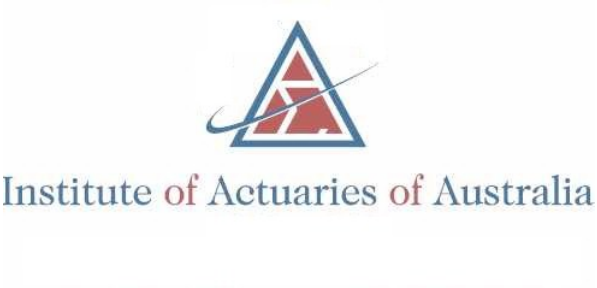

19 July 2004

The Secretary
Senate Economics Legislation Committee
Room SG.64
Parliament House
Canberra ACT 2600

By email: economics.sen@aph.gov.au

Dear Sir/Madam

INQUIRY INTO THE SUPERANNUATION INDUSTRY (SUPERVISION) AMENDMENT REGULATIONS (NO 2)

The Institute of Actuaries of Australia (Institute) appreciates the opportunity to provide comments for the inquiry into the Superannuation Industry (Supervision) Amendment Regulations (No 2).

In comments for the inquiry provided in the 2 Attachments to this letter, these Regulations are referred as the "new Regulations". Attachment 1 sets out general comments addressing the Terms of Reference. Attachment 2 sets out comments addressing specific issues relating to corporate funds.

Many of our serious concerns with these Regulations have already been raised with Senator the Hon Helen Coonan in a submission made on 10 June 2004. Rather than repeat all of these concerns in this submission, please find enclosed a copy of the submission to Senator Coonan.

We welcome the transitional measures and review announced by the Government on 23 June 2004 in regard to DIY funds.

However some of our major concerns cannot await this review – and indeed may not even be addressed by the review insofar as they relate to corporate funds. Indeed, some of our concerns have increased since our submission to Senator Coonan of 10 June. This is due to the difficulty that some re-structuring corporate funds have had in obtaining exemptions from APRA in regard to the new 50 member minimum rules for new defined benefit funds.

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We believe that there need to be substantial amendments to the new Regulations now so that corporate funds are not adversely affected by the changes while the DIY review is conducted and the final form of the changes worked out.

We would be happy to arrange further discussions on these issues if required. In the first instance, please contact Catherine Beall, Chief Executive via email (catherine.beall@actuaries.asn.au) or ph: (02) 9239-6106 should you require further information or wish to arrange a meeting.

Yours sincerely

Graham Rogers
President

ATTACHMENT 1

1. Current level of abuse

The Institute is aware of some opportunities for abuse and there is anecdotal evidence that some DIY funds have been taking advantage of these opportunities. However, we are unaware of any specific data to suggest that there has been widespread abuse of the system.

In the corporate fund segment of the market, we would be very surprised if there has been any significant level of abuse.

At the DIY fund level, in some cases we believe that what might appear to be abuse of the system is, in reality, an attempt to comply with conflicting elements of different pieces of legislation. For example, in order to meet the 'high probability' requirement for assets-test exemption of DIY fund life-time pensions, assets held must often be well in excess of the 'best estimate' value of the pension - which is then characterised as estate planning.

2. Will the new Regulations reduce the level of abuse?

It is difficult to comment on this without data on the current level of abuse and specific instances of the types of abuse that the new Regulations are aimed at preventing.

However we are concerned that those who wish to abuse the system will continue to find ways to do so despite the new Regulations. For example, as referred to in the attached submission to Senator Coonan, the definition of 'sub-fund' for the purpose of the 50 member rule appears to offer scope for the creation of master-trust type arrangements which avoid the 50 member rule.

What is not in doubt is that the new Regulations will have an adverse impact on many bona fide arrangements:

- Some bona fide funds will be impacted by higher compliance and other costs;
- Members will have less flexibility in taking their retirement benefits;
- Some employers are likely to reduce their support, resulting in lower retirement benefits.

3. Is there a better solution?

Again, it is difficult to provide detailed comments on this without specific details of the types of abuse that the new Regulations are aimed at preventing.

