2. What is superannuation?

Introduction

Definitions

2.1. 'Superannuation' generally refers to the payment of a benefit to a person upon retirement from employment. The term 'superannuation fund' is defined in the *Occupational Superannuation Standards Act 1987* (Cth) (OSSA) as a fund that

> (a) is an indefinitely continuing fund; and
> (b) is maintained solely for one or more of the following purposes:
>   (i) the provision of benefits for each member of the fund in the event of the retirement of the member from any business, trade, profession, vocation, calling, occupation or employment in which the member is engaged;
>   (ii) the provision of benefits for each member of the fund in the event of the member attaining a particular age (being an age not less than the age prescribed by the regulations) without having retired from any business, trade, profession, vocation, calling, occupation or employment in which the member is engaged;
>   (iii) the provision of benefits for dependants of each member of the fund in the event of the death of the member, being a death occurring before
>   (A) the member's retirement from any business, trade, profession, vocation, calling, occupation or employment in which the member is engaged; or
>   (B) the member attains a particular age (being an age not less than the age prescribed for the purposes of subparagraph (ii)) without having retired from any business, trade, profession, vocation, calling, occupation or employment in which the member is engaged;
>
>   whichever is earlier;
>
> or for one or more of those purposes and for such ancillary purposes as the Commissioner approves in writing.[1]

Classifications

2.2. Each of these funds can be classified into one of a number of different types of 'superannuation schemes'. One classification relates to whether the scheme is a personal scheme or an employer related scheme. Another classification relates to the basis of the benefits provided: 'defined benefit' schemes or 'defined contribution' (or accumulation) schemes. Accumulation schemes are those in which the amount of contributions payable to the scheme

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1. OSSA s 3(1).

are specified, but the amount of benefit depends primarily upon the future investment income of the scheme. Defined benefit schemes, usually single employer sponsored[2] schemes, are those in which the benefit to be received by members, or the way in which it is to be worked out, is specified. The level of employee contribution (if any) is also fixed and is often expressed as a percentage of salary. The amount of employer contributions necessary to provide such benefits is not fixed, however, and depends upon future investment income, taxes and charges and, in part, upon actuarial determinations.

Industry structure

2.3. ***Value of assets.*** At the end of September 1991 the total value of assets in superannuation schemes and ADFs was $139 billion. This consisted of $62 billion in the statutory funds of life insurance companies, $69 billion in superannuation schemes outside life offices and $8 billion in approved deposit funds.[3] Superannuation scheme assets are concentrated in the larger schemes. The largest 462 schemes in 1988 had an average level of assets of approximately $60 million. The majority of schemes, some 99%, had average assets of $150 000.[4]

2.4. ***Competition.*** Promotion of competition is a policy objective of the current federal Government and the Opposition. Employer related superannuation schemes do not compete with each other to any great degree because currently the employee has no choice of schemes. Thus one company's or industry's scheme does not compete against that of another, although it is recognised that the quality of superannuation is used by employers to attract employees. Therefore, only in an indirect manner are there any competition incentives placed on superannuation schemes. In New South Wales as at 31 March 1992,[5] the employees, with employer approval, will be permitted to nominate their superannuation scheme. To the extent that these type of arrangements promote competition between schemes without unduly increasing the administration costs, this form of limited transferability will reduce the existing situation of mini-monopolies.

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2. See para 2.7 for explanation of this term.
3. Australian Bureau of Statistics, *Assets of Superannuation Funds and Approved Deposit Funds*, September Quarter 1991. In addition, it should be noted that these statistics exclude arrangements where the employee makes no contribution and all benefits are met entirely from employer's resources as they become payable.
4. ISC *Annual Report* 1990–91.
5. *Industrial Relations Act 1991* (NSW) s 180.

Employer related and personal superannuation schemes

Classification

2.5. The substantial growth in the assets of the superannuation industry has been accompanied by significant changes and continuing financial innovation in the design of superannuation schemes. Currently, two major categories of superannuation schemes may be identified: schemes related to a specific employer or group of employers (employer related schemes) and personal schemes. Many employer related schemes are defined benefit schemes, while the remaining schemes, including personal and rollover schemes, are typically accumulation schemes. The following sections elaborate on the different types of schemes.

