

## Chapter 2

# Prudential framework, industry trends and benchmarking international practice

### Background

2.1 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 scheme requires all employers to provide a minimum level of superannuation contributions in each financial year for employees.<sup>1</sup> From 1987 all employers were effectively required to contribute 3 per cent of ordinary time earnings to a regulated superannuation fund. The rate of contribution gradually increased to 9 per cent of wages in July 2002.

2.2 The compulsory SG scheme is one of three pillars of Australia's retirement income system which aims to achieve a higher standard of living in retirement than would be possible from the publicly-funded age pension alone. The other two components are the means-tested, taxpayer-funded, age pension and additional voluntary superannuation contributions usually via a salary sacrifice, spouse contribution or co-contribution scheme.<sup>2</sup> It is acknowledged that many people save outside of superannuation, including but not limited to home ownership.

2.3 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, which came into effect in July 1994, replaced the *Occupational Superannuation Standards Act 1987*. The SIS Act remains the dominant legislative instrument setting prudential standards and protecting superannuation fund members' interests. Most superannuation contributions are made to funds (known as 'superannuation entities') that have elected to comply with the provisions of the act in order to obtain concessional tax treatment.

2.4 In 1996 the Government commissioned the Financial System Inquiry to undertake a major review of the financial services sector regulatory framework to ensure its continued effectiveness and efficiency. The report of that inquiry (the Wallis Report) made a number of recommendations that had significant implications for the structure of financial regulation.<sup>3</sup> In accepting many of the report's

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1 *Superannuation ready reckoner: taxation and preservation rules for 2004-05—revised* February 2005, Research Brief no. 10, 2004-05, Department of the Parliamentary Library, 14 February 2005, pp. 8-9.

2 *An adequate superannuation-based retirement income?*, Research Brief no. 12, 2005-06, Department of the Parliamentary Library, 16 March 2006, p. 9.

3 Australian Financial System Inquiry, *Final Report* (Wallis Report), Canberra, AGPS, March, 1997.

recommendations, the government decided that the best regulatory structure for the financial services sector would involve two regulators: one responsible for the prudential regulation of any entity that needed to be prudentially regulated; the other responsible for market and disclosure regulation of any financial products being offered to consumers.

2.5 The 'twin peaks' model of regulation that the government eventually adopted created two highly specialised agencies – the Australian Securities and Investments Commission (ASIC) and the Australian Prudential Regulation Authority (APRA) – with clearly defined regulatory roles, or what ASIC Deputy Chairman, Mr Jeremy Cooper, described as a 'division along functional lines'.<sup>4</sup> Under the new regime, which came into effect on 1 July 1998, policymaking for prudential services moved to the Department of the Treasury, APRA became the new prudential supervisory body assuming responsibility for policy implementation, and ASIC assumed responsibilities for regulation, consumer protection for financial services and enforcement.<sup>5</sup>

2.6 The institutional framework covering superannuation has also been affected significantly by the *Financial Services Reform Act 2001* (FSR), which addresses disclosure and consumer protection for the entire financial services industry. The FSR Act amended the Corporations Act and ASIC Act to provide for a single licensing regime for financial sales, advice and dealings in relation to financial products; a consistent financial product disclosure regime; and a single authorisation procedure for financial exchanges and clearing and settlement facilities.

2.7 The remainder of this chapter examines how the regulation of the superannuation industry is structured, and describes a number of industry-wide trends that have seen superannuation savings across Australia rapidly increasing to unprecedented levels. The committee then makes a few preliminary observations regarding these broader structural issues and trends, taking into consideration the views of the superannuation industry raised in evidence to this inquiry.

## **Prudential regulation**

2.8 Prudential regulation aims to promote prudential behaviour by financial institutions so as to ensure they will be able to meet their obligations to their depositors, policyholders or members. Its primary concern is the quality of regulated entities and their systems for identifying, measuring and managing business risk.<sup>6</sup>

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4 Mr Jeremy Cooper, *The integration of financial regulatory authorities – the Australian experience*, paper presented to the Securities and Exchange Commission of Brazil, 30th Anniversary Conference, Assessing the Present, Conceiving the Future, 4-5 September 2006, p. 3.

5 *Prudential Supervision and Consumer Protection for Superannuation, Banking and Financial Services: First Report*, Senate Select Committee on Superannuation and Financial Services, August 2001, pp. 5-6.

6 Australian National Audit Office, *APRA's Prudential Supervision of Superannuation Entities*, Audit report No.6 2003-04, pp. 21-22.

