Association of Independent Retirees (A.I.R.) Ltd

ACN 102-164-385

SUBMISSION
to the
NATIONAL COMMISSION OF AUDIT

26 November 2013

The Association of Independent Retirees (A.I.R.) Limited is the peak body representing the interests of retirees[1] who are wholly or partly self-funded in retirement. A.I.R.'s members include 8,000 self-funded retirees, part-pensioners, and superannuants. Founded in 1990, A.I.R. is a not-for-profit, non-political, volunteer organisation that is focused on matters affecting the standard of living, health and welfare of retired and partly-retired people.

This submission reflects the views, concerns and issues of its members who have experience in managing their affairs during retirement. As such they have a clear understanding of the issues that affect their capacity to live a fulfilling retirement and provide pragmatic and realistic advice relating to their current situation.

SUMMARY

The National Commission of Audit is charged with reviewing the activities of the Commonwealth Government including identifying areas of inefficiency in the provision of services.

This submission relates to superannuation as a very significant economic activity regulated by the Government through its Agencies, primarily ASIC, APRA and the ATO. Government also performs coordinating activities across the providers of superannuation funds, including Self-managed Superannuation Funds (SMSFs). These coordinating activities include SuperStream and Superseeker. The efficiency of SuperStream and Superseeker is restricted by the need to conform to superannuation regulations.

This submission is concerned with the regulation and coordination of superannuation primarily in the retirement phase when retirees are drawing down pensions.

The regulation of superannuation in the drawdown phase has developed to be highly inefficient and costly. While the Government may well be managing its role in

[1] The term 'retirees' in this submission refers to people who have met the condition of release for their accumulated funds.

superannuation efficiently, it is managing a wasteful and highly inefficient system. The Association submits that it is as important to optimise the regulations as it is to review the efficiency of the management of these regulations.

Accordingly, a set of two Recommendations has been prepared directly related to the Terms of Reference of the Review. In addition a set of key impediments to efficiency have been set out to justify the recommendation and to identify critical areas of change to superannuation policy.

Recommendations:

Recommendation 1: Government is wasting its resources as well as members' superannuation funds by regulating and coordinating activities that are inefficient and/or no longer needed. Superannuation regulations should be optimised to improve efficiency and reduce the cost of regulating and coordinating superannuation particularly in the drawdown phase.

Recommendation 2: Almost all Government regulatory and servicing costs in superannuation are met by user-pay levies imposed on fund members, without any accountability to them. The Government should establish transparent processes to examine and report to Government and superannuation members on the cost-benefit of its agencies' use of user-pay levies imposed on members[2].

Key Impediments to Efficiency in the Regulations:

1. To remove costly and frustrating circular transactions, retirees should have the option of having employers add the SG amount to their remuneration.
2. Regulation 1.06(1)(a)(ii) imposes extremely onerous, costly and frustrating conditions on all retirees trying to boost their superannuation funds. Retirees should be able to add any SG or other concessional or non-concessional contribution to an existing pension at any time.
3. Contributions made during a financial year should not affect the age-based minimum withdrawal amount for that financial year.
4. SuperStream development should identify and incorporate areas of improvement to the efficiency of the administration of superannuation for fund members as well as the industry as part of its Terms of Reference.
5. Retirees of any age should have the same ability to add concessional and non-concessional amounts to superannuation as those in the accumulation phase of superannuation. The 'gainful employment' test should be removed. All minimum conditions applying to the work test and to SG contributions should be removed.
6. The need to audit SMSFs in the full pension phase should be removed.

SUBMISSION

The National Commission of Audit is charged with reviewing the activities of the Commonwealth Government. The context of the review includes "the need to ensure that taxpayers are receiving value-for-money from each dollar spent". In this context the Commission is asked to identify "whether there remains a compelling case for

[2] Terms of Reference: Phase 2, Public sector performance and accountability – "review and report on the effectiveness of existing performance metrics and options for greater transparency and accountability through improved public reporting."

the activity to continue to be undertaken." "The Commission should also be guided in its work by the principle(s) that: - government should do for people what they cannot do, or cannot do efficiently, for themselves, but no more."

