

20 July 2018

Superannuation
Productivity Commission
Locked Bag 2, Collins St East
Melbourne VIC 8003

Submitted via Productivity Commission website lodgement portal

Dear Sir/Madam,

Superannuation: Assessing Efficiency and Competitiveness Draft Report

Chartered Accountants Australia and New Zealand welcomes the invitation to make a submission on this draft report. We would be pleased to discuss any aspect of our submission.

Chartered Accountants Australia and New Zealand is a professional body comprised of over 120,000 diverse, talented and financially astute members who utilise their skills every day to make a difference for businesses the world over.

Members are known for their professional integrity, principled judgment, financial discipline and a forward-looking approach to business which contributes to the prosperity of our nations.

We focus on the education and lifelong learning of our members, and engage in advocacy and thought leadership in areas of public interest that impact the economy and domestic and international markets. We are a member of the International Federation of Accountants, and are connected globally through the 800,000-strong Global Accounting Alliance and Chartered Accountants Worldwide which brings together leading Institutes in Australia, England and Wales, Ireland, New Zealand, Scotland and South Africa to support and promote over 320,000 Chartered Accountants in more than 180 countries.

We also have a strategic alliance with the Association of Chartered Certified Accountants. The alliance represents 788,000 current and next generation accounting professionals across 181 countries and is one of the largest accounting alliances in the world providing the full range of accounting qualifications to students and business.

Introductory Comments

A summary of our views in relation to the Productivity Commission's draft findings – with further discussions below of some of these points – are:

| | CA ANZ response |
|--|-------------------------|
| Investment Performance | |
| 2.1 Underperformance by large segments of APRA regulated super funds | More analysis required. |

| | | |
|--------------------------|---|---|
| 2.2 | SMSF sector underperformance due to excessive fees in funds with smaller balances | Agreed however there may be valid reasons for having a SMSF with a smaller balance. |
| 2.3 | Underperformance of a large portion of default funds | More analysis required. |
| 2.4 | Underperformance of choice segment | More analysis required. |
| Fees and Costs | | |
| 3.1 | Reporting gaps in how funds report fees and costs | We agree with the finding and believe more needs to be done. |
| 3.2 | Despite falling in the recent past, Australian super fund fees are higher than many other OECD countries. A minority of members are caught in relatively high-fee 'choice' products | We agree with this finding. |
| 3.3 | Larger SMSF costs broadly comparable with APRA fund costs; smaller SMSF costs significantly higher causing poor net returns | |
| 3.4 | Fees have a dramatic impact | We agree with this finding and question whether percentage fees create a conflict of interest. We also have concerns about the general management of tax liabilities. |
| Members' needs | | |
| 4.1 | A minority of members are dissatisfied with their fund; those who have poor understanding of the system and less capacity to judge performance are less satisfied | Noted. |
| 4.2 | It is hard for most members to compare superannuation offerings. 'No frills' with low fees product invested in a balanced portfolio would likely meet retirement needs of most Australians during their accumulation years. Default allocations need to be better designed. | This finding dovetails with our member's anecdotal evidence. We remain sceptical about the benefits of active asset management. |
| 4.3 | My-Super 'life-cycle' products provide questionable benefits to members especially returns. | Noted. |
| 4.4 | A default retirement income product – sometimes referred to as 'MyRetirement' – is not warranted. Good quality financial advice necessary to help members navigate complex products | We strongly agree with this finding. |
| 4.5 | Super funds do not gather sufficient member data and/or do not use member data to design products or their features | We strongly agree with this finding. |
| Member engagement | | |
| 5.1 | Overall member engagement remains low. It tends to be highest amongst those approaching retirement, higher balance members and SMSFs. Most have a good knowledge of the super system. Approximately 30% of members have low financial literacy, | This has been the problem for many years. |
| 5.2 | Demand side pressures are almost non-existent | We agree with this finding and believe there is much that could be done here. |
| 5.3 | Members often feel overwhelmed by complex information; salient, simple and accessible dashboards should be used to compare | We agree with this finding with some modifications to |