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Although the regulation and prudential supervision of the superannuation industry has undergone fundamental change over the past decade, a consistent objective underlying the regulatory system has been to increase superannuation savings and protect fund members' superannuation entitlements.<sup>7</sup>

2.9 The current prudential and disclosure framework applying to superannuation was established by the Government in 1998 as part of its response to the recommendations of the Financial System Inquiry. According to Treasury, the prudential framework has two principal aims of ensuring that:

- entities are managed prudently so that they are able to meet their financial obligations to consumers; and
- consumers are given adequate information and are kept informed of the nature and performance of their investments.<sup>8</sup>

2.10 Prior to the mid-1980s the superannuation industry was largely self-regulated. As a result of the dramatic increase in superannuation coverage and contributions in the late 1980s and early 1990s (as a result of the 1986 national wage case and the introduction of the SG) major reforms were undertaken in the regulatory framework. In 1987 the Insurance and Superannuation Commission was established as a specific industry regulator. This was followed in 1993 by the introduction of the SIS Act to regulate the compulsory employer superannuation schemes. The stated objective of the Act is contained in section 3:

...to make provision for the prudent management of certain superannuation funds, approved deposit funds and pooled superannuation trusts and for their supervision by APRA, ASIC and the Commissioner of Taxation.

2.11 In addition to the SIS Act, the main pieces of legislation that regulate the superannuation industry are the *Corporations Act 2001* (Corporations Act) and associated regulations, and to a lesser extent the *Income Tax Assessment Act 1936*. The compulsory employer superannuation schemes are regulated by the SIS Act, which:

- establishes APRA and ASIC as the regulators of the Superannuation Retirement Industry;
- introduces statutory duties on trustees of such schemes;
- provides for disclosure of information to members;
- incorporates certain covenants into Trust Deeds;
- establishes a compensation mechanism for the protection of members of superannuation funds in the event of theft and fraud (self-managed funds are excluded);

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7 Productivity Commission, *Review of the Superannuation Industry (Supervision) Act 1993 and Certain other Superannuation Legislation*, Report No.18, 10 December 2001, p. 9.

8 Treasury, *Submission 55*, p. 3.

- establishes wider reporting duties for auditors of superannuation schemes;
- provides full vesting of employer contributions for the employee;
- prohibits borrowing by funds;
- codifies the prudent person and sole purpose test; and
- includes a restriction on in house investment of 5 per cent.

## **Regulators**

2.12 The superannuation industry is regulated by three bodies: APRA, ASIC and the Australian Tax Office (ATO). These are independent government agencies that are responsible for different aspects of the regulation of the superannuation industry.

2.13 The role of each is described in more detail below. A general distinction in relation to superannuation is that APRA is responsible for the prudential aspects of the SIS Act, promoting the stability and soundness of superannuation funds; ASIC is responsible more broadly for corporations, financial services and consumer protection; and the ATO regulates the activities of self-managed superannuation funds (SMSFs) and enforcement of SG payments. While each of the regulators is heavily involved in regulating entities, only ASIC attends to the needs of consumers and beneficiaries. In addition, Treasury has responsibility for formulating policy on the broad features of the retirement income system, prudential regulation and consumer protection.

### ***Australian Prudential Regulatory Authority***

2.14 Prudential regulation seeks to reduce the likelihood that regulated entities will fail and be unable to meet their contractual commitments. Governments around the world have imposed prudential controls in the financial services sector because of the critical role the sector plays in the financial security of society and in a modern market economy. Prudential regulation is designed to promote stability and soundness within the financial entities it supervises. To this end, the SIS Act imposes duties and obligations on trustees and provides APRA with supervisory and regulatory power. It also provides key data on a range of superannuation fund statistics.

## **Recommendation 1**

**2.15 The committee recommends that APRA expand the information provided in its quarterly superannuation statistics to include a regular representative survey of the level of additional contributions above the 9 per cent superannuation guarantee from both employer and employee (salary sacrifice) and other forms of contribution. This should include analysis by income level and gender.**

2.16 APRA supervises complying superannuation funds worth approximately \$808 billion, other than self-managed superannuation funds worth approximately \$245 billion. However there is no prudential standard making power in respect of regulated superannuation entities. Further, APRA provides guidance on the manner in which it interprets and assesses compliance with the operating standards contained in the law

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(for more on this issue see the discussion of member investment choice in Chapter 4). APRA issues circulars and guidance notes on its interpretation of the SIS Act, SIS regulations and related matters. APRA's guidance on superannuation is non-binding.<sup>9</sup> Nevertheless, in practice, particularly in the context of the re-licensing of all superannuation funds, APRA has or is in the process of implementing various guidance notes.

