Executive Summary

Introduction

Since 1987 Australia has had a system of mandatory superannuation contributions. The level of superannuation contributions an employer is required to provide on behalf of employees is prescribed under some federal and state industrial awards and the Commonwealth's superannuation guarantee (SG) scheme. The introduction of the SG was accompanied by reform of the prudential framework governing superannuation. The *Superannuation Industry (Supervision) Act 1993* (SIS Act) and supporting regulations came into effect in July 1994. The SIS Act remains the dominant legislative instrument setting prudential standards and protecting superannuation fund members' interests.

In early 2007 total superannuation assets reached the $1 trillion mark, backed by strong equity markets and a guaranteed flow of money that some researchers estimate could double in size by 2015. This was up from $761.9 billion in June 2005 and four times the value of superannuation assets in June 1995. The significant growth in the level of superannuation savings over the past decade should be viewed in the context of government attempts to introduce choice and portability of superannuation and widen the eligibility criteria for low income earners to receive the government co-contribution.

Choice of Fund has been a central part of the national agenda to increase the level of retirement savings since 1996. The committee acknowledges and supports the principle of people having the freedom of choice of both superannuation fund and investment options, provided there is appropriate prudential regulation and licensing to ensure people are protected from unwarranted risk. The committee believes that in the long run (and with appropriate safeguards in place) choice will increase competition, resulting in efficiencies and improved returns on superannuation savings.

Regulatory framework and international benchmarks

A common thread running through evidence from peak industry associations and other stakeholders is that the laws and regulations governing superannuation have become too complex, onerous and conflicting in some instances and have not kept pace with industry developments. Some in the industry expressed the view that the legislation is repetitive, clumsy, ambiguous, and contains unnecessary definitions. There were calls for comprehensive change to improve the law.

The committee shares these concerns. It believes that the legislation needs to be as clear and concise as possible and fit the current policy environment for superannuation. Above all, it should provide an efficient and effective environment for the investment and management of members' funds. The complexity and length of the legislation and the fact that it has been subject to persistent and frequent change, has made it difficult to master.

In the light of industry concerns about the complexity of the SIS Act, the committee recommends that the government undertake a comprehensive review of the laws and regulations governing superannuation to identify how they may be rationalised and simplified. The review should be carried out by Treasury.

The committee also looked to overseas jurisdictions, especially the United Kingdom and the United States, to see if they shed any light on Australia's superannuation industry. The lack of any internationally agreed benchmarks suggests that it is difficult to compare Australia's compulsory, privately managed and prudentially regulated system with the wide variety of systems operating in other countries. Be that as it may, the committee finds that while few in the industry openly contest the view that Australia has a world class retirement income system that is the envy of many other countries, this does not mean that other systems have nothing to offer or that the government and the industry cannot learn from overseas developments.

The committee recommends that APRA, in consultation with peak superannuation bodies and academics in particular, undertake empirical research on the strengths and weaknesses of superannuation systems operating in other OECD countries in order to develop a framework for benchmarking Australia's superannuation system against international best practice.

Promotional advertising and third party transactions

Issues pertaining to the reporting requirements of superannuation funds are examined in Chapter 3. These include whether expenditure on promotional advertising complies with the sole purpose test and should be disclosed to fund members, use of the term 'not for profit' by industry funds in the context of third party transactions with service providers and the propriety and transparency of these relationships, and concerns about inefficiencies and cost associated with regulatory overlap.

Promotional advertising is an inevitable consequence of superannuation funds competing for business, which was one of the main objectives of the government's Choice of Fund legislation. Industry support for trustees to use member funds to advertise was widespread. It was argued that promotional advertising plays a positive role in educating members about the features of their fund, assists in retaining or attracting new members, and results in economies of scale.

The committee believes that APRA and the superannuation industry should strive to find common ground in compulsory and specific disclosure by funds of expenditure on advertising and promotion. The committee can see a potential application of Australian Accounting Standards Board (AASB) standards to the superannuation industry. Although the AASB has not yet considered the accounting treatment and disclosure of promotional advertising by superannuation funds, it expects to do so sometime in the future. The committee recommends that peak superannuation bodies and APRA work with the AASB to form appropriate compulsory accounting and disclosure by all funds for promotional advertising, sponsorship expenses and executive remuneration.