| | |
|--|---|
| products | the Commission's view. We are surprised the Commission did not express a view about portfolio holding disclosures. |
| 5.4 Quality of financial advice is questionable throughout sector. | We agree with this finding. |
| Erosion of member balances | |
| 6.1 Recent policy initiatives will promote Super Guarantee compliance. | We agree with this finding however we do have concerns about some additional powers for the ATO. |
| 6.2 The superannuation system, primarily due to its policy settings, does not minimise unnecessary and undesirable erosion of member balances. The erosion is substantial in impact and regressive ... Recent policy initiatives have improved the situation, but current policy settings are inevitably making slow progress by treating the symptoms and not the structural cause. | Given the weight of evidence presented by the Commission we believe it would be difficult to refute this draft finding. |
| Market structure, contestability and behaviour | |
| 7.1 The market structure of the superannuation industry is conducive to rivalry. | Noted. |
| 7.2 There are significant non-prohibitive barriers to entry – costs and access to markets. The default segment currently have high barriers to entry. The choice segment is contestable. Merger costs are frustrating consolidation. | We agree with this draft finding. Below we detail how we believe the current concession needs to be slightly broadened so that many of the benefits of fund mergers can be achieved without the need for completed mergers. |
| 7.3 Some competition in the super industry can be unhealthy especially because of product proliferation and poor comparability in the choice segment. The potential for conflicted inducements in the default fund segment remain a concern. | We agree with this draft finding. |
| 7.4 Reporting using associate service providers can give rise to conflicts of interest or at a minimum the perception of conflicts. Confident regulators need to address these issues by enforcing greater disclosure and reporting. | We agree with this draft finding. |
| 7.5 Economies of scale to date in the super sector have arisen because small, high cost funds have exited. Lack of evidence that remaining funds have realised cost efficiencies as they have grown. | We agree that some superannuation costs have not declined. A major problem in our view is constant regulatory change and ever evolving regulator demands. We also think many funds are run based on short-term outcomes. |

| | |
|---|---|
| Insurance | |
| 8.1, 8.2 and 8.3 | Given proposed legislation currently before Parliament we will not provide a response to these draft findings. |
| Fund governance | |
| 9.1 Trustee board appointment processes have improved. A skills matrix would provide further assistance to guide the appointment process. | We agree with this draft finding. |
| 9.2 Independent directors should make up at least one third of independent directors. Recruitment of highly skilled and experienced directors is equally important. | With caveats we agree with this draft finding. |
| 9.3 Many trustee boards fail to undertake third party board performance evaluation and capability. | We agree with this draft finding. |
| 9.4 Many funds 'follow the herd' mentality when investing member money | We agree with this draft finding. We believe this would be best addressed by not assessing funds using total returns. |
| System Governance | |
| 10.1 Package of reforms in <i>Treasury Legislation Amendment (Improving Accountability and Member Outcomes in Superannuation) Bill 2017</i> would improve member outcomes. | We agree with this draft finding. |
| 10.2 There is significant overlap between APRA and ASIC roles in supervising conduct (the legislation for these functions is confusing and opaque). The overlaps leaves open the potential for poor accountability. | We agree with this draft finding. |
| 10.3 AFCA should be a positive reform on the proviso it is adequately resourced. | We agree with this draft finding. |
| 10.4 At present Limited Recourse Borrowing Arrangements in SMSFs do not pose a systemic risk. | We agree with this draft finding. Most lenders only accept conservative loan to value ratios. We note that recently some large banks have withdrawn from this sector. |
| 10.5 The frequency and pace of policy change undoubtedly create real pressures for participants. However most of the recent changes have been beneficial from a public interest perspective | We believe the Commission under-estimates the cost of constant and incessant regulatory and tax policy changes both in terms of its distraction to super funds and the erosion of member confidence in the retirement system. Given superannuation is a long-term investment it is essential members have |