This submission relates to superannuation as a very significant economic activity regulated by the Government through its Agencies, primarily ASIC, APRA and the ATO. Government also performs coordinating activities across the providers of superannuation funds, including Self-managed Superannuation Funds (SMSFs). These coordinating activities include SuperStream and Superseeker. The efficiency of SuperStream and Superseeker is restricted by the need to conform to superannuation regulations.

There are two distinctly different elements of superannuation, the accumulation phase and the drawdown phase. Regulation of the drawdown phase is built on accumulation phase regulations supplemented by additional regulations. Regulatory and coordinating activities for the drawdown phase in particular are based on outdated regulations developed prior to recent experience gained as the number of people retiring increases[3] and on recent changes to legislation removing age barriers to Super Guarantee (SG) contributions.

Regulations in the drawdown phase have become increasingly unworkable, so complex as to destroy the credibility of the system, inappropriate following improvements to administrative services, and imposing unjustifiable costs. Supervision has become increasingly complex as a result of continuous changes made to how superannuation operates with consequent rapidly increasing supervision costs incurred by both APRA, ASIC and the ATO. The Association believes that current detailed micro management of superannuation has become absurd.

Almost all government activities in superannuation are funded by user-pay levies, namely ASIC auditor registration fees (unknown but passed on to members), APRA levies (unknown), SuperStream levies ($430million establishment levy) and SMSF supervisory levies ($150million). The government is wasting members' superannuation levies by regulating and coordinating activities that are inefficient and/or no longer needed.

Not only is the cost of government involvement increased, but there is also a very significant flow-on effect through increased fees charged by Accountants and Financial Advisers to meet their costs of understanding and advising on the regulations. There is also enormous waste in transaction fees in superannuation funds.

The cost arises from higher than necessary:

- User-pay levies paid to Government,
- Fees paid to superannuation funds,
- Fees paid to administer SuperStream,
- Fees paid to Accountants and other professionals to meet their costs of working within complex and inefficient regulation'

[3] About one-third of superannuants are now retired with a superannuation pension and this proportion is growing rapidly. Retirement is no longer a definable cut-off from work but is a continuum embracing work and leisure as priorities change. Surveys report that almost half of baby boomers approaching retirement expect to continue with work in some form as an activity and to supplement inadequate accumulated retirement funds.

- Loss of income from investment earnings to support retirees, and
- Increased future age pension costs to Government.

Optimising regulations will significantly reduce costs to members allowing them to more readily meet retirement income and life of retirement asset needs from their own resources. Cost to government will be subsequently reduced because demands on the age pension will be reduced. Effectively, outdated and unnecessary complexity of superannuation regulations has resulted in siphoning age pension funds into the ATO, ASIC and APRA.

The Association submits that the Review recommend that superannuation regulations should be optimised to reduce the cost of regulating and coordinating superannuation to government, and to retirees.

Recommendation 1: Government is wasting its resources as well as members' superannuation funds by regulating and coordinating activities that are inefficient and/or no longer needed. Superannuation regulations should be optimised to improve efficiency and reduce the cost of regulating and coordinating superannuation particularly in the drawdown phase.

Almost all regulatory and service costs are met by user-pay levies. However, there is no accountability or reporting to fund members, the ultimate payers of the levies[4]

Recommendation 2: Almost all Government regulatory and servicing costs in superannuation are met by user-pay levies imposed on fund members, without any accountability to them. The Government should establish transparent processes to examine and report to Government and superannuation members on the cost-benefit of its agencies' use of user-pay levies imposed on members.

KEY IMPEDIMENTS TO EFFICIENCY IN THE REGULATIONS

This submission sets out three key regulatory issues that are impediments to an efficient retirement phase superannuation system:

1. Concessional and non-concessional contributions,
2. Work and Age Barriers
3. Auditing of Self-Managed Superannuation Funds in the fully pension phase.

1. Concessional and non-concessional contributions

The SG is an integral component of total remuneration. Legislation in 2012 rightly extended compulsory employer SG contributions to retirees who work as employees. The SG is becoming an increasingly important proportion of remuneration as it moves to 12%.

Retirees are free to draw down any or all of their accumulated funds at any time after retirement. However, employers are compelled to pay the SG into an employee's superannuation fund, even if they are retired. Selection of a fund is often limited to a list nominated by the employer. In many cases an employee's existing fund is not included.