The committee considered whether industry funds' use of the phrase 'not for profit' is legitimate in the context of contractual arrangements with service providers. The key issue relates to the propriety and transparency of these arrangements, in particular related party arrangements where a competitive tendering process for service provision has not been undertaken. While the committee agrees with ASIC that use of the 'not for profit' label by itself is not misleading as a consequence of payments to third party service providers, the more significant issue is whether members are getting a reasonable deal on these transactions, they are conducted at arms length and overpricing is not occurring.

The committee received no evidence of impropriety in relation to related party service agreements. However, the decision by Industry Super Network not to provide answers to any questions it agreed to take on notice was unhelpful and therefore fails to allay concerns about the cost of third party transactions with service providers. The committee is concerned that fund members cannot be fully informed when investing superannuation savings if industry funds do not disclose the true cost involved in their administration. This is why the committee recommends that the government develop an effective disclosure policy to address deficiencies in reporting related party transactions, and that trustees of superannuation funds publicly tender key service provision agreements.

Member investment choice

The committee considered whether superannuation savings are safeguarded under the existing prudential framework, and whether potential risks to savings are adequately addressed in the current regulatory environment. Chapter 4 examines this issue through the lens of member investment choice and the role of the trustee. The committee focused on criticisms of APRA's interpretation of investment choice and a strongly held industry view that further regulatory clarity is needed on the role of the trustee.

There is widespread agreement that the trustee's responsibility in a member investment choice situation should be to its core statutory duties, including to act in the best interests of all members, implement the fund's investment strategy in accordance with the SIS Act and ensure proper disclosure. However, this gives rise to different interpretations of law and policy. While investment choice is ultimately the member's decision, the dividing line between the trustee's and member's responsibility may be legally unclear.

There is concern that APRA's interpretation may prevent trustees from offering real investment choice to those members who want it. This was balanced by evidence from APRA and Treasury that member investment choice is not unlimited choice. Trustees are not permitted to allow an individual member's investment choice if that would not be suitable for the fund as a whole.

A widely held view in the industry is that APRA's written guidance and the legal advice on which it is based appear to have created more uncertainty for some trustees

and their advisers, not less. However, the committee finds that this uncertainty reflects an underlying systemic problem, which is that the SIS Act has not kept pace with industry developments, government policy or even community standards.

Be that as it may, a strong case was made for APRA to clarify the trustees' specific obligations under the SIS Act in order for it to better accommodate the existence of member investment choice. The committee recommends that APRA release its legal advice on the role of the trustee in a member investment choice situation and consult further with industry to clarify the duties of trustees that offer member investment choice. It recommends that APRA review its written guidance and further clarify its interpretation of the role of the trustee to ensure that the reality of investment choice and the obligations of trustees under the SIS Act are better integrated. The committee also recommends that funds should be permitted to provide simple, standard advice to members at their request about the appropriateness or otherwise of non-standard default investment options within the fund.

Safeguarding superannuation savings

Another theme examined by the committee is the importance of trustees addressing operational and governance risks before a fund experiences major difficulties that could threaten members' savings. The superannuation industry has placed a great deal of emphasis on prevention, which is a major premise of the current trustee licensing system. A number of issues fall under the umbrella theme of safeguarding superannuation. These include capital requirements and unit pricing, APRA's standards, funding arrangements for prudential regulation, compensation arrangements, and lost superannuation and portability.

The superannuation industry on the whole is opposed to the introduction of uniform or universal capital requirements. There is widespread agreement that any change to the existing rules on capital adequacy for trustees of superannuation funds is unnecessary and inappropriate and is unlikely to bring additional benefits to fund members. Evidence from industry funds highlighted that APRA licensing has imposed a uniform and comprehensive system of risk management across all superannuation funds, requiring funds to demonstrate the adequacy of their resources.