| | |
|---|---|
| | confidence that changes – especially tax changes – will not unfairly impact them. |
| | |
| Overall assessment | |
| 11.1 Fixing some of the worst problems in the current superannuation system would bring substantial benefits | We agree with this draft finding. |
| 11.2 The superannuation system has not kept pace with members' needs. | We agree with this draft finding. |
| | |
| Competing for default members | |
| 12.1 The default segment has outperformed, on average, the system as a whole. However it fails to ensure members are placed in the best products and as a result a sizeable minority are in underperforming funds. Current arrangements deny some members any ability to choose their own super fund. Default arrangements needs to be modernised and recrafted to harness the benefits of competition for default funds. | We agree that the default super fund 'selection' process needs to be examined. |
| 12.2 Current default arrangements do not promote member engagement. Research shows that members might be more willing to choose from a simple and accessible list of products. | We have concerns about the current proposed product dashboard design. We appreciate the need for simplicity however do not agree with solely total returns being reported. |
| 12.3 A sovereign monopoly wealth fund model, whilst realising economies of scale, would run counter to the absence of an actual or implied government guarantee and would fail to harness the benefits stemming from a competitive system and would supplant member engagement. | We believe the superannuation industry and together with regulators should be given a period of time to self-regulate and adjust to government regulatory changes stemming from this Productivity Commission report. If insufficient change is not made then the concept of a sovereign wealth fund could become a viable option. |

Chartered Accountants ANZ believes there is much to like about the Productivity Commission's Draft Report *Superannuation: Assessing Efficiency and Competitiveness*.

We note that some key aspects have already been adopted by the government especially in relation to lower account balances and insurance options, exit fees and account consolidation. As the government has already accepted the draft recommendations in these areas we will not comment on these proposals in this submission.

However, we are particularly concerned about the Commission's use of total returns to assess fund performance and as the preferred methodology of ongoing assessment. Ideally the Commission needs to

adjust its assessment process and be open to revisiting some of its initial conclusions. Our preferred investment return approach is detailed in this submission.

We are concerned that the Commission's findings about the SMSF sector – especially that SMSFs with less than \$10m in total assets have lower returns than some APRA regulated funds – may be used by others to attack that sector primarily for competitive reasons.

As we have long argued in our pre-budget submissions to government we agree that there should be no tax disincentive for super funds to merge. However we strongly suggest that most efficiencies could also be gained much more quickly if super funds were permitted to transfer assets into other vehicles tax effectively. A good example is the use of Pooled Super Trusts or PST. At present if a super fund transfers money into a PST it is a deemed disposal of an asset and hence subject to CGT. In our submission below we detail several advantages with our preferred approach.

We are deeply concerned about the ongoing persistent lack of engagement in retirement savings by the majority of superannuants. Based on the Commission's report it would appear that it does not believe this problem can be fixed and hence the recommendation concerning the 'best of breed' default funds. It is difficult to disagree with this conclusion but nevertheless we find it concerning. In this document we refer to our own important research, in a related area, which finds that consumers understand the problem but are unwilling to see any consequential change to government policy.

Below we discuss what we believe needs to take place to address member apathy. Despite its unwillingness to act for over thirty years in this area the government together with major industry players need to take the lead and be prepared to do so over the long term.

We are also particularly concerned about reasonably large segments of the super industry not providing the Commission with requested data. We believe this calls for further reform and enforcement action by the Commission itself and perhaps the superannuation regulators.

Chartered Accountants ANZ agrees with the Commission about the lack of disclosure in the superannuation sector. We agree that regulators need to push harder to achieve meaningful, comparable data so they can perform their tasks more easily. Such data would also assist members, researchers and other interested parties.

The Commission needs to acknowledge the considerable time and cost super funds incur in order to generate reporting and market survey data. Many large super funds would have at least one full time staff member who spends the majority of their time completing these reports.

We find it unusual that the Commission elected to have nothing to say about the government's proposed portfolio disclosure policy currently before Parliament.

Investment Performance – Assessment Needs More Than Total Return Analysis

We note the Commission's preference for using "net total returns" – that is both income and asset price changes net of all fees and taxes expressed as single numbers.

This is a very popular assessment methodology because it pulls together what are seen as the major elements of investment performance. Conceptually it is easy to talk about one total return figure.