### ***Australian Securities and Investments Commission***

2.17 The Australian Securities and Investments Commission is responsible for administering and enforcing the Corporations Act, the *Australian Securities and Investments Commission Act 2001* and parts of the SIS Act as they apply to superannuation trustees and other financial service providers in the superannuation industry. The main role of ASIC is to regulate the activities of all corporate entities in Australia, including financial entities such as superannuation funds. From 1998 it became responsible for consumer protection in superannuation.

2.18 The ASIC submission described the regulator's main functions as:

- granting Australian Financial Services (AFS) licences and imposing and changing licensee conditions on superannuation trustees, advisers and other financial services businesses in the superannuation industry;
- maintaining public registers of, among other things, AFS licence holders and authorised representatives of AFS licence holders;
- issuing policy statements, guides, information sheets and answers to frequently asked questions to explain how the law works and compliance obligations;<sup>10</sup>
- modifying the application of many parts of the Corporations Act and SIS Act, and granting exemptions from some parts of the Corporations Act;
- monitoring how the superannuation industry complies with the law;
- enforcing the law by taking action against inappropriate advice about superannuation and misleading or deceptive and unconscionable conduct in relation to superannuation products and advice; and
- educating consumers in order to promote the confident and informed participation of investors and consumers in the financial system.<sup>11</sup>

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9 Australian Bankers' Association, *Submission 88*, p. 9.

10 From July 2007, ASIC rationalised and redesigned its regulatory documents to include consultation papers, regulatory guides, reports and information sheets. For details see 'ASIC's Better Regulation: New Regulatory Documents and Road Map', Information Release IR 07-36, Thursday 5 July 2007.

11 ASIC, *Submission 48*, pp. 5-7.

## *Australian Tax Office*

2.19 The Australian Tax Office is responsible for ensuring the effective management of assets invested in self-managed superannuation funds and SG compliance. Its main role is ensuring that SMSFs comply with the SIS Act and regulations. According to the ATO submission: 'Our focus is on whether fund investments are in accordance with trustees' stated investment strategies and in accordance with the SIS Act, but it is not our role to look at the overall soundness of the investments from a business perspective'.<sup>12</sup> It also pointed out that as more people with an SMSF retire from the workforce these funds are maturing into long term, intergenerational retirement vehicles.

### **Prudential framework**

2.20 The Treasury submission identified four main elements that comprise the prudential regime for superannuation: the trust structure, minimum entry requirements (licensing), the sole purpose test, and investment management requirements. A brief summary of the first three elements is provided below. The investment obligations on trustees under the SIS Act are examined as part of the committee's consideration of member investment choice in Chapter 4.

#### *Trust structure*

2.21 Regulated superannuation entities generally operate under a trust structure for the benefit of members and beneficiaries. The assets of the superannuation entity must be kept separate and distinct from the assets of the trustee of the entity, the members, or any related employer-sponsor of the fund.

2.22 According to the Treasury submission:

Under general trust law, the trustee must take ultimate responsibility for the entity and is obligated to manage the assets of the entity with competence, diligence, prudence and honesty, and to act in good faith for the benefit of all of the members of the entity. These governance principles also underpin the SIS Act, most notably being reflected in the duties – or covenants – contained in section 52 of the SIS Act.<sup>13</sup>

2.23 According to the Chairman of the Corporate Superannuation Association, the overriding and strongest feature of a trust structure is that it reinforces the no conflict rule and the principle that trustees act for the benefit of the beneficiaries and not for their own profit.<sup>14</sup>

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12 ATO, *Submission 36*, p. 2.

13 Treasury, *Submission 55*, p. 6.

14 Mr Mark Cerche, Chairman, Corporate Superannuation Association, *Committee Hansard*, 5 March 2007, Melbourne, p. 37.

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## ***Trustee licensing***

2.24 Since 1 July 2004, trustees have been operating under a universal framework of licensing and registration to ensure trustees satisfy certain minimum requirements before operating in the market. The licensing regime came into effect with the *Superannuation Safety Amendment Act 2004* that amended the SIS Act to require all trustees operating an APRA regulated superannuation entity to hold a Registrable Superannuation Entity (RSE) Licence. Existing trustees were granted a transition period of two years from 1 July 2004 to 30 June 2006. This licensing process has resulted in market rationalisation (see paragraph 2.27). By this time 307 trustees responsible for around 600 superannuation funds had obtained a RSE licence. A further 6300 small APRA funds (those with fewer than five members) were also licensed by the completion of the transition period. Trustees that have been granted an RSE licence manage combined assets of \$566 billion out of a total of approximately \$1 trillion in super funds.<sup>15</sup>

2.25 In order to obtain a licence trustees must, among other things, meet minimum standards of fitness and propriety and have adequate financial, human and technical resources, an adequate risk management framework and systems to manage the outsourcing of any material business activities.<sup>16</sup>