The accuracy and method of fund asset valuation is critical to the integrity of the investment process and ultimately investor confidence. A strong case was made for a mandatory unit pricing methodology for public offer funds. Fund choice and portability rules have contributed to inter-fund membership flows, which increases the need for funds to accurately price members' savings. The committee agrees that unit pricing is the most appropriate way to allocate investment earnings and appears to be the best way to ensure equity for members who move between funds. The committee recommends that the government mandate a uniform unit pricing methodology for all public offer superannuation funds, including any necessary transitional arrangements. It also recommends that where unit pricing is utilised improved operational risk parameters are identified and implemented by APRA.

The committee accepts that there must be accountability to ensure that revenue collected from superannuation funds to pay for the regulation of the industry is matched as closely as possible to the actual cost of supervision. The committee finds that current funding arrangements ensure transparency, relative equity and ease of administration by APRA. The committee does not believe another review of the levy issue is warranted at this point in time.

The committee accepts that it is impossible for the superannuation industry to completely insulate itself against the fraudulent activities of unscrupulous operators. A high degree of community confidence in the compulsory superannuation system is nevertheless important. The committee finds that existing compensation arrangements for theft and fraud are sufficiently robust to deal with instances of criminal activity. The committee is comfortable with the current levy arrangements, the amount of which is determined after an event has occurred. The committee believes that a so-called 'pre-event' levy would be difficult to determine and could potentially impose unacceptably high costs on the industry.

Portability and consolidation have become increasingly important issues for fund members under the Super Choice regime. The committee is concerned at anecdotal evidence that some funds are deliberately slowing the process of transferring funds and placing administrative hurdles in the path of fund members. It encourages APRA to be conscientious in enforcing the new 30 day limit on funds transfers. The committee also heard evidence of the potential for exit fees to undermine competition. The committee recommends prohibiting prospectively all exit fees that exceed the administrative cost of transfer.

The committee notes that there are 30 million superannuation accounts currently in existence, which is an average of 3 per employed person. The committee is concerned that of these some 5.7 million are lost accounts containing almost $10 billion. This represents a major structural weakness and inefficiency in the superannuation system that requires an active default solution. The committee expects lost superannuation will remain a real problem for large numbers of members. Good data collection and reporting by regulators and funds will be essential in order to devise further relieving strategies in the future. The committee recommends that where a tax file number is attached to a lost account it should be automatically consolidated or rolled together into a member's last active account using the tax file number system.

Financial advice

The central issue raised in evidence relates to the role of financial advice. Legislative barriers to cost-effective advice and how to overcome them in order to find a balance between consumer protection and accessibility of advice are examined in Chapter 6. How advisers are remunerated and debate over conflicts of interest associated with commission-based remuneration models are the focus of chapter 7.

Cost and accessibility

The advent of Super Choice and the autonomy it provides superannuation fund members have drawn attention to the role of funds and professional advisers in helping consumers navigate their way through the options they now face. The committee finds that most fund members will not seek individually tailored financial advice on superannuation, particularly on choosing their own investment strategy. A combination of apathy, inertia and a perception of those with low or moderate fund balances that the cost and effort would not justify the benefits are the principal reasons. Also important is a belief that the fund managers are experts and will do a good job. While the committee acknowledges that there is merit in the argument that all members would benefit to some extent from personal guidance on superannuation, the reality is that people cannot be coerced into taking such an active role in managing their superannuation affairs.

There was broad consensus over the inadequacy of current regulatory arrangements for the provision of basic, limited advice on superannuation. Criticism of the legislative framework for the provision of financial advice focused on the breadth of the definitions of 'financial product advice'. It was argued that definitions have restricted fund members' access to advice on issues where consumer protection should not, on the face of it, be a serious concern. Reforms to protect consumers have captured too many advice situations to the detriment of accessibility.

The committee considered possible remedies to enable the legislative framework to achieve greater proportionality between consumer protection and accessibility of advice. The committee supports the government's proposed measure to exempt advisers from providing a Statement of Advice where personal advice is provided that does not involve recommending a product or remuneration for the advice. The proposal to introduce a threshold for disclosure on a superannuation investment of less than $15,000, where the advice recommends consolidating investments or making additional contributions, is also supported by the committee. The committee recommends further regulatory guidance to remove uncertainty associated with funds communicating with their members. The objective is to enable funds to provide targeted information to different categories of membership and provide benefit projections to their members.

