SMSF governance (and 18.1 economies of scale)

The rise in self managed superannuation funds (SMSFs) is a source of angst within the superannuation industry in Australia (Self-managed pensions on the rise, Financial Times, 7 September, 2009, p.7). One plausible explanation for the rise in SMSFs is the referendum on member engagement and trustee accountability, neither of which the superannuation industry has actively encouraged. Engaged members, frustrated with a lack of representation from trustees, have opted for control of their own superannuation assets, including full knowledge of costs and fees. The potential for the recent rise in SMSFs to reduce the size of the superannuation “pie” that the incumbent superannuation funds have enjoyed over the last 18 years is, naturally, concerning (Lifelong vision for super reform, The AFR, 24 August 2009, p.46). The industry refers to the movement by
members to manage their own assets as a “romantic notion” (Self-managed pensions in the rise, Financial Times, 7 September, 2009, p.7). They have given many anecdotes where SMSF members have inappropriately used superannuation assets in violation of the “sole purpose” test. Equally, there are anecdotal examples regarding how the superannuation industry has also wasted superannuation monies on services that do not offer value to members. Exchanges of claim and counter-claim of this type do not advance the debate. The superannuation industry has overlooked the significance of keeping the member happy, informed about risk and engaged, so that post the GFC, many members have a strident unwillingness to rely upon financial intermediaries. It is only recently, when, in the face of financial turmoil such as the GFC and the significant shrinking of the superannuation “pie”, that the basis for handing out the pieces of “pie” to financial intermediaries has been thoroughly questioned.

The difference between a SMSF and a large industry fund is that a SMSF does not have agency costs since the trustee/member “wears the same hat”. On the other hand, industry funds manage “other people’s money” (OPM), and the agency costs can be huge, especially if there is a lack of relevant, reliable and comparable information supplied by the agents (trustees and managers) to the principal (the member). It is in the public interest to reduce both agency costs (of industry funds) and regulatory failure costs (of SMSFs) because both sides of the sector receive tax deductions/concessions. It is a biased view of the world to raise public interest arguments with respect to SMSFs but overlook these public interest arguments with respect to the large funds.

SMSFs have existed for a very long time in Australia. Many small businesses have established their own SMSFs and these entities have been operating successfully for many, many years. Further, small business, in many ways, represents the backbone of the Australian economy. It is reasonable to assume that if the small business owner knows how to run a successful business, then they are well prepared to administer and understand the rules for the SMSF. As with any change in legislation, the legislator/regulator needs to be mindful of who is affected by the change, and the scope of the change with respect to the rights, duties and obligations of the parties affected (that
is, what do they have to do to comply?). If the effect of the change is to undermine SMSFs and the choice legislation itself, this is difficult to justify using the Statement of Principles proposed by the Review and referred to earlier.

17.2 Trust model

17.2.1 Trustee education

*Given the obligations of being a trustee and the minimal barriers to entry, should there be some minimum level of financial and compliance knowledge required? Is there another way of addressing low trustee financial literacy, such as ....*

Financial literacy is a challenge for the entire industry, and is not just confined to the SMSF sector. Financial literacy is central to the choice architecture proposed by the Review. The members of large funds need relevant, reliable and comparable (like for like) information across funds in order to exercise choice. Member’ efforts to do this have been frustrated by the lack of relevant, reliable and comparable information on a like for like basis across the large funds. This may be one plausible reason why members are shy to exercise choice but opt for the default fund.

Because the trustee/member of the SMSF “wears the same hat”, the trustee/member makes all the investment and administrative decisions. To ensure the adequacy of superannuation retirement monies, all trustees (of large and small funds) should meet minimum qualification requirements. SMSF trustees should all undertake training courses or join a professional association, such as the SMSFs Professional Association of Australia (SPAA) that could direct their training requirements. This would need to be a simple procedure that adequately communicated to SMSF trustees the severe consequences of violating the “sole purpose test”. It is possible for these training courses to be done online and documentation kept by the trustees and tabled in the minutes of the AGM (to be reviewed by the auditor). There are also excellent publications by the ATO,
for example, “Role and responsibilities of trustees” (NAT 11032-11.2005). It should be mandatory for all trustees to read these documents.

18. SMSF operation and efficiency

18.4 Accounting Standards

Should SMSFs be required to complete general purpose financial statements so that assets are annually marked to market?

It is important for all funds to mark assets to market so that members’ balances (of both large and small funds) reflect relevant information. However, requiring SMSFs to prepare general purpose financial reports (GPFR) as a way to ensure assets are marked to market is extremely inefficient and, in my opinion, misdirected. SMSFs are required to have an annual audit, even though there is an absence of agency costs. (Normally audits are required to reduce agency costs of the principal). The cost of the SMSF audit is borne by the trustee/member and represents more a regulatory cost than an agency cost. A requirement of the audit could be to ensure that the SMSF assets are stated at market value. In any case, auditors should check the reasonableness of the asset valuations.

The valuation of specialised assets or assets that are unlisted is not an issue just for SMSF, but also for the large industry funds. For example, there are reports in the media concerning the valuation of unlisted assets by large industry funds (Industry funds hit by asset revaluations, The AFR, 10 August 2009, p. 44). According to this article, industry funds have approximately 28% of assets in unlisted assets at pre-crisis levels. In other words, these unlisted assets are not marked to market. Therefore, the preparation of GPFRs by large industry funds (and these should be made publicly available because the large funds are reporting entities under the Corporations Act 2001) has failed to ensure that assets are marked to market so it is baffling why the preparation of GPFRs by SMSFs would be helpful in achieving the same.
There is asymmetry between the audit requirements of SMSFs and large funds. As mentioned above, both types of funds are required to have an audit even though there is an absence of agency costs for the SMSF. To reduce the agency costs attached to the large fund, the SIS Act requires that GPFRs be supplied to the member upon request. However, the information supplied to members in the annual reports is largely unaudited. Given there are huge agency costs attached to the large funds, it is anomalous that the regulator has not noticed this gap.

Some concluding comments

Australia’s superannuation system is very different to the USA and the UK. Not only are there different institutional rules, but there are different taxation rules across these jurisdictions. For example, most employees in the USA who contributed $15,500 to a 401(k) plan were able to do so in 2007 on a tax deductible basis. In Australia, many SMSF members are not entitled to tax deductions for their contributions to SMSF (because they are not engaged in a business activity). To this extent, care must be exercised in ensuring that cross-jurisdictional comparisons are on a like for like basis. The objective of securing the adequacy of retirement savings is shared across jurisdictions.