Employer related schemes

2.6. *Introduction.* Employer related schemes may involve both employer and employee contributions (contributory schemes) or employer contributions only (non-contributory schemes). These schemes are not available, or marketed, to people who are not employed by the relevant employer or group of employers. There are three types of schemes in this category, single employer schemes, multi-employer schemes and industry schemes. Single employer schemes are sponsored by only one employer. Multi-employer schemes are typically schemes sponsored by single employers using a master trust arrangement of the type described in paragraph 2.12. Industry schemes are a special example of multi-employer schemes where more than one employer in an industry contributes to a scheme sponsored by the industry.

2.7. *Single employer sponsored schemes.* As the name suggests, these schemes are promoted by individual employers. Membership is available only to employees of the sponsoring employer, and may or may not be a condition of employment with the employer. They can be either defined benefit schemes or accumulation schemes. Most defined benefit schemes are unallocated, that is, the contributions by employees (if any) and the employer are pooled, and the benefits are determined by a formula in the trust deed or other instrument constituting the scheme, generally on the basis of salary and length of service. Actuarial calculations are used to determine the level of employer contributions necessary to ensure that there will be sufficient funds available to meet the scheme's expected liability for benefits. The distinguishing feature of defined benefit schemes is that the employer generally bears the investment risk of the scheme. The employees' contributions (if any) are fixed (for example, 2% of current salary), while the employer's contribution varies with changes in salaries, interest rates and resignations.[6] The benefit paid by a defined benefit scheme is most frequently paid as a lump sum but may also, or alternatively, be paid as a pension. However, the entitlement of the employee is based on the accumulated value of contributions made on his or her behalf by the employer as well as those made by the employee and the investment income of the scheme.

2.8. *Industry schemes.* As part of the Accord, the ACTU and the federal Labor Government each made a submission to the Industrial Relations Commission (IRC) in the 1986 National Wage Case. The IRC decided that, while it would not arbitrate to provide for superannuation, it would certify agreements or make consent awards covering superannuation in certain circumstances. The ACTU, in conjunction with employers, has established a number of schemes open to all employees of particular industries and, in certain cases, the 3% superannuation awarded by the IRC has been directed into these schemes.[7] These industry schemes are virtually all accumulation schemes.

Personal schemes

2.9. Personal schemes provide a means for individuals to make contributions towards retirement savings independently of their current employer. Tax concessions act as an incentive to invest in superannuation rather than in other forms of investment. Personal schemes are marketed to the public by a range of institutions, although the market is dominated by life offices. Retirement benefits are calculated as a lump sum based on the total accumulated contributions and investment income earned by the scheme. Personal superannuation schemes are the principal means of accumulating retirement savings for those in the workforce who cannot make contributions to an employer sponsored superannuation scheme, for example, the self employed. They are also useful for people in employment (whether regular, irregular part-time, casual or itinerant) to supplement their employer sponsored superannuation.[8] Regular or, in some cases, irregular contributions can be made to these schemes. Life companies, and only life companies, also market single premium personal superannuation schemes to cater specifically for those who wish to supplement on an irregular basis whatever other superannuation arrangements they may have.

6. For the purposes of AAS25, a defined benefit scheme includes all superannuation schemes other than defined contribution schemes.
7. There were a number of important industry schemes before the 1986 Wage Case (eg, SERF (1960's) Seafarers (1973), Pulp and Paper Workers (1974), LUCRF (1978), BUS (1984), TWU (1984)). The number and size of industry schemes has since increased.
8. Sometimes employers will make contributions to a personal superannuation scheme nominated by an employee to supplement contributions made by the employee.

Rollover arrangements

2.10. Rollover arrangements permit retirement related payments known as 'eligible termination payments' (ETPs) to be invested to defer tax liability until retirement age. There are currently two main types of rollover arrangements available: Approved Deposit Funds (ADFs) and Deferred Annuities (DAs). A distinguishing feature of rollover arrangements is that ETPs are the only money which may be contributed to them.[9] All money invested in ADFs is either repaid on death or on retirement after age 55, whichever occurs first. With DAs the money is repaid at or before the age of 65 if the investor elects to commute his or her income stream to a lump sum. Otherwise, the DA becomes an immediate annuity and the money is returned to the investor over a period of years in the form of regular annuity payments.

