



31 March 2015

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The Treasury  
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To whom it may concern,

### **Re: Financial System Inquiry Final Report**

Taxpayers Australia Ltd (TAL) is a not-for-profit organisation committed to a fairer and more transparent taxation system for all Australians since 1919. Taxpayers Australia also has a wholly owned subsidiary Superannuation Australia which is also a not-for profit organisation committed to a low cost and lightly regulated superannuation sector.

TAL has reviewed the *Financial System Inquiry Final Report* (FSI) and would like to make some comments in relation to its contents.

The FSI provides a number of recommendations in relation to superannuation which we have addressed in the accompanying submission. Broadly speaking our views are:

- TAL supports the requirement that the objectives of superannuation should be set out in legislation
- TAL does not support banning of LRBA's
- TAL supports review of "default superannuation" and competition for management of approved default superannuation funds
- TAL supports requirement that superannuation trustees (other than SMSF) to pre-select a comprehensive income product for members' retirement
- TAL believes "choice" of funds is instrumental to superannuation policy
- TAL supports majority independent directors in all funds (other than SMSF)
- TAL believes tax issues in relation to superannuation are best addressed by the Tax White Paper process

If you or anyone from your office would like to contact us in relation to the issues we have raised in our response please contact me at either (03) 8851 4508 or [ragland@taxpayer.com.au](mailto:ragland@taxpayer.com.au) or at the address details set out below.

Warm regards  
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## **Taxpayers Australia submission on the Financial System Inquiry's final recommendations**

### **Principles**

TAL supports the requirement that the objectives of superannuation should be set out in legislation.

#### *Primary objective*

We agree that the primary objective should be “*To provide income in retirement to substitute or replace the Age Pension*”. The recent debate about members accessing their superannuation to fund the purchase of a home shows how important the need is for this principle. The attacks on the concessional taxation of superannuation contributions by some commentators - without reference to the purpose of that policy in reducing future government expenditure on the Aged Pension – further necessitates the need to enshrine the objective of superannuation in legislation. Any policy direction must be based on meeting this required objective.

We do not believe that superannuation should be used to fund the purchase of housing and that it would be detrimental to the primary purpose of superannuation identified above. While we appreciate that this is a feature in some countries pension/superannuation system, the success of such an option is hard to determine. In Australia allowing access to superannuation for housing while not addressing the housing shortage and taxation advantages for property investment, is only likely to drive up the price of housing while exhausting superannuation at an early stage and ensuring inadequate income support in retirement. While we appreciate there is a need to address the housing issue, commandeering superannuation for this purpose goes against the fundamental rationale of the superannuation system. We believe it will diminish people’s ability to substitute the Aged Pension meaning higher pension costs for governments and lower economic activity because of the reduced purchasing power of retirees who take up this option.

The same rationale would apply to the argument in relation to the concessional taxation of contributions. If the concessions were removed or reduced would this impact on people’s ability to substitute or replace the Aged Pension? Most definitely it would. Therefore it goes against the primary objective of superannuation and should not be supported.

What is required is stable superannuation policy, not policy developed on the hop or with a view to plugging fiscal holes. We have seen all sides of politics tinker with superannuation, not always in the best long term interest of retirement policy or members retirement savings. Having agreed objectives against which any new policy recommendation is compared will ensure a more honest debate.

#### *Secondary Objectives*

Of the secondary objectives identified we believe the first should be a requirement that the system be as simple and efficient as possible while providing adequate safeguards. Some proposals to alter superannuation have had good intentions but the solutions have been complex and unwieldy. Simplicity is the key to people understanding and staying engaged with their super.

The second secondary objective should be that superannuation is invested in the best interest of superannuation fund members. Proposals that favour the fund managers (or others in the system

such as employers and unions) over the members should be rejected and existing inequities in the system addressed. Breaches of this needed to be heavily penalised such as unions accessing member details for alternative reasons or employers seeking inducements from fund managers.