2.26 It is important to highlight that an RSE licence is not the same as an AFS licence, which is issued by ASIC to providers of financial products under the Corporations Act. While an RSE licence enables the licensee to conduct business operations different from those holding an AFS licence, holding an AFS licence is still a requirement for undertaking certain types of business activities under an RSE licence; for example, where the trustee is dealing in a financial product or providing advice about financial products.<sup>17</sup>

2.27 APRA is currently undertaking two supervisory tasks following the completion of the licensing transition period. The first is resolving issues created by the large number of funds and trustees that have recently exited the superannuation system. Over 140 trustees that had not completed the wind up of their funds by 30 June 2006 have entered into enforceable undertakings to do so within a specified period. The second task is monitoring the undertakings made by licensed trustees in regard to the policies and procedures put in place prior to licences being granted.<sup>18</sup>

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15 APRA, *Submission 51*, p. 4.

16 Treasury, *Submission 55*, p. 6.

17 Australian Prudential Regulation Authority, *Licensing and registering a superannuation entity: Explanatory guide on licensing and registration*, July 2004, pp. 6-7.

18 APRA, *Submission 51*, p. 4.

### ***Sole purpose test***

2.28 The trustee of a regulated superannuation fund must comply with the sole purpose test as set out in section 62 of the SIS Act. According to the relevant APRA circular, a regulated superannuation fund must be maintained solely for:

- at least one of the legislated 'core purposes', which are the provision of benefits on or after the member's retirement; and
- for one or more of the prescribed or approved 'ancillary purposes', which are the provision of employment termination insurance, salary continuance (on a member ceasing work because of ill health), reversionary benefits and other approved benefits on or after an appropriate condition has been met.<sup>19</sup>

2.29 The main objective of the sole purpose test is to ensure that superannuation assets are maintained solely for the purpose of or providing some form of retirement benefit to members. The test is meant to achieve this objective by prohibiting the use of tax concessions for purposes such as providing pre-retirement benefits to members, benefits to employer sponsors or facilitating estate planning.<sup>20</sup> The committee's main interest in the sole purpose was to examine whether expenditure on promotional advertising by superannuation funds, especially since the advent of Choice of Fund on 1 July 2006, is consistent with the sole purpose test. The views of APRA and other industry stakeholders on this issue are examined by the committee in Chapter 3.

### **Committee view**

2.30 A 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. Even the Productivity Commission's detailed review of the SIS Act and regulations noted the complexity and length of the legislation and that it has been subject to persistent and frequent change, thus making it difficult to be familiar with: 'As a result, there is reason to consider how it might be improved, including whether comprehensive changes might be justifiable'.<sup>21</sup>

2.31 The committee agrees with this assessment, although it did not receive much evidence in relation to the operation of the SIS Act and regulations. Some in the industry expressed the view that the legislation is repetitive, clumsy, ambiguous and contains unnecessary definitions that, in the words of Trowbridge Deloitte consultant

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19 Australian Prudential Regulation Authority, Superannuation Circular no. III.A.4, *The Sole Purpose Test*, February 2001

20 Productivity Commission, *Review of the Superannuation Industry (Supervision) Act 1993 and Certain other Superannuation Legislation*, Report No.18, 10 December 2001, pp. 117-18.

21 Productivity Commission, *Review of the Superannuation Industry (Supervision) Act 1993 and Certain other Superannuation Legislation*, Report No.18, 10 December 2001, p. xx.



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Mr Anthony Asher: '...makes life very difficult for anyone working in the industry'.<sup>22</sup> Trowbridge submitted further that the SIS Act and regulations contain counter-intuitive definitions and compare unfavourably with other acts administered by APRA as well as some international legislation such as the Canadian Pension Benefits Standards Act (1985). The submission made a number of practical suggestions to simplify the legislation, including:

- transferring those parts and sections administered by the ATO and ASIC to legislation they administer;
- rationalising APRA's powers under the licensing regime to enable it to issue prudential standards that specifically cover operating risks and fiduciary standards;
- removing the distinction between superannuation funds and approved deposit funds, pooled superannuation trusts and retirement savings accounts; and
- removing 'member protection' that prevents administration charges exceeding investment earnings for accounts of less than \$1000.<sup>23</sup>

2.32 Strongly worded criticism of the superannuation legislation came from Mercer Human Resource Consulting. It argued that the worst examples of complexity and ambiguity are found in recent legislation such as the Corporations Law, which is '...just unintelligible'. Moreover:

Once you have waded through [the Corporations Law], you then have to check whether there is an ASIC policy statement or class order that may override the regulations. In some cases we have legislation that is written so ambiguously that the various regulators cannot even agree on what the legislation means. In other cases it is the inconsistencies in the legislation that are a problem.<sup>24</sup>

2.33 The committee believes that the level of concern expressed by industry stakeholders about the complexity of the SIS Act would justify the government undertaking a comprehensive review of superannuation laws. This should be carried out by Treasury.

