Investment & Financial Services Association Ltd
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Dr Sarah Bachelard
Secretary
Senate Economics Committee
Parliament House
CANBERRA ACT 2600

Dear Dr Bachelard

Reference:

Superannuation Industry (Supervision) Amendment Regulations 2004 (No. 2)

The Investment and Financial Services Association represents Australia's leading investment managers and life insurance companies who are responsible for investing approximately $685 billion on behalf of over 9 million Australians.

These regulations were made on Budget night 2004, without prior consultation with the superannuation industry. As your Committee's invitation for submissions suggests, the stated purpose of the regulations was to close what are regarded as loopholes in superannuation regulation.

> *The purpose of the regulations is to address a range of tax avoidance strategies primarily involving small superannuation funds. These strategies are designed to avoid reasonable benefit and deduction limits, and the superannuation surcharge. They are also used to obtain taxation concessions for wealth accumulation and estate planning arrangements rather than for retirement income purposes.*
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> *The regulations target strategies involving the forfeiture of superannuation benefits, the use of reserve accounts, and defined benefit and pension arrangements. They also ensure that funds providing defined benefits and pensions have the capacity to provide the benefits.*

IFSA strongly supports the integrity of Australia's retirement incomes system. We have previously placed on record our support for the closure of opportunities used to circumvent the intent of policy settings. To the extent that these regulations aim to close further unintended loopholes in system rules, IFSA supports that aim.

Self managed superannuation funds (SMSFs) are funds in which the members are also trustees and consequently dealings within the fund are not at arm's length. This is a critical distinction when considering regulations that apply to large and small funds

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alike. SMSFs are also not subject to prudential supervision by APRA. It is important to note that some small funds do (or can) have an arm's length arrangement: Small APRA Funds (SAFs) have an approved trustee, which is subject to prudential supervision by APRA. Two IFSA member companies offer SAF arrangements – one has around 5500 SAFs while the other has around 1200.

Forfeiture and reserves

Where a superannuation fund is able to use contrived arrangements to avoid taxation, IFSA supports measures to ensure the integrity of the system is upheld. Strategies such as forfeiture of benefits into fund reserves, and payment of contributions to reserve accounts, in funds that do not operate at arms' length, are cause for some concern. Where these strategies can be used in SMSFs, and given the parties are not at arms' length, the fund member / trustee is still able to retain effective control of the assets in reserves. Integrity measures are very appropriate for this sort of situation.

IFSA does not have any particular knowledge of, or insight into, contrived arrangements in SMSFs. We cannot comment on how widespread these practises may be.

Some of these regulations will impact on large funds as well as small funds. It is clear that on-market, arm's length arrangements are not the target of these measures, and the regulations and explanatory note make a clear distinction between SMSF practices and legitimate vesting and reserving practices in arms' length superannuation funds. A specific regulation - SIS Reg 5.08(2) – provides a grandfathering arrangement for vesting arrangements in place before 12 May. The explanatory note makes reference to APRA's modification powers under SIS section 328 to provide relief where arrangements meet the spirit but not the letter of Reg 5.08(2). We have already had positive initial discussions with APRA on this issue.

Defined benefit funds and income streams

These regulations prevent superannuation funds with less than 50 members becoming defined benefits funds. This means a small superannuation fund established after 12 May 2004 will not be able to offer a defined benefit pension. The underlying rationale for this measure is sound: defined benefit arrangements are based on the principle of pooled risk, and below a minimum pool size there would be no real risk pooling.

Superannuation and tax legislation has not previously prevented small funds from providing defined benefit pensions. While small funds' ability to offer defined benefit pensions may be seen as a loophole, it has nonetheless been permitted under the law. The process has been that a small fund offers its member a lifetime pension, the rate of which is set by an actuarial calculation to ensure the underlying funds are at least sufficient to meet the income stream offered. Tax legislation then values the pension by multiplying the annual income by a pension valuation factor. This strategy is tax effective where the value of a retiree's superannuation assets exceeds the pension reasonable benefit limit.

On 24 June, a further regulation was made, which provided a 'window' for people who had a small fund before 12 May, and who retire before 1 July 2005, to obtain a

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defined benefit pension. IFSA understands a number of people close to retirement had planned to use a defined benefit pension, usually after becoming aware of the arrangement through financial advice or planning. In many cases, the new regulations would have prevented that arrangement. This new regulation does appear to soften what could otherwise be a potentially harsh impact from the earlier regulations.

One of the key reasons many people turned to small superannuation funds in the pension phase was to be able to use growth assets as part of a balanced investment portfolio, while still qualifying for 'complying' status under tax and social security rules. Because of the limitations and guarantees that applied to complying pensions, these were effectively limited to interest-based investments in retail superannuation. These guarantees also meant that on-market complying income streams could offer very little flexibility or control to retirees. The changes to tax and social security rules to give complying status to market linked income streams (term allocated pensions) mean that this limitation will be removed from 20 September 2004.

A combination of allocated pension and term allocated pension can give retirees who are affected by tax and social security rules the combination of portfolio flexibility and control previously only available in SMSFs and SAFs. For many retirees, this will mean that their needs can be met through on-market, arms' length income streams.

The recognition of market linked income streams will provide a solution for many retirees whose total superannuation assets lie somewhere between the social security assets test threshold and the pension RBL. This solution could be effected though an SMSF, a SAF or a retail fund. Consequently, IFSA does not believe this group will be unduly affected by the regulation preventing small funds from offering a defined benefit income stream.

As with the vesting rules, the limitation on size of defined benefit funds could have an unintended impact on arm's length superannuation funds. This could occur where a superannuation fund takes on new defined benefit members, and most likely through a sub-fund structure in order to match benefit structures. This could occur through successor fund transfers, many of which are expected as smaller funds close over the next few years. It is not uncommon for master trusts to take on successor fund transfers and implement the defined benefit structure in a sub-fund. Many of these defined benefit funds do not offer pensions. Provided the new fund or sub-fund is a genuine arm's length arrangement, it would not offend the spirit of the new regulations even if membership was initially lower than 50. These modifications fall within APRA's powers under SIS section 328: no further legislation is required.

Estate planning

IFSA research, undertaken in 2001, showed that Australians approaching retirement have a strong preference that any superannuation balance that might remain on death should go to their estate. However, the same sample indicated that they did not necessarily plan to leave superannuation unspent on death – leaving the family home appeared to satisfy the bequest motive. People in our sample did not intend to live less well in retirement to create a larger estate.

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From this research, we can surmise that the most attractive aspect of complying income streams in small funds has been that any superannuation balance would pass to an estate on early death. Term allocated pensions, complying fixed term income streams and allocated pensions all pass a remaining superannuation balance to an estate on early death. Both allocated pensions and term allocated pensions can be offered through an SMSF or a SAF.

IFSA suggests that some of the estate planning motive attributed to SMSFs and SAFs can now be met by a combination of allocated pensions and term allocated pensions, whether through a small fund or through a retail fund.

Revenue impacts

IFSA cannot comment on the impact of these measures on Commonwealth revenue and outlays.

Thank you for the opportunity to comment.

Yours sincerely

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