Another important secondary purpose is to alleviate the looming fiscal pressures on governments from an ageing population. Policies such as accessing superannuation for housing or reducing the concessional taxation of contributions will severely impact on this secondary policy objective.

While we agree that in general the system needs to be fully funded (the examples of unfunded liabilities in Europe and US show why this must be the case) we do not support the complete banning of borrowing by Self-Managed Superannuation Funds.

Of more controversy in our view is the suggestion that secondary policy objectives include smoothing consumption in retirement and manage financial risk. While these are important objectives there is a concern that they will be used by fund managers to create complex solutions that provide ongoing fees to the fund manager. Is this really in the best interest of the members? This needs further development.

One secondary objective that is not included and we believe should be is that the system should provide for choice in superannuation. While choice currently exists in the system, there are those who would like to see choice removed or downplayed in the favour of particular interest groups. Choice is fundamental. It ensures some form of competition and encourages the development of better financial products. It also encourages those that want to be more engaged in their superannuation to do so.

## **Direct borrowing by superannuation funds**

TAL does not support a reinstatement on the general prohibition on direct borrowings in superannuation. While we accept there are concerns in the market about the impact of such arrangements, no definitive study has been conducted to show they are anything but a legitimate means of boosting a person's income in retirement.

We disagree that Limited Recourse Borrowing Arrangements (LRBA's) create a build-up of "risk" in the superannuation system or that they are against the objective of the superannuation system.

The reference to the increase in the number of LRBA's, while headline grabbing, does not truly reflect the riskiness of LRBA. While the rate has increased significantly, this is off a very low base so any increase is likely to be large in a percentage form. If anything the percentage growth of investment in property generally has decreased in recent years. Furthermore a lot of property investments by SMSF are not LRBA's invested in residential property but business property investment. A more stable form of investment.

A better measure is the total SMSF assets in LRBA arrangements. ATO statistics indicate that in December 2013 SMSFs had a total of \$2.6 billion invested via the use of an LRBA. This represents around 0.5% of all SMSF assets. This cannot be seen as a systemic risk to the Trillion dollar superannuation system.

Another factor that should be considered if there is risk is the number of SMSF with LRBA's that are in current financial difficulty. We do not have statistics on this but if LRBA's represented a risk this should show up in the data. The reality is that lenders are not going to lend to funds that can't pay back their loans. The lenders already introduce a number of measures to reduce the risk posed by LRBA - such as maximum percentage of the loan subject to a LRBA. The market is addressing and pricing that risk.

The reality is that for younger Australians with little superannuation but a long term horizon to invest their superannuation, LRBA's provide a relative safe means to increase their superannuation savings so that when they retire they are in a better retirement position. Therefore we think that LRBA's by young people are consistent with the objective of superannuation to ensure people have money in retirement and are less reliant on the aged pension.

What TAL would like to see though is some restriction on those that can advise on LRBA's. They are complex investments and must be looked at not in isolation but through a thorough understanding of a person's financial position and retirement goals. This can only be done by someone that is a licensed financial adviser. Limiting to advice about LRBA's to licensed financial advisers will ensure greater integrity in the system and address the concern that some of those recommending LRBA's are not properly equipped to do so. It is unclear at the moment when a license is needed to talk about an LRBA in a SMSF. It would be much simpler if this advice was designated and licensed advice that can only be provided by a licensed financial adviser.

## **Improving efficiency during accumulation - Default super**

TAL believes that a better default superannuation framework is both possible and necessary and we should not wait for the MySuper process to be reviewed in 2020. The question has to go back to basic principles. Why do we have and need a default system? In a world of perfect information people could make a perfect choice, but that is not the real world. In the real world most people don't want to think about super and are happy for it to go into some mandatory (default) fund. Given that is the reality. How do we determine which funds should be default funds? What are the factors that should be considered? The current system is not level; some funds have an advantage (either because they are enshrined in awards, are backed by special interest groups or have a market dominance). The question is that the appropriate reason for a fund to be a default fund? We believe that objective criteria should be set and that a tender process is entered into to determine a small number (4) of default funds.