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22 Mr Anthony Asher, Consultant, Trowbridge Deloitte, *Committee Hansard*, 7 March 2007, Sydney, p. 43.

23 Trowbridge Deloitte, *Submission 80*, p. 17.

24 Mr John Ward, Principal Manager, Mercer Human Resource Consulting, *Committee Hansard*, 25 October 2006, Melbourne, p. 65.

## Recommendation 2

**2.34 The committee recommends that Treasury conduct a review of the laws and regulations governing superannuation to identify how they may be rationalised and simplified.**

2.35 Other concerns with the SIS Act and Corporations Act and those acts that cover the regulators generally fall within one of four main areas:

- regulatory overlap between APRA and ASIC, especially in the areas of data collection, reporting and notification of change;
- confusion over the status of APRA's guidance with regard to how it interprets and assesses compliance with the operating standards set out in the SIS regulations;
- additional complexity for trustees and the financial planning industry, especially meeting the product disclosure requirements of FSR legislation; and
- rapidly increasing compliance costs that are passed on to the consumer that have made it difficult for many fund members to receive cost-effective financial advice.

2.36 In relation to the 'twin peaks' model of regulation, the committee notes that while the responsibilities of the three regulators (ASIC, APRA and the ATO) are specified in law, in practice there is some administrative overlap and duplication of functions. This emerged as a consistent theme in evidence to this inquiry. The issue of duplication of information gathering between APRA and ASIC was highlighted by CPA Australia, specifically in relation to the recent transition period for trustee licensing:

...we had Australian finance services licensing two or three years ago and we have just gone through the two-year transition period for trustee licensing under APRA. There were a lot of the same questions and a lot of the same requirements, although perhaps couched a bit differently. The trustees had to jump through the same hoops again, providing the information to APRA, when a lot of it could have been shared in the first place. Because we have that separation, we end up with a lot of duplication.<sup>25</sup>

2.37 The committee notes that while steps have been taken by the regulators to address this issue, for example by entering into memoranda of understanding to define responsibilities more clearly, some sections of the superannuation industry support a review of the 'twin peaks' system to overcome what is perceived to be conflict involving different regulatory perspective and objectives. The issue of regulatory overlap are matters of real concern for the committee and are examined in Chapter 3.

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25 Mr Michael Davison, Superannuation Policy Adviser, CPA Australia, *Committee Hansard*, 25 October 2006, Melbourne, p. 59.

It is noteworthy that the industry as a whole, including some of those levelling criticism at the legislation, believe the regulatory framework for superannuation created by the SIS Act, for all its faults, continues to provide an efficient and effective legislative framework for the prudent management of superannuation funds.

## **Industry trends: A snapshot**

### ***Growth in superannuation savings and industry composition***

2.38 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.<sup>26</sup> This was up from \$761.9 billion in June 2005 and four times the value of superannuation assets in June 1995 (\$250 billion).<sup>27</sup>

2.39 During the March 2007 quarter superannuation assets grew by \$44.7 billion or 4.4 per cent, to \$1.1 trillion, which represents a 17.1 per cent increase over the 12 months to March 2007.<sup>28</sup> According to APRA's media release:

Industry funds showed the strongest growth during the quarter, with assets increasing by 6.2 per cent (\$10.6 billion) to \$182.7 billion. Public sector fund assets grew by 5.1 per cent (\$8.0 billion) to \$165.8 billion, retail fund assets by 3.7 per cent (\$12.4 billion) to \$343.9 billion and corporate fund assets by 2.6 per cent (\$1.7 billion) to \$69.4 billion.<sup>29</sup>

2.40 The shifts that have occurred within the superannuation industry over the past decade have seen the emergence of four distinct streams of superannuation funds (of which the first three are APRA-supervised funds):

- corporate funds that are sponsored by a single employer or group of related employers and cover their employees;
- industry funds that cater for members as a result of an agreement between parties to an industrial award. Some industry funds offer their products to the public at large, like retail funds;
- retail funds that are public offer superannuation funds that members join by purchasing investment units or policies that are sold through intermediaries such as financial planners; and

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26 'APRA figures show superannuation assets reach \$1.0 trillion', APRA Media Release, 29 March 2007; Jonathan Barrett and Brendan Smith, 'Super industry swamped by cash flow', *Australian Financial Review*, 21 January 2007, pp. 40-41.