For example, if one of the objectives is to prevent one member of a DIY fund forfeiting part of their benefit to another member (their spouse) in order to improve their overall RBL and/or tax position, surely this type of activity could be addressed specifically, rather than by the seemingly extreme approach of the new minimum vesting provisions which outlaw all bona-fide vesting arrangements as well.

Similarly, some of the RBL 'rorts' are arguably a result of the outdated lifetime pension valuation factors set out in the SIS Regulations for RBL purposes. These factors should be updated.

We also note that two recent actions by the Government are likely, even if nothing else had been done, to significantly reduce the level (or perceived level) of abuse. These changes effectively tackled the specific issues rather than the much more broad-brush approach of the new Regulations. Specifically these changes were:

- The reduction in the social security asset test exemption from 100% to 50% for new pensions. This will significantly limit the ability of those with large superannuation benefits from accessing the old age pension; and
- The introduction of market linked growth pensions which for the first time will enable retirees to take a complying pension which is not a defined benefit pension. This will be an attractive alternative for many retirees.

By contrast with these targeted measures, the new Regulations effectively ban small funds from providing either lump sum defined benefits or defined benefit pensions; ban all accumulation funds from providing partially vested benefits; and ban a commonly adopted approach used by employer-sponsored superannuation funds to meet expenses in an efficient manner.

As indicated above, there are obvious alternative strategies that those trying to abuse the system can adopt to get around the new Regulations. The new Regulations do not address the root causes of the problem. They impose limitations on some types of funds, whilst allowing others to be restructured or redesigned.

The Institute believes that it would be more appropriate to replace the new Regulations with more specific requirements that directly address the issues of concern. The Institute would be happy to work with the Government to achieve a more satisfactory outcome.

As noted above, we welcome the review announced by the Government on 23 June 2004 in regard to DIY funds. We are keen to participate in this review and are hopeful that it will result in better-targeted measures.

However, in the meantime, corporate funds are being adversely affected by the changes. The transitional measures do not provide any relief to corporate funds while the DIY review is conducted, despite the changes being aimed at preventing DIY fund abuse.

We believe that there need to be substantial amendments to the new Regulations now so that corporate funds are not adversely affected by the changes while the DIY review is conducted and the final form of the changes worked out.

In addition to our submission to Senator Coonan of June 10, we have set out further comments on the issues from a corporate fund viewpoint in Attachment 2.

ATTACHMENT 2 – CORPORATE FUND ISSUES

1. Defined Benefit Plans – 50 Member Limit

The new Regulations effectively ban new defined benefit funds from being established if they have fewer than 50 defined benefit members, and prohibit small existing defined benefit funds from admitting new defined benefit members.

At least part of the reasoning put forward for this change appears to be that it will protect consumers because the Government considers that it is too difficult to monitor small defined benefit funds.

The Institute is very concerned with this reasoning. Our members have many years' experience in controlling and monitoring employer-sponsored defined benefit funds. With few exceptions, these defined benefit funds have operated satisfactorily through many investment cycles. In our view, a defined benefit fund can operate effectively irrespective of the number of members. All funds are subject to investment risk, which can generally be controlled by an appropriate investment strategy.

Likewise, whilst we acknowledge that there are some issues involved in managing longevity risks with small pools of pensioners, this is relevant to very few corporate funds, with the vast majority having benefit designs whereby mortality risks can be controlled by an appropriate level of insurance.

In the corporate sector, small defined benefit funds are usually associated with multinational employers who sponsor defined benefit funds around the world, and with executive schemes of (generally large) Australian companies. The very fact that these funds are small in relation to the size of the employer actually reduces the overall risk profile for members.

As indicated in our submission to Senator Coonan, we are particularly concerned about the impact of the new Regulations on the rationalisation of the superannuation industry. Many funds are in the process of winding-up and merging with other funds. The introduction of the new Regulations caused extreme difficulties for some of these funds, in particular, those which had planned to wind-up by 30 June 2004. Some of these difficulties are highlighted in the attached letter.

As a result of the new Regulations, delays in obtaining exemptions from APRA, and in some cases at least partial refusal of exemption applications, a number of funds have been forced to postpone the merger. This has resulted in considerable additional costs for these funds, including another APRA levy.

