30 August 2017

Productivity Commission
Superannuation
Locked Bag 2, Collins Street East
MELBOURNE VIC 8003

Email: superannuation@pc.gov.au

Dear Madam/Sir,

SMSF ASSOCIATION SUBMISSION TO THE PRODUCTIVITY COMMISSION SUPERANNUATION ISSUES PAPER

The SMSF Association (SMSFA) welcomes the opportunity to make a submission to the Productivity Commission's ongoing review of the efficiency and competitiveness of the Australian superannuation system.

Our submission focuses on four key areas that the review is addressing:

1. Policy and regulatory impediments to an efficient and competitive superannuation system.
2. SMSF members' experiences with the superannuation system.
3. The use of an investment benchmark as a metric to assess the system.
4. Default arrangements within superannuation.

We have addressed these issues from the perspective of the peak body representing the self-managed superannuation fund (SMSF) sector but also with the view of improving our superannuation system for all Australians, irrespective of their fund membership.

The detail on these issues can be found in the Attachment.

ABOUT THE SMSF ASSOCIATION

The SMSF Association is the peak professional body representing SMSF sector which is comprised of over 1.1 million SMSF members who have $696 billion of funds under management and a diverse range of financial professionals servicing SMSFs. The SMSF Association continues to build integrity through professional and education standards for advisors and education standards for trustees. The SMSF Association consists of professional members, principally accountants, auditors, lawyers, financial planners and other professionals such as tax professionals and actuaries. Additionally, the

SMSF Association represents SMSF trustee members and provides them access to independent education materials to assist them in the running of their SMSF.

If you have any questions about our submission please do not hesitate in contacting us.

Yours sincerely,

John Maroney
Chief Executive Officer
SMSF Association

ATTACHMENT

Policy and regulatory impediments to a competitive and efficient superannuation system

Regulatory change

The superannuation sector has undergone significant upheaval in the wake of the 2016 Budget and recent passage of the *Treasury Laws Amendment (Fair and Sustainable Superannuation) Act 2016*. Currently, many fund members and their advisors are working through the actions and strategies required to ensure they comply with the new laws which took effect on 1 July 2017. In addition to the need to revisit strategies and undertake actions to meet the new rules, many SMSFs will be faced with increased reporting compliance obligations under the new Transfer Balance Cap rules after 1 July 2017.

Political instability and ongoing change to the superannuation laws have created a level of distrust and instability in the superannuation system. When superannuation changes occur at the whim of budget policy and when consistent tinkering occurs, these activities affect the public trust in superannuation which can lead to individuals becoming disengaged with the superannuation system. They may withhold from making contributions and managing their superannuation savings in the most appropriate way for them (either in an SMSF or APRA-regulated fund) to maximise their retirement benefits.

The superannuation system needs a period of stability free from significant changes, especially changes to taxation settings, to allow members to have confidence in the system and make long-term savings plans. When superannuation changes do occur they should be fit for purpose and allow time for analysis. Supporting this, the purpose and objective of superannuation should be solidified so that broad policy issues can be evaluated more conclusively against the objective as envisaged by the Government's proposed Superannuation (Objective) Bill 2016. In turn, any sensible changes that improve the system and efficiency will clearly meet these objectives. The SMSFA supports this approach to superannuation policy making.

The SMSFA has been a vocal supporter of the Financial System Inquiry's (FSI) recommendation to enshrine the objective of superannuation in legislation and believes that the Government should seek industry consensus on the primary objective and proceed with this important step to provide stability for the superannuation system.

We believe that the objective for the superannuation system should be based around the provision of retirement income, as recommended by the FSI, and supported by a set of guiding principles that can be used to give context to the primary objective. It is essential that the objective not only has a focus on providing retirement income but also ensures that retirees are able to build adequate retirement savings through the superannuation system to manage financial risks of aging and retirement.