27 Treasury, *Submission 55*, p. 4.

28 APRA, *Quarterly Superannuation Performance March 2007*, issued 28 June 2007.

29 'APRA figures show superannuation assets reach \$1.1 trillion', Media release No. 07.22, 28 June 2007.

- Self-managed superannuation funds (SMSFs)<sup>30</sup>

2.41 At March 31 2007, retail funds held the largest proportion of superannuation assets, accounting for 32.6 per cent of total assets, followed by self-managed superannuation funds with 23.3 per cent, industry funds 17.3 per cent, public sector funds 15.7 per cent and corporate funds 6.6 per cent. Small APRA funds held 0.3 per cent of total assets.<sup>31</sup>

2.42 The committee notes that while the level of superannuation assets in Australia has overtaken \$1 trillion, there remains a high level of industry concern that many people's expectations of their living standards in retirement greatly exceeds what their superannuation savings will actually provide. This is commonly referred to as the retirement savings gap. There is also concern with the poor level of overall financial literacy in the community and the high level of disengagement over retirement savings and superannuation issues, especially among younger people.

### ***Choice of Fund***

2.43 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.<sup>32</sup> Government policy to give employees the right to choose which superannuation fund receives the superannuation guarantee contributions was first articulated as part of the 1997-98 budget process. Attempts by the government to pass choice of superannuation legislation in 1997 and 1998 were unsuccessful. However, the policy was implemented by the *Superannuation Legislation Amendment (Choice of Superannuation Funds) Act 2004*. The Choice of Fund regime commenced operation on 1 July 2005 for federal awards and 1 July 2006 for state awards.

2.44 Where an employee does not choose a superannuation fund, the employer may choose a complying fund provided it is an 'eligible choice fund'.<sup>33</sup> Various groups of employees are excluded from the coverage of the choice of fund legislation, including Commonwealth public sector employees, employees covered by state awards and employees covered by a certified agreement or an Australian Workplace

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30 Productivity Commission, *Review of the Superannuation Industry (Supervision) Act 1993 and Certain other Superannuation Legislation*, Report No.18, 10 December 2001, pp. 20-21.

31 APRA, *Quarterly Superannuation Performance March 2007*, issued 28 June 2007, p. 5.

32 *Australia's corporate regulators—the ACCC, ASIC and APRA*, Research brief no. 16 2004-05, Department of the Parliamentary Library, 14 June 2005, p. 9.

33 An eligible choice fund is a complying superannuation fund, a retirement savings account, a fund presumed to be a complying superannuation scheme under section 24 of the *Superannuation Guarantee (Administration) Act 1992*, or a fund presumed to be a complying superannuation fund under section 25 of the act.

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Agreement that stipulates the superannuation fund to which contributions are to be made on behalf of the employees.<sup>34</sup>

2.45 Choice of Fund has been a central part of the government's agenda since 1996. The main arguments in support of choice of fund arrangements are that it gives employees greater control over their superannuation savings, a greater sense of ownership of these savings and increases the competitiveness of the market for superannuation products.<sup>35</sup> The committee acknowledges and supports the principle of people having the freedom of choice of both superannuation fund and investment options, provided appropriate prudential regulation and licensing is in place 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. It is still early in the new regime's operation and, as yet, there is no evidence that operational costs have been reduced.

### ***Demise of defined benefit funds***

2.46 Superannuation funds normally fall in to one of two categories: defined benefit (DB) funds and defined contribution (DC) funds, which are widely known in Australia as accumulation funds. Defined benefit schemes calculate the final benefit based on a predetermined formula unrelated to the fund's performance, which may take into account a members' final salary, length of service and salary averaged over a period or at a particular point in time, rather than the investment earnings of the fund. Thus if market returns decline to leave the fund in deficit, the fund's sponsor is required to contribute money to ensure members receive their promised entitlements. Under the SIS Act, DB funds are required to undergo periodic actuarial reviews to maintain its assets at an adequate level to meet the obligation to pay current and future benefits.<sup>36</sup> In Australia, DB funds have generally been managed by individual companies and employers through their corporate pension fund, or as public sector schemes.

2.47 Defined benefit funds stand in stark contrast to accumulation funds where the end benefit is made up of contributions to the funds plus any investment earnings less costs. Under this arrangement, the financial risk of retirement saving is borne by the fund member. Employers simply pay an agreed amount into their employee's fund.

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34 *Superannuation ready reckoner: taxation and preservation rules for 2004-05—revised* February 2005, Research Brief no. 10, 2004-05, 14 February 2005, pp. 9-10.