In addition, a focus on total return figures makes it easier to charge fees based on a percentages of assets under management especially within a unitised investment fund. And it encourages greater turn-over of assets as investment managers will attempt to chase the 'in your face' capital returns rather than the more sedate, significantly less exciting, income returns.

Superannuation is a long investment journey

However as the Commission acknowledges, superannuation for some younger super fund members will be an investment journey of 70 years or more. In fact, superannuation will also be a long-term investment for most people except those within 20 years of death.

The primary purpose of superannuation is to provide savers with an income in retirement. Ideally that income will increase by, at least, average consumer inflation so that a retiree can maintain their pre-retirement standard of living. However, given average wages often increase faster than inflation it would be better to index retirement income by average wages so that a retiree's standard of living improves in line with the general community.

The value of income returns are often misunderstood and calculated incorrectly

As superannuation's primary purpose is to provide retirement income we need to assess investment performance by taking a long term view and in particular on how well investments held by super funds can deliver income. In effect the key to this issue is the growth in earnings from investments not the fluctuating market value of each asset – or the change in the value – of a portfolio given that in most cases short-term market volatility will have no impact on a long-term member's asset holdings.

In addition, it is commonly assumed that a capital return of 5% p.a. and an income return also of 3% each year delivers a total return of 8%. This is incorrect for all time periods but becomes particularly evident over longer periods of time. Over 10 years the income return is actually 3.7% but over 40 years it is 6.2%.

It is not clear from Technical Supplement 4 whether or not the Commission has made this mathematical mistake in its analysis. However given the Commission elected to use total return indices in its creation of Benchmark Portfolios¹ we suspect this might be the case.

We believe that it should be possible to disaggregate this data so that capital and income returns can be assessed.

Therefore, with respect, we suggest the Commission needs to revisit how it has assessed super fund performance and the cameos it has built as well as how both of these have been used to determine the assessment criteria of funds. We would encourage the Commission to investigate this issue thoroughly and make any necessary adjustments in its final report.

We do support the construction of benchmark portfolios. We recognise that many inputs into the current benchmark portfolios used by the commission would need to be revisited to disaggregate between capital and income returns.

¹ Productivity Commission 2018, 'Investment performance methodology and analysis', Technical Supplement 4 to the Draft Report Superannuation: Assessing Efficiency and Competitiveness, Canberra, May, p. 17

Problems with SMSF data

We note the limitations in ATO SMSF data and its lack of comparability with APRA super fund data.

The ATO primarily collects data to ensure SMSFs are complying with the *Superannuation Industry (Supervision) Act 1993* and is not a prudential regulator. On the other hand APRA collects data to satisfy its statutory prudential regulator obligations. Clearly these are different functions which means that the ATO and APRA will want to collect different data to satisfy their separate legislative functions.

In addition APRA super funds are reporting entities and must comply with AASB 1056. Conversely SMSFs are not reporting entities and need to satisfy, at a minimum, basic accounting standards.

We note that in draft recommendation 22 the Commission says that a range of government agencies need to create a data working group to improve overall system data to help improve consistency. We believe this would be a welcome outcome as long as the collection of data did not degenerate into a large and expensive function for funds to comply with.

Smaller SMSFs

We note the Commission's comments about small SMSFs having lower net returns due to higher administration fees. The implication of these comments is that perhaps smaller SMSFs should not exist.

However we wish to point out that there may be valid reasons why low balance SMSFs exist:

1. A SMSF may have a temporarily low balance because substantial contributions or benefit transfers will be made in the future
2. The members in the fund wish to use their SMSF to hold a specific investment that is not available in other vehicles – for example, artwork, collectibles or real estate
3. Active market traders who wish to use some of their retirement savings to actively trade a small portion of their retirement savings and have decided it is easier to have this money in a separate entity

Our members have told us that the majority of smaller balance SMSFs are established for a specific purpose or will not have a low balance for an extended period of time.

The continuing publicity about poor behaviour within large financial organisations, including industry funds, directly and indirectly also encourages consumers to take control of their own retirement affairs.

