Industry Superannuation Funds Ignore Retirees

The needs of retirees in industry funds are ignored

The vast majority of members of an industry super fund are in accumulation mode. For example, it has been suggested that Australian Super, the largest industry fund, has 98% of its members in accumulation. The focus of the fund, therefore, is clearly on growing the member's super balance to maximize the size of their nest eggs for retirement. The goal of these members clearly aligns with the goal of the fund because the fees earned by the fund are based on a fixed percentage of the size of those super balances.

There is no change in the fund's investment strategy, however, when members retire even though they have very different goals compared to accumulators. Industry funds simply assume that, just as workers are accumulating assets, retirees are progressively disposing of assets and that they only need to find a combination of investment options that meet their risk/return appetite to accomplish this.

Members of an industry fund accumulate superannuation savings by purchasing units in their preferred investment option every payday. These units are purchased at the prevailing unit price and the final balance of their retirement savings is the final number of units owned, multiplied by the final price. Similarly, an industry super fund account-based pension is funded by the regular sale of units from the fund at the prevailing price to generate regular cash payments. Falling prices mean that the super fund needs to sell many more units to generate the same cash payment and this will reduce the life of the pension in the same way as a lump sum withdrawal. Regularly selling assets at market prices means that the risk of market volatility then needs to be managed.

For members, the only way to manage market volatility is to hold a larger proportion of diversified investments in more conservative assets such as cash, bonds and term deposits. It is clear that conservative assets will produce greater capital stability, but only at the expense of capital growth. In the context of increased life expectancy, the lack of growth can often mean that retirees run out of money well before they die, and they then rely on to the age pension for their income needs.

In other words, by managing the volatility risk introduced by operation of the fund, retirees increase their own longevity risk – the risk that they run out of money. There is no requirement for industry funds to take responsibility for longevity risk. The safety net of the age-pension means that the taxpayer is always responsible for longevity risk.

There is a structural misalignment between the goal of the fund and needs of the retiree. The goal of the fund is always to maximize wealth. Retirees, on the other hand, often don't want to get rich; they want to avoid dying poor.

To achieve that, they need an income stream that lasts as long as they do and one that grows with inflation. Therefore, a retiree should be able to access a pension that is based on the income produced by the underlying assets alone and that ensures their income is matched to their future liabilities.

In an SMSF it is possible to construct a portfolio of assets where the retiree can live off the income produced and leave the capital intact. In an industry fund that is simply not possible because every pension payment requires the sale of units. Each unit is a combination of both capital and income and that process continues until all the units are sold and the pension stops. A chart of this process resembles that of amortising a mortgage. Every payment includes some capital and that proportion increases over time until all the capital is paid out.

The requirement for retirees to take an increasing percentage of their superannuation fund's balance as mandated pension withdrawals as they age, simply accelerates this process of fund depletion.

Under industry fund practices, the continued liquidation of assets in the member's account to pay pensions combined with the conservative portfolios required to protect members against the fund's volatility risk, leaves the retiree with increased risk that they run out of money.

Because the majority of members in industry funds are in accumulation mode, the needs of retirees are simply ignored and therefore the taxpayer is exposed, through the age pension, to compensating for this lack of planning and foresight on the part of industry funds.

The derivation of unit prices is a mystery

Members of an industry fund have no way of monitoring the activities of their fund. For many disengaged members that is the main attraction. The lack of transparency, however, is a key concern. Due to their intellectual property, funds do not disclose their portfolios, they merely disclose their unit prices, but how those unit prices are derived, is a mystery. Yet, an essential component of a fund's documented performance is the change in unit prices over time.

It is clear that many industry funds hold unlisted assets, so the contribution of those assets to the unit price depends entirely on subjective valuations, not market prices. In the absence of any independent verification, it is therefore possible that the superior performance that industry funds like to trumpet could be based on unrealistic or even bogus figures. In the absence of transparency and accountability, members would never know.

The majority of members of industry funds are in accumulation mode. Since members in accumulation cannot access their super balances prior to retirement, it means that the inflow of cash to the fund far exceeds the money flowing out to pay pensions. Therefore, even if the unit

prices and performance figures are artificially inflated for marketing purposes, the demand from retirees for cash based on those inflated unit prices will not embarrass the cash-flow of these funds for many years. Some might describe this as a Ponzi scheme.

How do industry funds deal with franking credits?

In the last election campaign, Labor announced that under their government, unused franking credits would no longer be refunded in cash to taxpayers whose personal tax rate was lower than the company tax rate, but taxpayers whose tax rate was higher than the company tax rate would continue to be able to use those credits to help pay their tax. It was immediately obvious that SMSFs in pension mode, with a zero-tax rate on their income, would be severely affected by this sudden and large drop in cash income.