We believe that the primary objective for superannuation should be:

> *"To provide income in retirement to substitute or supplement the age pension, delivering a financially secure and dignified retirement for Australians."*

In support of this primary objective we believe guiding principles are required in order to provide policy makers and superannuation system stakeholders context as to how the primary objective is to be interpreted and applied to retirement incomes policy. The guiding principles should be:

1. *Providing a secure and dignified retirement*
2. *Managing risks in retirement*
3. *Be invested in the best interest of members*
4. *Alleviate fiscal pressures on Government from the retirement income system*
5. *Equity*
6. *Maintain a pool of national savings*
7. *Be simple, efficient and provide safeguards.*

In addition to enshrining the objective of superannuation in legislation, the SMSFA has advocated for removing superannuation policy from the annual budget policy cycle to promote stability, competition and efficiency for the superannuation system. Superannuation policy can then potentially be undertaken in a review of superannuation settings linked to the Intergenerational Report required under the *Charter of Budget Honesty Act 1998* to be completed every five years and released by the Treasurer at the time.

As the Intergenerational Report projects the long term sustainability of current Government policies over a 40 year time frame, with a focus on demographic change, it is a sensible vehicle on which to base superannuation policy changes. Having the Intergenerational Report released once every five years will allow the Government, industry and consumers to take a 'health check' on the superannuation system to see whether it is attaining its goals and whether any adjustments/changes to policy settings are required. The process should allow Government and key stakeholders to evaluate whether structural changes are needed to ensure the fulfilment of the goals of their superannuation system. In-built with this process should be orderly and timely consultation with appropriate superannuation system stakeholders.

This would allow the superannuation industry and consumers to have confidence that changes to superannuation will only be made with a long-term focus rather than in an arbitrary manner or with short-term Federal Budget goals as a key motivation.

Increased costs and complexity

New regulatory requirements, introduced on an almost annual basis in recent years, also have the effect of increasing the financial costs for both large superannuation funds and SMSF members involved in controlling their own superannuation. The major driver behind the increased costs is the level of unnecessary complexity involved in recent superannuation reforms. This can have the effect of reducing a member's retirement benefits over their lifetime due to increased fees and inefficiencies. Individuals may also become disengaged when they fail to understand complex changes in the superannuation system.

The introduction of the $1.6 million Transfer Balance Cap is an example of a policy that will materially affect the behaviour of SMSF trustees. This will involve the continual monitoring of event based reporting to the Australian Taxation Office (ATO) and increased contact with intermediaries such as a

financial advisor or accountant. Further, the inclusion of superannuation as a financial product under the AFSL regime requires financial advisors to be licensed when giving advice relating to a member's SMSF. This has resulted in Statements of Advice being required in an environment when in the past they have not been. The SMSFA estimates that recent regulatory changes could cost an SMSF an extra $2,000 in fees per year where additional advice is required.

The SMSFA is completely supportive of measures that increase the standard of financial advice and integrity in the superannuation system but note these changes also can have adverse effects on the competitiveness and efficiency of the superannuation system.

Insurance in superannuation

Insurance in superannuation is another policy issue that the SMSFA is concerned with, especially regarding the provision of default life insurance to young superannuation fund members on an opt-out basis. Our concern stems from the reduction in member account balances of young superannuation fund members caused by insurance premiums that may not meet their requirements.

The SMSF Association generally supports the provision of insurance through superannuation where it meets member needs. Where members are not able to work until retirement age due to disablement or death, insurance provided through superannuation is an important source of income for the fund member and their family. However, we have concerns that the current arrangements are inappropriately targeted and result in the erosion of member balances early in life.

The current practice of large superannuation funds is to issue new members of their fund with default total and permanent disability insurance (TPD), life insurance and in some circumstances income protection insurance. MySuper products are required to automatically offer members these polices on life and TPD polices on an opt-out basis. While this approach may overcome cognitive biases of disengaged superannuation fund members to not insure against income risk, it also comes with the downside of eroding retirement income and poorly targeting the insurance needs of fund members.

We are most concerned about the default provision of life insurance policies to young superannuation fund members as opposed to TPD cover. We believe that for employees of any age, TPD cover is an appropriate use of superannuation as it can play an important role in providing income if a young worker suffers permanent disablement early in life. However, it is less likely that a young superannuation fund member requires life insurance to insure against financial risks associated with their death.