Existing default superannuation funds have a lot of power in that most people are not engaged with their superannuation and go with the default option offered by their employer. This has a number of problems. It encourages disengagement with superannuation, provides an incentive for fund providers to offer inducement to employers which may select fund that is best for the employer but not the employee. It also encourages expensive advertising campaigns that appropriate member funds to pay for them. Another problem with the default system is that when people changes jobs, particularly early in their working life, they are encouraged to go with the default of their new employer which may be different from their previous employer. This can lead to a proliferation of funds and is a factor in the \$18 billion of lost super.

What is required is a simple system for default funds that removes some of the negative aspects of the current system and improves outcomes for all people.

Taxpayers Australia proposes a change to the process of selecting a default fund. The first step is to remove the employer from the process. This is not a process that most employers understand or take a lot of care in deciding upon. They may be attracted to things other than the outcomes to members such as favourable banking or other products offered. Furthermore it is the members fund not the employers.

Taking the employer out of the system may cause some controversy, particularly for those that see superannuation as part of the industrial relations process rather than what it should be; retirement incomes policy. To ensure that employees see superannuation as their own it should be linked to the employee not the employer.

The question then comes how you get someone to choose a default fund so early in their working life and what should be the basis of that choice. Most people are disengaged with super at this stage and may not be able to make a good choice. Clearly offering endless choice would be counterproductive and may encourage superannuation funds using member funds to pay for advertising at the expense of member returns in order to attract new members. Endless choice would also be overwhelming for the individual involved.

Several overseas default pension/superannuation funds are provided by tender or auction every few years. To be the default fund they have to show they have performed for the members and are low fee charging. This ensures that the default fund is well run and efficient.

One option is to have a public tender process where existing funds, either on their own, or through collaboration with others, tender to run one of four national default funds. These would be plain labelled to remove marketing and brand names (to discourage advertising to promote their brand) as fund A, B, C, and D. Each of the funds would set out their history of performance for the past income year, 5 income years and 25 years if available. They would also set out what fees they charge so that employees will be able to make simple decision as to which fund to select.

There would be two "for-profit" run funds and two "not-for-profit" run funds. This will ensure competition between for-profit and not-for-profit funds and between funds. Competition is necessary to ensure good ongoing performance and to give some choice.

The government should then set up a body to review the tenders to determine the most appropriate. There would need to be criteria established for selecting the default fund such as performance, costs and protection of member assets. Another factor may be an approved retirement life product.

Once the Government has selected the default funds these would remain for 5 years, at the end of year 4 a process would start for a new tender for the next five years. The funds would remain but the managers of those funds may change.

The question then is how do you start the system? What happens to those in existing default funds, would they stay with their existing funds or made to make a choice? It is recommended that those with an existing default fund stay with that fund, however, they should be given the opportunity to change over to one of the new default funds.

To ensure ongoing competition and engagement, the individual would receive every 5 years a request whether they want to stay with that default fund, switch to another default fund or make a choice in a non-default fund. They would also be able to change at any time (though only once every 12 months), through the web, their default option or to make a choice decision.

This proposal will be opposed by those with entrenched positions. Both for-profit and not-for-profit funds will likely oppose it for their own self-interest; this does not though undermine the advantages of the proposed system. The proposed system is likely to accelerate further mergers between various funds as they will need to achieve scale to be competitive. This may not be a bad thing. While competition can drive down prices, a large number of entrants reduces the advantages of scale and may increase fees. Where the process for choosing a fund is opaque to the member it encourages a large number of providers to stay in the market. A smaller number of larger funds that are forced to compete for default status will achieve the required level of competition while encouraging scale.

TAL sees no reason why some default funds should be advantaged by their preference in awards or other mechanisms that are unclear and have more to do with industrial power than member benefit.

## **Retirement phase of superannuation**

*Recommendation 11: Require superannuation trustees to pre-select a comprehensive income product for members' retirement. The product would commence on the member's instruction, or the member may choose to take benefits in another way. Impediments to product development should be removed.*

TAL believes this is an intriguing idea that requires significant research as to its implementability and product design.