[4] Terms of Reference: Phase 2, Public sector performance and accountability – "review and report on the effectiveness of existing performance metrics and options for greater transparency and accountability through improved public reporting."

Retirees have the option of immediately withdrawing the SG contribution. To do this, an employee must nominate a fund (if not the employer must pay it into a default fund), receive the SG less an administration fee and 15% tax and then apply to have the funds paid out as a lump sum, eventually receiving the monies less a pay-out fee. This may occur every payday, often fortnightly.

Potentially, millions of these circular transactions will need to be processed through SuperStream as the number of retirees engaging in work increases.

Impediment 1: To remove costly and frustrating circular transactions, retirees should have the option of directly adding the SG contribution to their remuneration.

Retirees have an option of using the SG to increase their pension assets. However, Regulation 1.06(1)(a)(ii) of the SIS Act, enacted in 1994, prohibits contributions to an existing pension, including SG contributions.

Consequently, retirees with their superannuation in full pension phase who work and receive the SG (or who make non-concessional contributions) must set up additional accounts. Eventually many retirees will end up with multiple pension accounts, often in multiple funds because of employer restrictions.

If retirees are paid regularly and wish to continue this option, then they must set up a new pension account each time they receive an SG contribution; this can mean 26 new pensions each year for those paid fortnightly. A minimum age-dependent pension must be withdrawn each financial year for each pension commencing at the time of commencement of the pension, thus reducing the SG asset immediately.

Retirees have an option of adding the SG to a separate accumulation fund to build insurance against unknown longevity and health and ageing circumstances. The earnings from accumulation funds attract 15% tax. Accumulated funds are expected to be used later in life. New pensions must be established if accumulated funds are used to eventually boost pensions rather than withdrawn as lump sums.

Unless Regulation 1.06(1)(a)(ii) is changed, millions of retirees will have to manage multiple accounts, with multiple statements of different amounts, and often with fees that cancel investment income because of their small size.

It is possible to combine multiple accounts in both the accumulation phase, built up through changes in employment, and also for account-based pensions in the drawdown phase. The Association of Superannuation Funds of Australia (ASFA) released a research report on 13 November[5] stating that: "A survey of 1,023 respondents, conducted by CoreData and commissioned by ASFA found while around half of respondents said they are likely to consolidate funds in the next two years, at least one in five (19.2 per cent) don't know how to consolidate their super fund accounts .Excessive paper work, exit fees and differing rules and requirements were the greatest challenges people identified when it came to consolidating their accounts."

While the ASFA report may have contained some retirees, the process of consolidating pensions is far more complex than consolidating accumulation accounts. The complexity involved in adding contributions to an existing pension was raised by the superannuation industry at the National Tax Liaison Group (NTLG)

[5] Ref: **www.superannuation.asn.au/policy/reports**

Superannuation Sub-Committee meeting of March 2010 (at agenda item 6.11) in terms of Transition to Retirement arrangements[6].

The extract below from the minutes explains the processes necessary in the Transition to Retirement phase but applies equally in the retirement phase:

"The effect of regulation 1.06(1)(a)(ii) of the Superannuation Industry (Supervision) Regulations 1994 (Cth) is that the capital supporting a pension may not be added to by way of contribution or rollover after the pension has commenced. As a result, in order for contributions to be added to an existing pension, the following steps must be taken:

Step 1: the contribution is made to an accumulation account. The member therefore then has two accounts: an accumulation account and the pension account.

Step 2: a pro-rated minimum of the existing pension must be paid.

Step 3: the existing pension is commuted. The paperwork to document this step typically incurs considerable costs.

Step 4: the lump sum that arises upon commutation must be internally rolled over within the same fund back to the member's accumulation account. The member therefore now has only one account: the accumulation account.

Step 4: a new pension is created. The member therefore now has only one account: the new pension account. The paperwork to document this step also typically incurs considerable costs.

Step 5: the value of the new pension account is calculated. This essentially requires the preparation of interim accounts, which can also typically incur considerable costs of accounting attendances, valuations, etc.