Life insurance provides protection against risk of financial loss that would result from the death of the insured individual. The financial risks life insurance seeks to protect against include providing the deceased's family financial resources for mortgages, expenses of raising children and maintaining a standard of living for the deceased's dependants. It is less likely that a superannuation fund member holding life insurance early in their careers need to insure against these risks. However, default life insurance is a feature of APRA-regulated superannuation funds for new members, including those early in their career. We believe that this is inappropriate targeting of life insurance and the associated premiums reduce retirement savings.

Further, younger superannuation fund members are likely to have multiple accounts as they work in various jobs early in their career or undertake a combination of part-time work and study. This means

that they can often have multiple life insurance policies being funded from their compulsory superannuation. Australian Taxation Office superannuation account statistics show that for the 2015-16 income year:

- 32.4% of people aged 18 to 25 have two or more superannuation accounts, and
- 44.2% of people aged 26 to 30 have two or more superannuation accounts.

These fund members, who are often the most disengaged from their superannuation due to retirement being a long way off, are potentially having their retirement savings eroded by multiple life insurance premiums that do need meet any of their current financial needs.

Preventing life insurance premiums from eroding the retirement savings of younger works will have a number of benefits:

- Retirement savings will be preserved through reduced premium payments from superannuation and reduced administrative costs benefitting fund members as investment returns compound over time.
- Confidence in superannuation will be improved for young people as their superannuation savings are not reduced by unnecessary insurance premiums

Accordingly, the SMSF Association believes that default life insurance offered by APRA-regulated superannuation funds need to be better targeted.

We believe an appropriate solution to better targeting life insurance offered by APRA-regulated superannuation funds is for life insurance to be an opt-in product for people of under 30 years of age. We understand that at around age 30 people begin to consolidate their superannuation accounts making it less likely they will have multiple insurance policies eroding their retirement savings. Age 30 also aligns with when the Lifetime Health Cover penalty takes effect. We acknowledge that this proposal has risks of a reduction in coverage, and also introduces anti-selection risk and potentially more complex underwriting processes.

Alternatively, insurance cover in superannuation could be redesigned to closer meet the financial needs of members. As insurance in super depends on age and family situation, insurance products could be designed around such variables as age and family type. Currently insurance is sometimes a 'one size fits all' arrangement with everyone paying the same premium in the same category and getting the same level of cover. It is noted that the industry has begun to respond to the issue being raised in the insurance sector.

SMSF member experiences with superannuation

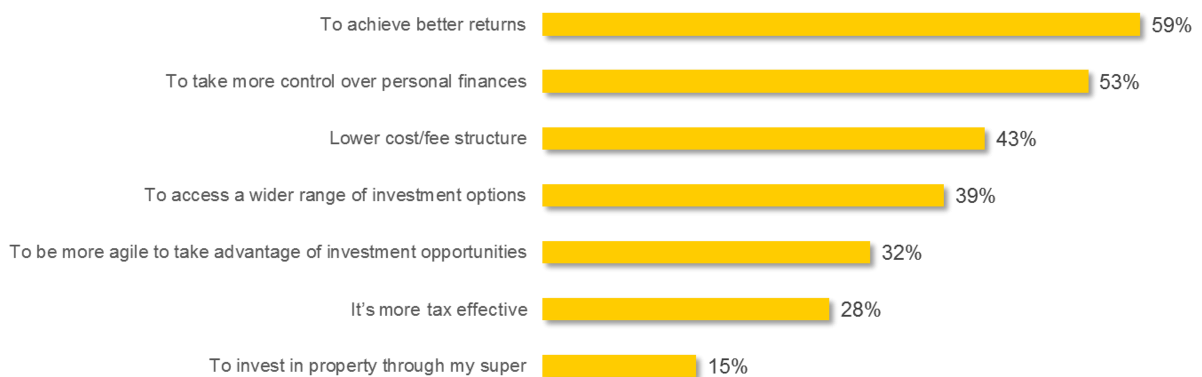
The SMSF Association has consulted with its SMSF trustee member base in a survey undertaken in August 2017 to form a broad opinion on how the superannuation system has met their needs. We also have undertaken significant research in the past on SMSF members experiences with the superannuation system