Industry funds promptly announced that, because they are a single taxpayer on behalf of all their members, they would generate enough franking credits so that all their members would not be affected. This included those members drawing pensions in retirement who are also entitled to a zero-tax rate in their super fund. This advice prompted many trustees of SMSFs to consider closing their fund to move to an industry fund in order to protect their income.

It was only in the last week of the election campaign, that questions were raised about how industry funds would deal with franking credits under that new proposed law. If franking credits could only be used to pay a tax liability, how would it be possible for pensioners in an industry fund to continue to be given a refund of franking credits if they had no tax liability, unless other members of the accumulation fund were paying more tax than necessary to subsidise those pensioners. At that point the industry funds went very quiet and said they would wait until they saw the proposed legislation.

It raises an important question. How do industry funds deal with franking credits under present legislation? Members of an industry fund who are invested in a managed option will have no idea what assets they are invested in, what franking credits those assets generate, and what happens to their distribution. Industry funds tell us that these franking credits are apportioned across members accounts in the various investment options and are therefore reflected in unit prices. In the absence of transparency and accountability provided by independent verification, these franking credits could be syphoned off as additional fees and members would never know.

Sole Purpose Test

The Sole Purpose Test is a legal requirement that requires all super funds to be maintained for the sole purpose of providing retirement benefits to their members (or to their dependants if any of their fund members die before retiring).

The Banking Royal Commission identified many cases of conflicts of interest in industry super funds, where the retirement benefits to members provided by the fund's activities, are very suspect. These include the use of corporate credit cards, the purchase of corporate boxes at sporting events, the establishment of an internet newspaper and the expenditure on advertising.

The Banking Royal Commission identified a much more disturbing conflict of interest that appears to be a breach of the sole purpose test. It uncovered a clear case where an industry super fund is paying a large sum of money annually as a dividend to its foundation shareholder, the union. (Vol 2. Page 244, 249). This is in addition to any directors' fees refunded to the union. According to the Royal Commission that practice is approved because, as long as the super fund has a "rigorous approach to its commercial relationships", it meets the sole purpose test of meeting the needs of its members.

From the perspective of members in an industry superannuation fund, this appears to be members savings directed away from their future retirement benefits. This practice raises several points:

- Super contributions are now compulsory at 9.5% of wages and scheduled to rise to 12%. The bulk of that money flows into industry funds.
- The assets in a super fund are held by the trustees, not the members.
- From the fees they generate, industry funds are paying an annual dividend to the unions; money that clearly belongs to fund members.
- Industry funds can do this because the vast majority of their members are totally disengaged from their super.
- We can assume that all industry funds follow this practice, and it now has the stamp of approval from the Royal Commission.
- Unions are unconcerned about falling union membership because they now have a guaranteed income stream flowing from compulsory super.
- Union donations are the main source of funding for the Labor party.

According to this logic, members of industry super funds are effectively making regular compulsory donations from their retirement savings to the Australian Labor Party, without their knowledge or consent.

None of these conflicts of interest over the use of those member's assets have come to light outside the Royal Commission because members of an industry fund have no mechanism of holding the trustees of those funds accountable for the management of their money and the regulator, APRA, has proven to be a toothless tiger. Compared with SMSFs, which are subject to annual audits and strict supervision by the ATO, industry super funds appear to be a law unto themselves.

This state of affairs arises because most members of an industry fund are totally disengaged from their super because it is primarily the responsibility of their employer. In many cases the employer even chooses the default super fund. The evidence for this apathy is in the large number of

dormant super accounts. Members entrust their retirement savings to the fund but they have no say over how the fund operates. They are not shareholders and they do not elect the Directors/Trustees, who are appointed by unions and employer groups. Members must take the fund's assurances on unit prices and franking credits on trust, and then when they retire their needs are ignored. Unfortunately, the Banking Royal Commission has shown how easily trust in institutions can be abused in the absence of transparency and accountability.

Compared to the accountability Directors of public companies must demonstrate to their shareholders, their auditors, ASIC and the stock exchange itself under the listing rules, industry super funds are a closed book and yet they control the life savings of the majority of Australian workers, hold assets in excess of $2 trillion and their activities have a major impact on the cost of the age pension to the government. Moreover, they are beginning to use their financial muscle to dictate their politically correct agenda to public companies.

Not only do industry super funds lack member engagement and accountability, they now also have commercial clout and political immunity. As they are growing larger daily, they have become untouchable and are now contemptuous of any scrutiny. It explains why they are free to continue charging such high fees and feel free to use member savings in any manner they consider appropriate.

The retirement incomes of many workers would increase dramatically if some of the arcane workings of industry funds listed here, saw the light of day.