The ATO has said on numerous occasions that most SMSFs are well run and trustees seek to comply with the laws and most attempt to invest sensibly. The views of our members, who collectively perform a wide range of functions for most SMSFs, concur with this conclusion.

Most industry, corporate, public sector and retail super funds have a small cohort of members with large balances and many members with small to moderate balances. In many cases the small cohort of large balance members pay the majority of the fees used to run the fund.

Some APRA regulated super funds may not be financially viable without a sufficient number of higher account balance members.

As the Commission is aware from its own research it is those with these larger account balances who

might be more willing to consider a SMSF because of the estate planning and potential tax planning benefits which it is often claimed large funds do little to consider when deciding to buy/sell/hold a particular investment that may be available because of their larger pool of assets.

As a result of this potential loss of larger balance members many industry and retail super funds have taken active strategies to address this competition from SMSFs. It is our firm view that SMSFs have provided important competitive pressure on APRA regulated super funds that in most cases otherwise would not have existed.

However it remains the case that there is a cohort of smaller balance SMSFs that are being indefinitely adversely impacted by high fees. We believe the ATO needs to identify the number of SMSFs that have been created in each of the last five years that had less than \$150,000 in total net assets for the fund's first annual return. The ATO should then observe each fund for each of the remaining financial years to see how many of these funds still had less than this net asset threshold at the end of each financial year. Once armed with this data we will know how many smaller funds commenced with low balances and have not grown significantly. From this analysis we will know how big a problem these small balance SMSFs might actually be within the system.

In our view the biggest problem with these medium term smaller funds is what to do with them. In many cases the trustees/members may not have access to licensed financial advice, and may be reluctant to seek it out especially given the recent poor publicity referred to above. Or they may be unable to find a financial adviser with whom they feel comfortable. Or given their total net wealth they may be reluctant to pay for financial advice.

Public practising accountants, such as Chartered Accountants (including those who are registered tax agents and/or hold ASIC SMSF auditors registration who do not hold an appropriate financial services license which permits the provision of personal financial advice for superannuation products), cannot recommend that a SMSF with small or modest total assets be closed.

This is also an issue for SMSF trustees with various mental impairments such as senility.

Accountants in this situation are only permitted to factually discuss with a SMSF trustee their various options and then, if requested, act upon the trustees' decision.

Given the lack of data from the ATO and our members' feedback we are currently of the view that it would be inappropriate to place a restriction on the total net assets a SMSF should have either initially or over an extended period of time.

Fees and Costs

The Commission found that members feel overwhelmed and do not know where to find unbiased valuable and useful information. This matches our member's anecdotal feedback about their clients' experiences.

We are concerned about the use of percentage fees. It is our belief, based on financial literacy studies², that most members can neither determine the dollar value of these fees each year nor their longer-term impact.

We agree that the superannuation regulators need to do more work to standardise super fund and

² <http://www.financialliteracy.gov.au/research-and-evaluation/australian-research-and-evaluation>

investment option reporting to ensure members are able to independently assess fund performance and fees.

Member Needs

As noted above we are concerned about the lack of standardised reporting of super fund performance and fees and costs. We believe that as superannuation is compulsory – under government legislation – for most of the workforce then it should be the government agencies that gathers appropriate data and then displays it in a suitable unbiased fashion.

Member Engagement

We agree member engagement is low and knowledge is often quite poor. Constant regulatory change – both in the super laws and associated tax laws – saps member's confidence in the system as does the constant bickering among the various superannuation industry sectors.

See our suggestion under proposed changes to the default fund selection process (below) as to how member engagement could potentially be improved.

Barriers to entry into the superannuation sector

We believe there are significant barriers to entry in the super system. However there is a necessary tension between making the establishment of a super fund available to third parties too difficult – which restricts entrants – and making it too easy, thereby allowing fraudsters and others wishing to do harm to enter the market.

We agree that the current default fund system discourages market entrants.

Fund Mergers

We agree that mergers between super funds should be encouraged and as part of this process permanent CGT rollover concessions are an important tool.

But we also believe super funds should receive CGT relief for transferring assets or asset sale proceeds to other investment vehicles such as Pooled Superannuation Trusts.