35 *Superannuation Legislation Amendment (Choice of Superannuation Funds) Bill 2002*, Bills Digest No. 31 2002-03, Department of the Parliamentary Library, pp. 13-14.

36 APRA, 'Adoption of International Financial Reporting Standards', *Discussion Paper*, 24 February 2005, p. 17. See also Guest, R. et al, 'Employees' Choice of Superannuation Plan: Effects of Risk Transfer Costs', *Journal of Industrial Relations*, Vol 46, No. 1, March 2004, p. 2.

This regular payment fully discharges the employer's obligations, while fund members receive a final amount determined by their contributions plus investment earnings.<sup>37</sup>

2.48 The Treasury submission made the following important distinction between the structure and funding arrangements of DB and accumulation funds (which are reflected in the SIS Act):

As a defined benefit entitlement is not linked, or only partially linked, to market reforms, it is the employer-sponsor who bears the financial risk of ensuring the fund is able to meet its benefit promises to members. In contrast, an accumulation fund pays benefits to members equal to the amount accumulated in the fund in respect of the member, being made up of contributions and investment earnings, less fund expenses. Consequently, members directly bear the investment risks in accumulation funds, including the risk of investment losses.<sup>38</sup>

2.49 Of the two, accumulation funds are overwhelmingly the most common variety in operation in Australia in 2007. However, this was not the case three decades ago. Prior to the major reforms of the superannuation system beginning in the mid-1980's, superannuation schemes covered only 45 per cent of employees and were primarily of the defined benefit variety.<sup>39</sup> In 1982-83, 82 per cent of superannuation fund members were in defined benefit funds. By 1999-00 the figure had dropped to 14 per cent.<sup>40</sup>

2.50 The gradual decline in the number of defined benefit funds is shown in Table 1. The committee notes that the closure of many defined benefit schemes and their replacement with accumulation-style funds is a global trend.<sup>41</sup> According to a Parliamentary Library research paper:

Demographic trends and reforms to pension systems towards the privatisation of pension savings, will most likely reinforce the creation of more and larger pools of investment capital that will be managed via [accumulation] schemes.<sup>42</sup>

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37 Guest, R. et al, 'Employees' Choice of Superannuation Plan: Effects of Risk Transfer Costs', *Journal of Industrial Relations*, Vol 46, No. 1, March 2004, p. 2.

38 Treasury, *Submission 55*, p. 17.

39 Allan Borowski, 'The revolution that faltered: two decades of reform of Australia's retirement income system', *International Social Security Review*, vol.58, no.4, 2005, p. 46.

40 Productivity Commission, *Review of the Superannuation Industry (Supervision) Act 1993 and Certain other Superannuation Legislation*, Report No.18, 10 December 2001, p. 19.

41 Recruitment and Consulting Services Association and the Professional Associations Superannuation Limited, *Submission 56*, p. 11.

42 Leslie Nielson, *Benchmarking Australian Superannuation Regulation and Practice*, Department of the Parliamentary Library, Economics Section, May 2007, p. 23.

**Table 1: Changes in Superannuation Benefit Structure - September 2003 and June 2005**

Benefit Type	Number of Funds 2004	Number of Funds 2006	Assets 2004 \$ bn	Assets 2006 \$ bn
Accumulation	290,659	327,214	388.7	511.9
Defined Benefit and Hybrid entities	529	299	180.3	356.3

Source: APRA Annual Superannuation Bulletin June 2004 & June 2006

2.51 The committee notes that the decline is likely to be a long term trend. Evidence before the committee pointed to a number of possible reasons for the trend. The complexity associated with DB funds has been accompanied by the problem of unfunded liabilities accrued during periods where market returns fall short of benefits owed to members. While this was not a pressing issue for defined benefit funds during the 1990's, many were abruptly reminded of the financial risk they were bearing when market returns declined after the technology bust and global instability that characterised the early part of the decade. An analysis of many corporate funds' unfunded liabilities in 2003 found that:

In the 1990's, defined benefit funds largely took care of themselves, with strong returns allowing many companies to have contribution holidays during the bull market. But this has changed over the past four years, with sharp falls in nearly all major stockmarket indexes.<sup>43</sup>

2.52 There was considerable concern at the time that many companies would have to contribute a proportion of their profits to rectify fund deficits. In March 2003 APRA released the results of its survey on the health of DB funds. It concluded that while larger funds remained generally solvent, the capacity of a majority of smaller funds to meet their present and future obligations had declined by more than ten per cent. APRA encouraged employer sponsors to, where applicable, 'contribute to their funds at the actuarially recommended rate'.<sup>44</sup> Although subsequent buoyant market conditions alleviated those immediate solvency concerns, the prospect of uncertainty over business profits when markets are trending down is a strong disincentive for companies to manage defined benefit funds.