Other remedies considered by the committee relate to the regulation of accountants and product disclosure information. The committee does not believe accountants should be exempt from holding an AFS licence when providing financial product advice. However, the committee recommends that accountants be able to advise clients on altering their superannuation contribution levels and consolidating superannuation investments into an existing fund, without requiring an AFS licence.

The readability of disclosure material is vital for consumers to be able to readily access information and advice on superannuation. Unfortunately, this is seldom the case as most product disclosure statements (PDS) are too long and complex and unsuitable for general consumption. While the industry agrees that consumers would

benefit greatly from shorter, more comprehensible and comparable product disclosure statements, the means to achieve this are in dispute.

The committee believes that the readability of PDS' could be improved by ensuring important information is prominently displayed, in summary form, at the front of the document. This would enable a comparison between products to be made without the need for the entire document to be read. The committee strongly encourages superannuation product issuers to improve their PDS' in this fashion. If this cannot be achieved by the industry of its own volition it should be mandated by government. The committee recommends that the government conduct market research on the readability of superannuation with the goal to introduce simple, standard, readable documentation.

Remuneration, education and financial literacy

The effect of different remuneration models on the standard of superannuation advice was a major issue raised during the inquiry. The committee considered evidence in relation to potential conflicts of interest in commission-based remuneration models, payment of ongoing trailing commissions and use of approved product lists and 'tied' adviser relationships. The committee considered possible remedies to improve the quality of superannuation advice, including banning commissions and shelf fees, improving disclosure of conflicts of interest, mandating a higher standard of advice and facilitating the provision of fee-for-service advice.

The committee accepts the view that commission-based remuneration generates conflicts of interest for advisers that can lead to inappropriate advice, as demonstrated by ASIC through its shadow shopping survey. Furthermore, trailing commissions potentially lead to significant sums being paid to advisers throughout the life of a financial product without a commensurate return in the form of ongoing superannuation advice.

However, the committee does not recommend the prohibition of commissions on superannuation products, as argued by industry funds. Many consumers cannot afford to pay for up front fee-for-service advice on their superannuation. This situation is compounded by the unresolved problem that the current disclosure regime causes advice to cost more than its inherent value. Furthermore, banning commissions will not remove all potential conflicts of interest in the industry. Superannuation funds, including industry funds, have other remuneration practices such as bonuses and incentive plans for sales people that may give rise to conflicts.

The committee is more concerned about the effect of shelf fees. Shelf fees can be anti-competitive and may encourage products to be listed and subsequently recommended that may not be in the best interests of the client. Unlike commission-based remuneration, shelf fees cannot be said to facilitate access to advice by making it more immediately affordable to those without discretionary funds to pay up-front fees. As the industry is progressively moving from commission-based to fee-based advice fees, so it should move from shelf fees to a more competitive means of meeting the cost of product listings. Ultimately, the industry should move towards fees for advice,

payment for funds management and payment for administrative services. The committee recommends that ASIC work with the industry to provide investors more effective and detailed disclosure of shelf fees.

The disclosure of conflicts of interest needs to be more effective to ensure consumers are better able to measure their likely effect on the quality of advice they receive. The committee believes that disclosure must be effective and meaningful rather than a perfunctory process undertaken to comply with legislative requirements. However, the committee does not support a proposal to raise the threshold of the standard of financial product advice from 'appropriate' to 'best'. The reality of providing financial advice within the constraints imposed by approved product lists renders this an unobtainable objective.

The committee is of the opinion that disclosure will not be effective unless the nomenclature attached to financial advisers accurately conveys to consumers the adviser's relationship with, and interest in, the superannuation products they recommend. Accordingly, the committee recommends that the government should investigate the most effective way to develop with the industry appropriate nomenclature where the product recommendation advice available to consumers is limited by sales imperatives.