In addition, as a result of the new Regulations, some employers are now required to provide different benefits (ie accumulation style) for new employees in relation to those provided for existing employees (ie defined benefits). This in itself will create additional costs as well as potentially causing industrial relations issues.

It is also likely that many of these employers will decide to provide only the minimum level of Superannuation Guarantee benefit to new employees instead of the higher

defined benefits currently provided. The provision of reduced benefits does not seem consistent with encouragement of saving for retirement.

The Institute recommends that the Government reconsider the need for these restrictions. If this recommendation is not adopted, then we consider it important that the Government formally clarifies the meaning of some parts of the new Regulations and facilitates the process of obtaining exemptions for fund mergers.

2. Accumulation Funds - Requirement for Full Vesting

We have set out our major concerns on these changes in the attached submission to Senator Coonan.

On the assumption that the new Regulations require all unvested and partially vested accounts as minimum benefits and hence effectively become fully vested, we consider that this is retrospective in nature, and will require past contributions made under an agreement between the employer and the trustee to be paid to members in a manner not envisaged under that agreement.

We expect that this will lead to employer concerns that they cannot rely on the superannuation system as the Government of the day can change the rules retrospectively at any time. This will discourage voluntary contributions to superannuation.

We also consider that employers should be able to apply special rules to voluntary employer contributions to act as part of a strategy of employee retention.

If these arrangements are banned, then we expect that some employers will merely cease making voluntary contributions, or defer doing so. This is hardly in the members' best interests.

We are unsure of the Government's concerns in this area. With a mature SG system in place, we are unaware of any significant abuse of vesting arrangements, certainly in larger corporate funds.

Benefits foregone are often used to meet expenses or to support the interest rate for remaining members. There does not appear to be any scope for significant avoidance of tax or surcharge (in fact, some contributions are actually subject to surcharge on more than one occasion – firstly in respect of the member they were initially paid in respect of, and secondly on reallocation to another member.)

As indicated in the attached letter, the new Regulations provide some level of exemption in respect of existing members under certain bona fide arrangements. However the requirements necessary for such exemption are so unlikely to be met that few, if any, funds would qualify.

The Institute recommends that the Government reconsider the need for these restrictions. If this recommendation is not adopted, then we consider it important that the Government formally clarifies the meaning of some parts of the new Regulations

and adopts a more appropriate definition of the circumstances in which funds are automatically exempt from the definition.

3. Accumulation Funds - New Allocation Provisions

Again we have raised considerable concerns in the attached letter.

We have difficulty in understanding the Government's concern about such arrangements. Many employers have, to date, been willing to meet some or all of the expenses of running a superannuation fund for employees. In fact many employers have set up funds where the Trust Deed requires the employer to meet expenses rather than these expenses being met from member accounts.

We have seen no evidence of tax avoidance issues in this area. Whilst the Government may be concerned that there is a level of surcharge avoidance on such amounts, we do not believe that this is the case. We agree that under the surcharge legislation, contributions to meet expenses may be liable for surcharge. However, in our experience, larger funds have already been notionally allocating such contributions amongst members for surcharge reporting purposes. If other funds are not following this practice, then the problem lies with the ATO's audit process and/or lack of clear explanation of these requirements to trustees.

The requirements of the new Regulations will create considerable initial and ongoing administrative costs for many funds. Further costs will be incurred in amending trust deeds and Product Disclosure Statements and providing explanations to members. Some employers will be required to breach agreements with employees that expenses will not be deducted from member accounts.

Assuming that employers are prepared to continue meeting expenses (including the increase in costs resulting from the new Regulations), then members will see higher contributions going into their accounts with higher expenses coming out. At best, the member will be no better off. We suspect that some employers will no longer be prepared to meet expenses in this way and hence reduce their overall level of contributions. This will result in members receiving lower benefits.

The Institute considers that a minor amendment would remove the difficulties resulting from the new Regulations. The new Regulations should be amended so that any contribution that is used to pay an expense or insurance premium within 12 months does not need to be allocated to members. Greater clarification of the surcharge legislation should ensure that these amounts are properly taken into account for surcharge purposes where they are not already. Any corresponding concerns with Maximum Deductible Contribution Limits should be dealt with in the same manner.