Step 6: a pro-rated minimum based on the new pension account value must be calculated and paid by the end of the year.

The above outlines a cumbersome and time consuming process. It can easily incur more than several thousand dollars in costs for no real benefit for members."

The ability to add to an existing pension may not be possible if that pension is not in the form of an account-based pension. For example, a retiree may have purchased a retirement product such as an annuity, which may not be added to because of its design. However, there is no need for a regulation specifying particular conditions for different retirement products. These should be built into the product by the developer. This is not a reason for retaining Regulation 1.06(1)(a)(ii).

Impediment 2: Regulation 1.06(1)(a)(ii) imposes extremely onerous, costly and frustrating conditions on all retirees trying to boost their superannuation funds. Retirees should be able to add any SG or other concessional or non-concessional contribution to an existing pension at any time.

Regulations require that a minimum age-dependent amount be withdrawn from a pension each financial year. It has been argued that contributions to an existing pension would require adjustment to the minimum withdrawal amount for that pension at the date the contribution is made.

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[6] See: http://www.ato.gov.au/Tax-professionals/Tax-practitioner-consultation/In-detail/Technical-and-special-purpose-working-groups/Super-Technical-Sub-Group/Minutes/Super-technical-minutes,-March-2010/?default=&page=19#6_11__Allocations_from_contribution_reserves_to_capital_of_pension

Age-dependent minimum withdrawal amounts are determined at 1 July of each financial year based on the total of all pension assets at that date. The amount does not change during a financial year even though significant changes in the pension asset caused by investment fluctuations occur and the amount is not adjusted at the birth date of a retiree. This rule has been established for pragmatic convenience reasons. It is equally reasonable to extend the rule to allow fluctuations to the pension asset arising from contributions made during a financial year

Impediment 3: Contributions made during a financial year should not affect the age-based minimum withdrawal amount for that financial year.

SuperStream is established for the purpose of facilitating and reducing the cost of SG and roll over transactions. The parameters needed for SuperStream going forward need to be defined urgently to ensure that SG transactions in the growing pension phase are efficient and the cost of $430million to superannuation members achieves the required outcomes[7]. For example, it should be possible to allow retirees working as employees to nominate their existing fund for the receipt of the SG rather than be restricted to an employer-nominated list. It is acknowledged that there may need to be some exceptions such as public service defined benefit funds.

Impediment 4: SuperStream development should identify and incorporate areas of improvement to the efficiency of the administration of superannuation for fund members as well as the industry as part of its Terms of Reference.

2. Work and Age Barriers

Coalition policy is to encourage people to accept responsibility for their own needs. Arbitrary regulations defining ‘gainful employment’ and consequently reducing remuneration by the amount of the SG for retirees who do not meet the ‘gainful employment’ restriction, are discriminatory and do not recognise modern community work needs in retirement. As the SG increases to 12% this represents a very significant reduction in remuneration. The need for a ‘gainful employment’ test on the grounds that it is too difficult for an employer to administer small amounts is no longer valid as SuperStream facilitates the transfer of all SG contributions. In any event a retiree has the right to receive the correct total remuneration for work. All minimum conditions applying to the work test and to SG contributions should be removed.

Even if retirees meet the work test, age barriers continue to restrict concessional and non-concessional contributions, using the argument that such contributions are for estate planning purposes and not for legitimate retirement income purposes. It is now well recognised that (a) in the great majority of cases, superannuation assets will produce insufficient retirement income across an extended period of retirement and, (b) unexpected and high costs of health and ageing place greater demands on retirement assets as people age. Modifying the regulations to allow contributions to be added to the level of the defined caps removes discrimination and enhances the ability of people to meet their retirement income requirements. The percentage of people in retirement who can use contributions primarily for estate planning purposes is small and does not justify restricting the ability of the majority of retirees to be more self-sufficient and less uncertain about their capacity to meet retirement needs.

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[7] The ATO confirmed on 8 November 2013 that SuperStream was being built around existing regulations.

Restricting retirement income to fund earnings and in this way maintaining the level of the capital asset cannot meet retirement incomes over an extended retirement because of inflation. The assumption that income needs will decline with age at a rate equal to the rate of inflation has been shown to be false in many studies. Retirement income must be maintained at least in real terms.