The committee is concerned about insufficient transparency with regard to the relationship between advisers, their licensees and superannuation product providers. It is apparent clients may not be aware of the integration of superannuation product supply and sales advice and the incentives that stem from such an arrangement. The committee, therefore, recommends that financial advisers should be required to disclose the ownership structure of the licensee he or she is operating under.

Arming consumers with the skills to interpret the quality and independence of the advice they receive is a priority issue. The shift from passive superannuation investments in which employers bore investment risk, to today's competitive market in superannuation products where investment risk is transferred to employees, has left consumers more vulnerable to the vagaries of the marketplace than previously. This transfer of risk has left superannuation fund members with the responsibility for taking decisions that were previously not required of them. As such, measures need to be taken to enable consumers to adapt to their new responsibility.

The committee believes this challenge can effectively be addressed by improving the accessibility of advice for those already in the system, from funds and licensed financial advisers, and ensuring that future fund members are provided with appropriate guidance during their school years. The committee notes with approval the government's Better Super television and radio advertisements designed to inform and educate people about the reforms to superannuation that came into effect on 1 July 2007. The committee also supports the government's Financial Literacy Foundation initiatives and recommends that they be reviewed when their effectiveness is able to be measured against clear performance benchmarks.

Self-managed superannuation funds

Self-managed superannuation funds are a significant part of the Australian superannuation landscape. They have become an increasingly popular way for people to hold retirement savings. The SMSF sector accounts for over 99 per cent of the total number of superannuation funds and represents 23 per cent of total superannuation savings.

The committee finds there is general agreement in the industry as to the reasons for the dramatic rise in the number of SMSFs. Self-managed funds enable members to control their investments, earn higher returns and diversify their assets. The popularity of SMSFs is also attributed to the absence of fees charged by professionally managed superannuation funds, the ability to invest in assets not otherwise available in a regulated fund and the provision of advice from accountants and financial planners.

The committee considered a number of regulatory and compliance issues associated with SMSFs. Trustees residing overseas for periods in excess of two years risk having their fund deemed non-complying, on the basis that the active member test for an Australian superannuation fund requires a resident active member's accumulated benefit to be greater than 50 per cent of the total accumulated benefit for all active members. The committee finds that the active member test is unnecessary because its objectives are met by other applicable laws and recommends that it be removed from the definition of an Australian Superannuation Fund.

The wisdom or otherwise of imposing a minimum balance on the operation of SMSFs was raised in evidence. The committee sees problems with the imposition of a statutory viability limit, particularly in light of its likely effect on younger investors. The highly individualised advice provided by accountants and financial advisers is an appropriate safeguard for investors seeking to establish an SMSF without viable seed funding. The committee, therefore, makes no recommendation in regard to minimum thresholds.

The committee heard evidence that the current limit of four individuals who can own and manage a SMSF should be increased in response to the prevalence of family businesses and funds that operate over two or more generations. It appears that the problem that exists now, on whatever scale, particularly affects funds seeking to operate across multiple generations, as well as co-owners of small businesses seeking to invest together. The effect of this restriction is likely only to worsen in the future, and should be addressed sooner rather than later. The committee recommends that the ATO consider raising the maximum number of trustees for any one SMSF from four to ten, in line with current and future demand.

In relation to the regulation of SMSFs, the committee accepts the argument that greater reliance should be placed on safeguards offered by accountants as the key interface between members and the regulatory and compliance system. In view of the current and future growth of SMSFs, it is important to ensure that the right balance is struck to minimise the regulatory burden of administration while also maintaining

financial and legal integrity. The committee recommends that SMSFs run by qualified accountants be audited annually for three years from their commencement and, subject to no irregularities, thereafter every five years.

The ability of recognised accountants that hold appropriate qualifications to provide advice to their clients on a decision to acquire or dispose of an interest in an SMSF, without the need to be licensed under financial services regulation, was a central issue raised in evidence. Consistent with its findings and recommendations from previous inquiries, the committee supports the argument by peak accounting bodies that the exemption should be extended to include general structural advice on all superannuation funds. The committee recommends that the exemption be broadened to enable accountants to provide advice on the structure of superannuation funds, rather than being limited to advising on SMSFs.