Many people are not engaged with their superannuation and are not financially literate enough to make good decisions on which type of retirement option is best for them. Even with the help of a financial adviser they are still unlikely to be equipped to make a sound decision and many will not be able to afford a financial adviser. It therefore makes sense to have a form of compulsion in the retirement phase.

We also support that such a solution is the default solution but people will have the choice to make their own decisions. As the report says those at the bottom with small superannuation accounts are likely to take a lump sum and then go on the Age Pension while those at the top can structure their financial affairs sufficiently. For the remaining middle many will stick with the default option but those who are more financially literate will be able to look after themselves.

TAL also agrees the requirement for trustees to pre-select a comprehensive income product (CIPR) should not apply to SMSF trustees. Those with an SMSF will already have planned their retirement and are generally more financially literate. Also it would be hard for them to get the scale necessary to have an affordable CIPR. Some of our members have been concerned that the recommendation would apply to SMSF, it needs to be made more clear that it would not.

While TAL supports in principle the idea, there are certain practical issues that need to be addressed.

While the need for a CIPR is recognised, there is a concern within TAL that this may be used as an excuse for funds to develop costly products that provide a regular income to the providers at the expense of members. While some compensation for the cost of the products is necessary, given the experience with default superannuation funds some product providers may gold plate their offerings to increase their own fee income. Therefore the design of these CIPR products needs to ensure they are low fee but provide a worthwhile product for the members.

Another concern that TAL has is that many may be concerned with the idea of pooled-risk products. While pooling is necessary there may be backlash to the requirement to have a pooled product that means any unused superannuation funds are not provided as bequests to family but pooled amongst the remainder of those covered. Many will not like this. They have been forced to put some of their income away for superannuation, the idea that some of this could end up in the hands of people unrelated to them is likely to put people off pooled-products.

The Government will need to undertake a thorough explanation of the benefits of a pooled solution so that there is general acceptance of the need for such a product. At the moment we do not believe there is majority support for such a product for the reasons outlined above. Unless those issues can be addressed there will be objections to this recommendation.

## **Choice of Fund**

As mentioned previously, TAL believes that “choice” in superannuation must be one of the secondary objectives of superannuation policy development. We do not believe that anyone should be prevented from having choice in their superannuation options, particularly where this is a result of industrial policy not retirement income policy.

A person must have the option to choose the fund and the fund type of their choosing should they choose to exercise that choice.

It is anachronistic and contrary to good policy that a person should be prevented from making choice. It also creates a disincentive for the funds receiving those contributions from providing the best option at the lowest cost. They face no competition so there is no price pressure to bear. This will always lead to suboptimal outcomes.

## **Governance of superannuation funds**

TAL has long supported the principal that a majority of superannuation fund directors must be independent directors.

While most funds are well managed there have been examples of poor management. These are often resolved not by failure of the fund but rolling that fund over into another fund and providing some directorships in the merged entity to the previous directors of the failing fund. This allows some to claim there has never been a failure of a fund, but covers over poor management.

We also believe that a majority of independent directors is best practice and normal practice around the world. It ensures that no special interest group is able to manipulate the system to their advantage. There is a risk that issues such industrial relations impact on decisions made by the fund due to the influence of non-independent directors that are not necessarily in the best interest of the fund members.

We agree that there should be no differentiation between industry funds and retail funds in the application of this rule, a majority should apply to both.

The idea that superannuation directors are not subject to criminal or civil penalties for failure to act in the best interest of members is very concerning. The definition of what is in the best interest of members has to be clearly articulated as the best interest on the financial management of the fund. There are concerns that some directors come with a specific bias that is difficult for them to overcome, as such they may not even be aware of what acting in the members best interest actually means. The rules should be no different than those apply to other directors of different types of corporate entities.

## **Taxation of Superannuation**

We believe that policy issues in relation to the taxation of superannuation are best dealt with through the Tax White Paper process rather than the FSI.