Impediment 5: Retirees of any age should have the same ability to add concessional and non-concessional amounts to superannuation as those in the accumulation phase of superannuation. The 'gainful employment' test should be removed. All minimum conditions applying to the work test and to SG contributions should be removed.

3. **Auditing of Self-Managed Superannuation Funds (SMSFs) in the fully pension phase.**

SMSFs are a significant part of the superannuation system. They hold about $500billion in funds (about one-third of the total) and have about 800million trustee members.

SMSF funds have been in existence since the middle 1900s. Compliance regulations to protect Government taxation concessions were understandably conservative at that time and the Government emphasised education of trustees. Experience has shown that the great majority of funds are compliant; serious non-compliance is less than 0.1% of funds.

The ATO has worked assiduously to improve the administration of the SMSF system including improvements to reporting and to the SMSF Annual Return. For example, because of the high level of compliance, the SMSF Annual Return no longer requires trustees to confirm compliance in detail.

There is a marked difference in the concessional taxation aspects of SMSFs in the accumulation phase to those in the fully pension phase. For example, issues of early withdrawal and related party transactions are important in the accumulation phase but not in the pension phase. Earnings in SMSFs in the fully pension phase are tax free and members have the right to access their funds at any time. There is little compliance value to Government in external auditing of these funds compared to the cost of auditors totaling around $100million per year for simple funds in the fully pension phase.

The 2013 SMSF Annual Return identifies tax-free funds and provides a simplified return for them. SMSF Annual Returns include Member Statements allowing the ATO to check whether contributions have been made and whether minimum withdrawal conditions have been met. There are no other compliance factors that would justify external auditing of these funds.

The Association does not accept the proposition that because concessions are provided by Government, it must demonstrate to the community that compliance requirements have been met by external auditing. No other similar financial entities or small businesses in the economy of the average size of SMSFs in the fully pension phase are required to carry the cost burden of external auditing.

A very high proportion of funds are prepared by Accountants. Auditors are effectively auditing Accountants, not Trustees. Trustees expect that their Accountants will prepare their accounts professionally and advise them on compliance and financial matters. They expect that, at the very least, auditors they pay will be professional.

This is a classic case of professions trying to capture captive markets for their own benefit, and not for the good of their clients.

There is significant underperformance by some Auditors. Dissatisfaction with the quality of external auditing has led the Government to require all SMSF auditors to register and those who audit only a small number of funds to sit a competency examination. It is understood that there has been a significant failure rate amongst auditors. The ATO has announced that its objective is to audit one in thirty funds in this financial year, duplicating the external audit process for which funds have been compelled to pay external audit fees. This is clearly a reflection on the performance of even the large audit firms who are not required to convince ASIC of the competency of their audit staff, who do not need to be registered.

To further highlight the absurdity of the situation the ATO Deputy Commissioner Superannuation said in a recent speech at the Small Independent Superannuation Funds Association SMSF forum that the regulators' intention was to shift from education to enforcement in its regulation of auditors. "Over the past year or so we've been focusing our approved auditor work on education and support. From next year we will increase our focus on compliance monitoring, taking advantage of the fact that for the first time we will have a stable, known population of registered approved auditors," he said. This has to be a classic example of bureaucrats inventing a problem and then setting out to solve it at taxpayer's expense. If there was less of a requirement for auditing (and there is no justification at all in the case of SMSFs in the pension phase) then the problem of auditing the auditors would disappear.

The SMSF Levy has increased from $45 five years ago to $256 this financial year on the grounds of full user-pay recovery of costs. While the Association accepts the principle of user-pays, there is no accountability to users of the purpose and efficiency of the levy. Duplication of the external auditing process by ATO auditors gives no confidence to trustees that the increases in levy can be justified for the very high proportion of compliant funds.

The average size of funds for members who meet the COR is around $300,000 leading to a retirement income of around $25,000. Auditing fees of around $500 plus ATO supervisory fees in excess of $250 (partly to pay to audit Auditors) plus accounting fees now remove up to 4% of income on funds that are well below self-supporting member income levels. This is an unjustifiable imposition.

Impediment 6: The need to audit SMSFs in the full pension phase should be removed.

End of submission.