Rationalisation of administration and investment of superannuation schemes

Introduction

2.11. Superannuation schemes involve three basic functions — administration, investment and, in most cases, the provision of life insurance cover for scheme members. A number of arrangements are available to trustees of superannuation schemes to streamline the administration procedures or to facilitate the tax effective investment of their funds. Life insurance can only be provided to a superannuation scheme by a life insurance company. It takes the form of a policy for each scheme member or a 'group life' policy.[10]

Master trusts

2.12. Master trusts allow employers to participate in a common master trust rather than under their own unique deed. Since there is only one scheme, the master trust completes only one ISC return and one income tax return and is subject to only one audit, thus minimising the costs of legislative compliance. They may pool funds for all participating employers, as is usually the case under industry schemes, or may keep separate sub funds for each employer. The trustee may perform the investment and administration functions itself or it may

9. In addition, money from an ETP may also be invested into a superannuation scheme or an immediate annuity.
10. A group life policy is a single life insurance policy which covers a group of individuals, such as all the members, for the time being, of a superannuation scheme.

contract these out to professional managers. Master trusts are available for both employer sponsored and personal superannuation schemes. They are typically marketed by life offices, banks and other fund managers and superannuation advisers.

'Fund of funds' arrangements

2.13. This term refers to arrangements under which small superannuation schemes place their superannuation contributions into the statutory fund of a life company. These deposits are not required to be identified separately in the life insurance company's statutory fund return. The Review understands there are arrangements which are referred to as 'fund of funds' arrangements that do not invest wholly in life office funds. Those arrangements do not fall within the Review's definition of a 'fund of funds' arrangement. Rather they are a special example of a master trust.

Professional administration organisations

2.14. These are commercial organisations which undertake the administration of superannuation schemes. The tasks they perform for the schemes include maintaining member accounts, distribution of member statements and collection of contributions.

Pooled superannuation trusts (PSTs)

2.15. PSTs help provide superannuation schemes with greater economies of scale when investing. They are unit trusts that can only accept funds from superannuation schemes which comply with OSSA, or from ADFs, other PSTs and some other tax preferred institutions.[11] OSS Regulations contain rules to ensure that only complying funds are able to invest in PSTs.[12] However, to date they do not impose prudential standards or investment controls on PSTs.[13] The issue of whether the same prudential standards applying to superannuation schemes ought apply to PSTs is addressed in chapter 11.

Professional investment managers

2.16. Many superannuation schemes contract out the investment of the scheme's funds to one or more professional investment managers. These managers may be contracted to invest the funds in specific asset classes or generally.

11. OSS Regulations reg 3A, 23C, 23E.
12. OSS Regulations reg 23A.
13. However, OSSA s 8A allows a wide range of prudential requirements to be imposed upon PSTs.

New types of rationalisation arrangements

2.17. It is possible that other ways of rationalising the administration and investment activities of superannuation schemes will be developed in the future. The Review is concerned to ensure that relevant recommendations in this report extend to such arrangements so that organisations providing the same product or service are subject to the same regulatory framework.

Legal structure of superannuation schemes

2.18. All of the different types of superannuation schemes outlined above, including PSTs and ADFs, are structured as trusts or are established by or under an Act of a parliament. In much of the current debate surrounding the reform of superannuation it is assumed that the trust structure is the most appropriate for superannuation. The recommendations contained in chapter 3 onwards of this report are made on the assumption that the trust structure is retained for superannuation,[14] but that the trustee will, in most cases, be incorporated.[15]

Institutions offering superannuation schemes

Introduction

2.19. The superannuation schemes outlined above are offered by a growing variety of institutions. For the purposes of this report, offering institutions have been divided into two categories, employer offerors and other institutions. The types of scheme offered by each institution are outlined below and summarised in Table 1 at the end of this chapter.

Offerors of employer related schemes

2.20. ***Public sector employers.***[16] Superannuation has for many years been a feature of employment in the public sector. Until recently, superannuation schemes offered by public sector employers have been considerably more generous than those offered by private sector employers. Public sector schemes have also been characteristically offered as defined benefit schemes, although some public sector employers now offer accumulation schemes. Most public

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14. The exception is a DA, which is not structured as a trust but as a life policy.
15. In the US, UK and Canada, the trust structure is used extensively. Although in certain instances each of these countries either requires or permits a corporate trustee, unincorporated trustees are also allowed: Baker & McKenzie *Submission* February 1992.
16. Public sector schemes are schemes established by a law of the Commonwealth or of a State or Territory or under the authority of the Commonwealth or the government of a State or Territory: OSS Regulations reg 3.