This approach would allow funds to merge some or all of their investment holdings with other super funds without the need to formally merge. This would allow funds to reduce costs while still remaining independent.

It would also allow some larger super funds to market their in-house investment services to a range of other super funds including SMSFs

Proposed Changes to Default Fund Process

We agree with the Commission's assessment that, members are ending up in a default fund selected by their employer or specified under an industrial agreement or award. And clearly a significant minority of employees are denied any ability to select their own fund.

To address these concerns the Commission has suggested that the default fund approach must change to encourage competition with the selection of a top 10 list of default funds.

We believe the current model – that is, default funds nominated by an employer or in an industrial agreement or award – is not without its faults and consideration should be given to put in place another model.

It is clear from member behaviour over the last 25 years that the vast majority are reluctant to engage with their retirement savings in any serious way and select their own fund or their own investments. And as the Commission notes a significant number of members lack the necessary skills to make a decision about a suitable retirement product.

Our own market research which we published in February 2018 shows that the community knows the population is ageing and that this is likely to see increasing cost to government in age pension and health care costs, but there was no desire to make any changes to current regulatory settings such as the age pension age or including the family home in the assets test.

We presume the Commission's top 10 default fund concept has been suggested because of doubts that members will significantly alter their behaviour.

It is painfully clear that to date the superannuation industry and government have been thoroughly unsuccessful in communicating with members or changing member behaviour. Before there are any changes to the default process we think it would be better for the government and retirement industry players to go back to the drawing board and determine, after seeking assistance from marketing and communication experts, how they could potentially deliver key messages through to members that they are more likely to listen to and act upon with confidence.

Government Run Super Fund

We agree with the Commission's findings that at this time, the creation of a single government run default super fund would be inappropriate. This solution should only be adopted after the superannuation industry has been set relevant milestones to achieve by the government (in response to the Commission's final report) and fails to achieve them. That is, it needs to be obvious to all that the industry cannot self-regulate and the only solution at that point is the creation of a government default fund.

Income Tax Settings

We note the Commission has elected not to make any recommendations about tax policy as it applies to super funds. However for all members current tax settings reduce net retirement benefits. It is likely in many cases that the amount of tax paid in super funds for each member is higher than the administration and investment fees charged to each member.

In addition for lower income earners the super fund tax rate is often higher than their marginal rate. In other words super for these low income earners is regressive.

We are therefore surprised this topic is of no interest to the Commission, especially now that improved data (e.g. from Single Touch Payroll) and the promise of a 'hardwired government' will make it easier to identify those on low incomes.

Franking credits **do not** reduce super fund tax rate

In Section 6.3 of the Commission's draft report the following statement is made: "At a high-level, super funds are taxed on investment earnings at 15 per cent. But in reality the actual rate paid is quite different as investment earnings in the pension phase are tax free, and the use of franking credits and capital gains discounts can greatly reduce the effective rate paid."

This statement (especially in relation to franking credits) is misleading and inaccurate and the Commission should recast it before finalising its report to government. The fact is franking credits alter the tax paid on franked dividends to the tax rate of the ultimate shareholder which, in this context, is a super fund. Individual resident shareholders, charities and various other shareholder profile receive similar tax treatment.

As larger Australian companies are taxed at 30%, super funds will receive a refund as they're either taxed at 15% or 0%.

The franking credit (franking tax offset) merely taxes the dividend at these rates.

This means that super funds receive a refund for any unutilised credit but this is not a reduction in the effective tax paid. The money returned to the super fund is the tax which the Australian Taxation Office has been holding since it had been paid to it by the company.

In effect, franking credits alter the timing of tax payments by shareholders who have a tax rate lower than the company tax rate.

More research into the impact of tax payable on fund operations required

As we note above, the current tax settings which apply tax we believe the Commission should thoroughly research how effectively super funds – especially APRA funds – consider tax impacts in trustee decision making especially investment considerations.

Should you require any further information or wish to discuss the contents of this submission, please contact Tony Negline, Head of Superannuation

Yours sincerely,

Michael Croker CA
Taxation Leader
Chartered Accountants Australia and New Zealand