Our recent survey showed that with regards to SMSF members' overall impressions of superannuation, there has been a decline in both satisfaction with how the system has performed for them and the trust they have in the system to deliver the best outcomes in retirement. We believe that these relate to constant regulatory change, most notably in regards to the 2016 Budget announcements that have been the cause of much frustration.

Over a number of years SMSFA research has shown that legislative change and speculation has resulted in many Australians losing confidence in the superannuation system and reducing their contributions to superannuation.[1] The 2015 SMSF Association Intimate with Self-Managed Superannuation Report showed that advisers most commonly cite regulatory/legislative change as the greatest challenges they face in advising SMSF clients.[2] Similarly, a Vanguard/Rice Warner survey of SMSF trustees noted that 88% of respondents were concerned that they will be significantly impacted by changes to superannuation or taxation law.[3]

Furthermore, it was a common theme amongst our members that high institutional superannuation fund fees were a large issue. This was one of the main motivating reasons for our members establishing an SMSF and not retaining an institutional fund. They believed that large superannuation funds were over-regulated and wanted greater control over their investments and how their funds are spent.

This echoed finding in the '2017 SMSF Report'[4] authored by the SMSFA and Commonwealth Bank which showed that the key motivating factors for establishing an SMSF were as follows:



Unsurprisingly, our member base is extremely engaged in their superannuation and SMSFs. All respondents showed a very strong response to the fact they closely follow the performance of their SMSF, which is inherent in the nature of a self-managed fund. Notably, the majority of respondents named the internet as the most common information source used to make decisions about their superannuation. This is more significant given the SMSF trustee age demographic is older than the

[1] SPAA/Russell Investments, Intimate with Self-Managed Superannuation, 2012, 2013, 2014
[2] SMSF Association/nabtrade, Intimate with Self-Managed Superannuation, 2015
[3] Vanguard/Rice Warner, Survey of Financial Needs and Concerns, 2014
[4] SMSF Association/CBA, The SMSF Report, 2017, <https://www.commbank.com.au/content/dam/commbank/personal/superannuation/smsf/smsf-thought-leadership-report.pdf>

average APRA regulated fund member. This response demonstrates the need urgent need for an accessible and easily understood centralised information source on superannuation, based online for all individuals to access.

There was a mixed response relating to the fees and features of our members' SMSFs and how that information is relayed back to them. Members found that the information on their SMSF's fees and features, and similar information across the superannuation system more broadly, was easily accessible. However, the feedback was not as strong when relating to how well people understood the fees and features. This could be attributed to the complex nature of reporting that can sometimes be displayed by superannuation funds, the regulatory burden which has forced fees to rise and the need for financial advisors to then explain these changes to their clients.

Our members are even less satisfied with regard to the availability of comparable information on fees and features for their SMSF and across the system more broadly showed. This shows an indication that SMSF members cannot really compare the performance of their fund with other SMSFs and against the institutional funds due to different reporting styles and methods. This is an important area that should be looked at by the Productivity Commissions to ensure that all superannuation system participants can compare their fund to others in the market.

Finally, our SMSF members were not very comfortable in allocating a portion of their superannuation savings to life and total permanent disability insurance. In addition, the majority of respondents did not hold another superannuation account for the purpose of retaining an insurance policy attached to a previous superannuation product. This bias may be driven by the older age of our trustee members who are either in retirement phase or close to it.

Investment Return Benchmarking

The SMSFA appreciates the Commission's desire to use benchmarking as a method to measure the competitiveness and efficiency of the superannuation system. We understand the Commission intends on using passive, liquid reference portfolios to compare against the long-term return of superannuation funds.