sector schemes operate on a 'pay as you go' basis, that is, the employer makes no contribution to the fund but meets any unfunded retirement benefit either from the current income of the fund or from consolidated revenue. The cash flow difficulties associated with unfunded schemes have, in the past, been overcome by providing retiring members with the choice of a less generous lump sum payment or a more generous pension. Under the pension option, resigning members forgo immediate access to their benefits by leaving them in the scheme and receive instead an increased entitlement to benefits. Unfortunately, this mechanism has not been entirely successful in reducing the cash flow difficulties, especially during periods of high inflation, retirements and retrenchments. Particularly in state schemes, there has been a recent shift to providing lump sums rather than pensions. Until 1990 the regulations applying to private sector schemes did not apply to public sector schemes. These schemes are now subject to the same regulatory regime as private sector schemes, including the same taxation liability.

2.21. *Private sector — single employer.* Historically, superannuation has not been as important a component of the employment contract in the private sector as it has in the public sector. Where superannuation has been available in the private sector, it has taken the form of both defined benefit schemes and, increasingly, accumulation schemes. Whereas in the public sector schemes defined benefits are typically unfunded, private employer sponsored defined benefits schemes are invariably fully funded.

2.22. *Private sector — multiple employers.* Trade unions have been closely involved in the establishment and administration of industry schemes following the 1986 National Wage Case decision.[17] Since that time these schemes have grown quite rapidly. As at April 1991, the eight largest industry funds had a total of $1.2 billion in assets under management.[18] Although the involvement of trade unions in superannuation schemes is quite recent, trade unions have historically had a role in the provision of retirement incomes through their capacity to provide pensions. This capacity arises through their historical connection with the friendly society movement.[19] However, with the introduction of government pensions funded from Consolidated Revenue, the power to pay pensions that many unions possess under their rules has fallen into disuse. The increasing involvement of unions in the retirement incomes debate may, however, see a revival of this function.

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17. See para 2.8.
18. Examples of such funds include HESTA (for the Health Industry), BUSS (for the building unions and construction industry), STA (Superannuation Trust of Australia-Metal Industry), REST (Retail), HOST-PLUS (Hotels), CARE (Clerical and Retail) and ARF (Australian Chamber of Manufactures and ACTU).
19. Some trade unions began as friendly societies.

Offerors of personal schemes and rollover arrangements

2.23. *Introduction.* Certain institutions offer superannuation schemes directly to the public at large. The range and type of such products available varies considerably across different types of offering institutions. There are four major groups of institutions offering these superannuation schemes: companies subject to the Corporations Law, life insurance companies, State government insurance offices and friendly societies.

2.24. *Offerors subject to the Corporations Law.* These include corporations which promote trust arrangements that enable them to provide a wide range of superannuation schemes in addition to the other collective investment schemes they promote to the public. They promote personal accumulation schemes and ADFs. They also promote master trusts and PSTs to employers, unions and other superannuation scheme promoters.

2.25. *Life insurance companies.* Life insurance companies are registered under the *Life Insurance Act 1945* (Cth). They can be structured either as mutuals or as companies limited by shares. Traditionally, personal superannuation schemes promoted by life insurance companies were offered in the form of risk based life insurance policies, particularly whole of life endowment policies. This key difference is reflected in Table 1. For example, life companies offer DAs instead of ADFs. In recent years life companies have begun offering investment linked superannuation policies. These policies now account for a significant proportion of their total premium income.

2.26. *State government insurance offices.* These institutions offer a range of schemes similar to those offered by life insurance companies. Only the life insurance activities of State government owned insurance companies that occur outside the State concerned are subject to the requirements of the *Life Insurance Act 1945* (Cth).[20]

2.27. *Friendly societies.* These State or Territory based financial institutions are similar to mutual insurance companies. They have traditionally offered social welfare related services, such as health care facilities and sickness insurance, to their members. However, as governments have taken over responsibility in these areas, friendly societies have branched out to offer a range of superannuation schemes similar to those offered by life companies and government insurance offices.

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20. *Life Insurance Act 1945* (Cth) s 5. The Constitution exempts State insurance within the State concerned from Commonwealth legislative control: Constitution s 51(xiv).