We caution the Commission from using one benchmark to assess the entire superannuation system, given that superannuation fund membership is not homogenous and different funds and members will be aiming to achieve different investment outcomes. This is most relevant when comparing the objectives of superannuation fund members who are in accumulation phase and those who are in retirement phase.

This is especially relevant for the SMSF sector where approximately 590,000 SMSFs have different investment goals driven by each trustees' individual risk appetites and portfolio preferences. In addition, the SMSF sector is more heavily weighted to fund members who are in or close to retirement phase with 59.9 per cent of SMSF members being aged 55 or above as of June 2016. These members tend to have more conservative asset allocations weighted towards asset classes that offer liquidity and capital protection rather than a growth focus. Naturally these funds will tend to have a lower return than a broad industry average. Accordingly, comparing the entire SMSF sector against a system wide benchmark could result in misleading findings.

As an alternative, it may be more appropriate to apply a single accumulation phase investment return benchmark across the accumulation phase of the superannuation system. This will have the benefit of excluding retirement phase members who have a diverse range of objectives, risk tolerances, resources and strategies to draw down on their retirement income. In addition, accumulation phase members generally have the same objective of maximising the accumulation of retirement savings to be drawn down on later in life (even though they will have different strategies to achieve this goal).

Another issue with benchmarking is the difficulty of applying a standard tax rate to an industry wide benchmark, due to the differences between funds and market segments. For instance, SMSFs as a segment can have a lower tax rate than APRA regulated funds due to a higher allocation to Australian equities where they benefit from franking credits. However, as the same tax rules apply to all superannuation funds – whether APRA regulated or SMSF – a system average tax rate could be used in creating a benchmark or separate average tax rates for the accumulation and retirement phases.

The difficulty in applying a system wide benchmark encapsulating both accumulation and retirement phase is also difficult due to the different tax outcomes for superannuation fund members in retirement phase. Fund members in retirement phase generally have tax-free earnings on assets supporting income streams (subject to the Transfer Balance Cap). Accordingly, their effective tax rates on superannuation will be significantly lower than members in accumulation phase skewing a benchmark tax rate to a lower rate not reflective of accumulation phase rates.

While we believe it is important to take a sophisticated approach to benchmarking, we note that investment return benchmarking is not the only metric that the Commission is applying to measure efficiency of the system.

SMSF data on investment returns

Current data on SMSF investment returns is generally limited to that collated by the ATO through the SMSF annual return process. This process is driven by the ATO's taxation administration and regulatory oversight of SMSFs rather than the need to collect statistical information about SMSFs. This results in a different standard of data being collected regarding SMSFs that for APRA regulated funds which can make investment return benchmarking difficult.

In addition, there are some specific issues regarding ATO SMSF data that can distort investment returns calculated using ATO data.

The ATO calculates return on assets (ROA) by "*determining the net earnings, and comparing this to average assets during the financial year to determine the percentage return on assets.*" This methodology raises a number of issues.

- Using net earnings can lead to distorted ROA calculations where all fund expenses are deducted from investment earnings for this calculation. This is especially the case for new funds, where establishment costs (which are of a capital nature) are deducted from investment earnings to have a net earnings figure. The ATO SMSF statistics include all expenses reported in the SMSF annual return in calculating net earnings.
- In comparison, APRA-regulated funds net earnings only include operating expenses which are "*expenses incurred which are not ordinarily directly associated with the generation of*

investment income (i.e. expenses that are not directly related to the investment portfolio of the superannuation entity, but more toward the administration of the superannuation entity)."

- This different approach between APRA-regulated funds and SMSFs makes comparing investment returns between the sectors fraught with difficulty.
- Also, using average assets during the financial year can distort results too, especially where new funds may be established earlier in a financial year but contributions/roll-over are made towards the end of the year (e.g. May-June). This larger end of year balance can increase the average assets figure, reducing the overall ROA calculation, while the true amount of assets exposed to risk/return has been far lower for much of the financial year.

Accordingly, when comparing different sectors against a system wide benchmark, caution must be taken to understand the limitations of data and the effect on calculating investment returns. Also, the SMSFA recognises the lack of quality SMSF sector data is a hindrance to accurate assessment of the sector and is currently working to improve data availability which may assist the Commission in its review.