Proposed superannuation schemes

2.28. Several banks are proposing to create 'superannuation savings accounts' which will compete directly with other superannuation schemes currently offered by other types of institutions. The ANZ Bank is currently developing a product which will be marketed by ANZ Life. The money received will be invested in an account with the ANZ bank. This is merely a superannuation scheme which is no different from the others offered by ANZ Life. The only bank element is the fact that the money will be held in a bank account instead of being invested in other vehicles by the life company. It is possible, however, that in the near future other banks will develop proposals for 'superannuation accounts' which would be able to receive deposits direct from individuals on condition that the money would not be able to be withdrawn until the depositor had retired. Currently, it is not clear whether these accounts, if offered, will form part of the bank's main business or whether those funds will be held on trust or outright by a subsidiary. If the banks offer superannuation schemes which are not part of their banking business, the funds should be regulated in accordance with the recommendations in this report.

Retirement incomes — lump sums and annuities

2.29. All of the schemes and arrangements outlined above are designed to facilitate the process of saving for retirement. The Commonwealth grants them tax concessions designed to make them a more attractive alternative of saving for retirement. These tax concessions are subject to certain conditions.[21] Retirement income may either be provided by a pension offered by the scheme or by the retiree investing the lump sum he or she receives to produce an income stream or by purchasing an annuity. While annuities are not strictly 'superannuation' within the definition adopted by the Review, they play an important role in retirement incomes. Annuities may either be for a fixed period (a term certain) or whole of life. Currently, whole of life annuities are only available from life insurance companies.[22] In return for the payment of a lump sum by the retiree to the life insurance company, the retiree receives a regular (often indexed) pension payment until his or her death.[23] The income earned by the life insurance company from the investment of the lump sum is exempt from taxation.[24] That part of the income received by the retiree which represents a return of his or her capital is also exempt from income tax. The risk borne by the

21. See para 5.4.
22. Friendly societies only offer term certain annuities.
23. Often an annuity plan includes provision for payment of a reduced pension to the retiree's surviving spouse for the remainder of his or her life.
24. ITAA Pt III s 112A.

life insurance company is that the capital sum will be exhausted before the retiree, or his or her spouse, dies. An alternative to an annuity is a cash back or allocated pension. These pensions differ from annuities in that the pension received by the retiree can be varied at the retiree's discretion. Consequently, the capital sum invested to generate the pension may be exhausted quite quickly. Unlike an annuity, when the capital is exhausted the pension ceases. Thus an allocated pension may be distinguished from an annuity on the basis of who bears the risk that the capital will be exhausted before the death of the retiree. Allocated pensions are treated in the same way as life annuities for income tax purposes.[25]

25. They receive concessions for undeducted purchase price and post 1983 rebate. The lump sum used to purchase an allocated pension is currently limited to the lower lump sum reasonable benefit limit (RBL). The ISC is reviewing whether the higher RBL should be allowed. Currently, if a benefit is greater than the lower lump sum RBL, the excess does not receive a tax concession but is taxed at marginal rates.

Table 1
Superannuation Schemes
and their Offering Institutions

	Type of Offering Institution						
	Employment related sponsors			Offerors of other schemes			
Type of Superannuation Scheme	Public Sector Employer Sponsors	Private Sector Employer Sponsors	Unions/ Employers	Management Companies[1]	Life Insurance Companies[2]	Government Insurance Offices	Friendly Societies
REGULAR CONTRIBUTION SUPERANNUATION SCHEMES							
• Accumulation	X	X	X[3]	X	X	X	X
• Defined benefit	X	X					
SINGLE CONTRIBUTION SUPERANNUATION SCHEMES							
• Superannuation schemes				X			
• Superannuation bonds					X	X	X
ROLLOVER SCHEMES[4]							
• Approved deposit funds	X			X		X	X
• Deferred annuities					X	X	X
SIMPLIFICATION SERVICES							
• Master trusts				X	X		
• Pooled super trusts				X			
• Fund of fund arrangements					X		

1. Fund management companies include the wholly owned subsidiaries of banks, building societies, life insurance companies and credit unions.
2. Life insurance companies now also include wholly owned subsidiaries of banks.
3. One submission suggested that at least one industry plan (sponsored by employers and unions) offers a defined benefit for apprentices.
4. Employees often 'rollover' superannuation entitlements into their next employer's superannuation scheme.