Default superannuation arrangements

Current default arrangements

As the SMSF Association does not represent participants in the default superannuation fund sector we will only be making comments of a general nature in relation to this issue.

The SMSF Association has concerns where employees do not have a free choice of superannuation fund. We believe that constraining employee choice has negative effects of disengaging people from their superannuation and also reducing competition, which can drive better member outcomes.

While we believe that default superannuation funds are an essential part of the system to cater for those who do not engage with their retirement savings, or do not have the financial skills to do so, limiting individual choice reduces competitive pressure on funds that have a guaranteed source of members. This can result in funds being run in a sub-optimal way and having disengaged members who either do not realise their fund is poorly run or who are constrained in their choice and unable to leave the fund. This increases the risk of individuals being defaulted to an underperforming superannuation product.

Default arrangements which do not give employers or employees any choice as to where superannuation contributions are made create a multitude of issues, the most significant being account proliferation and the consequent multiple sets of fees and insurance premiums which continually degrade people's superannuation balances. This is exacerbated by disengagement with superannuation, especially amongst younger employees.

The SMSF Association believes the ability for all employees to choose their superannuation fund is an important element in promoting an efficient and competitive superannuation sector. In addition, all employees should be provided information about what choices they have in the superannuation sector available to them (e.g. industry fund, retail funds, SMSFs, etc.).

On the first timer default mechanism:

As discussed above, the SMSFA is supportive of having more choice and information in the superannuation industry for fund members and believe that this is key to ensuring that disengagement is not entrenched through a new default system. We believe increased information and transparency regarding how default superannuation funds are selected for employees and what choices employees have available to them at a high level will engender greater trust and engagement in superannuation.

We also believe that the following would help avoid entrenching disengagement with superannuation:

- Increase financial education and literacy in younger individuals through school, with a particular focus on the importance of saving generally and the role of superannuation.

- Using technology such as the establishment of a centralised online service for members, employers and Government (building on the existing functionality of myGov and Single Touch Payroll) to assist employees monitor, engage with and consolidate their superannuation. This online service should consider the high percentage of use of mobile technology to access digital content (e.g. online banking applications, etc.).

- More broadly the process behind consolidating superannuation fund accounts and being prompted about existing accounts when beginning a new job should be easier, especially when young individuals switch or start new jobs. This involves creation of the online service, buy in from employers and greater choice and relevant information.

On the proposed centralised clearing house

The SMSFA is supportive of further exploration of a centralised clearing house as part of stage 3 of the Commission's review.

A centralised clearing house could be beneficial if it could provide a more comprehensive service with reduced administration costs. Specifically, it would be beneficial for members who choose SMSFs if it helped facilitate rollovers from larger funds into SMSFs. The recent SuperStream reforms have been working effectively and could provide a foundation for the introduction of a clearing house or leveraged to generate efficiency gains beyond the expected gains from the current arrangements.

Currently the process for rolling over superannuation from an APRA-regulated fund is inefficient and anti-competitive. Roll-over processes to SMSFs are inconsistent amongst funds. Some funds utilise digital platforms to rollover funds to SMSFs while many APRA-regulated funds still require members to submit roll-over requests via paper forms which are sometimes not available through their website. This makes transferring retirement savings to an SMSF an inefficient exercise.

Allowing individuals to orchestrate a transfer of their retirement savings to an SMSF through a centralised clearing house would improve the efficiency and competitiveness of superannuation. The key functions a clearing house would perform for SMSF rollovers would be to:

- Validate the individual has access to their APRA-regulated superannuation through necessary proof of identification checks.

- Validating the receiving SMSF as being registered with the ATO and having a verified bank account.
- Sending a release authority to the relevant APRA-regulated fund(s) to transfer the retirement savings to the validated SMSF.

We encourage the Commission to investigate how the existing ATO myGov platform, which has worked well in assisting people monitor and consolidate their superannuation, could be augmented to create a broader clearing house structure.