2.53 Other reasons were also identified. The cost of obtaining a licence in terms of time, resources and funding, together with the progressive adoption of new international financial reporting standards for APRA-regulated reporting entities from 1 July 2005, have been driving the recent decline in the number of DB funds. While these are comparatively new factors, other likely reasons for the decline in DB funds in Australia have been identified:

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43 John Stensholt and James Thomson, "The super 'time-bomb'", *Business Review Weekly*, vol.25, no.14, 17-23 April 2003, p. 15.

44 APRA, 'APRA releases results of defined benefit superannuation funds survey', *Media Release*, 27 March 2003.

- the recent trends in public finance has been to reduce long term liabilities. This may have led to the reduction in the number of public sector defined benefit schemes;
- the move away from corporate defined benefit schemes is part of modern corporate management practice. Corporate sponsors recognise that the provision of superannuation benefits is not part of their 'core' business – it is less trouble to outsource this part of their activities;
- the introduction of Australian rules that immediately vest superannuation benefits in a member means that corporations cannot use the availability of superannuation benefits as a means of ensuring an employee's loyalty. Thus, corporate superannuation benefits have become far less important as a factor in a corporations' industrial relations, and
- accumulation funds are relatively simple to operate and the size of their benefits is very easy for members to understand.<sup>45</sup>

2.54 As previously noted, through its Super Choice regime the government has encouraged a competitive and efficient market in superannuation fund products by allowing consumers almost unlimited choice in the marketplace. In theory, the investment risks borne by accumulation fund members should be compensated by the ability to choose funds that offer the most suitable arrangements and/or best returns. Consequently, superannuation funds that perform below a reasonable standard will be uncompetitive when held against better performers.

### **Benchmarking international practice**

2.55 The committee's term of reference number 13 refers to benchmarking Australia against international practice and experience. During the early stages of the inquiry, the committee sought assistance from the Parliamentary Library and requested that it prepare a research paper on this issue, with particular attention to be given to two of the most relevant overseas jurisdictions: the United Kingdom (UK) and the United States (US). The paper provided background on a number of issues in the terms of reference by comparing relevant features of the retirement income systems of Australia, the UK and the US.<sup>46</sup>

2.56 While the paper found that Australia's superannuation industry overall compares favourably with that of the UK and the US, it emphasised there are no agreed international benchmarks on the structure of superannuation systems and their

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45 Leslie Nielson, *Benchmarking Australian Superannuation Regulation and Practice*, Department of the Parliamentary Library, Economics Section, May 2007, p. 24.

46 A final version of the paper was presented to the committee in May 2007 and subsequently made available as a public document on the committee's inquiry website: Leslie Nielson, *Benchmarking Australian Superannuation Regulation and Practice*, Department of the Parliamentary Library, Economics Section, May 2007.



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regulation and supervision. The committee notes that APRA has been working closely with OECD working groups on the international stage in the development of guidelines on regulation, supervision, investment practices and other related subjects from which international benchmarks may eventually emerge.<sup>47</sup>

2.57 The APRA submission described the regulator's contribution, as a foundation member of the International Organisation of Pension Supervisors (IOPS), to the development of the IOPS Principles of Private Pension Supervision.<sup>48</sup> These principles were approved by the organisation's governing membership at its annual general meeting held in December 2006. According to the final document:

The main objective of private pension supervision is to promote the stability, security and good governance of pension funds and plans, and to protect the interests of pension fund members and beneficiaries. Pension supervision involves the oversight of pension institutions and the enforcement...and promotion of adherence to compliance with regulation relating to the structure and operation of pension funds and plans, with the goal of promoting a well functioning pensions sector. In addition, achieving stability within the pension sector is an important part of securing the stability of the financial system as a whole.<sup>49</sup>

2.58 There are currently ten IOPS principles of private pension supervision. These include:

- objectives: national laws should assign clear and explicit objectives to pension supervisory authorities;
- independence: pension supervisory authorities should have operational independence;
- adequate resources: pension supervisory authorities require adequate financial, human and other resources;
- adequate powers: pension supervisory authorities should be endowed with the necessary investigatory and enforcement powers to fulfil their functions and achieve their objectives;
- risk orientation: pension supervision should seek to mitigate the greatest potential risks to the pensions system;
- proportionality and consistency: pension supervisory authorities should ensure that investigatory and enforcement requirements are proportional to the risks being mitigated and that their actions are consistent;

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47 APRA, *Submission 51*, p. 12.

48 The IOPS describes itself as an independent international body representing those involved in the supervision of private pension arrangements.

49 The International Organisation of Pension Supervisors, *IOPS Principles of Private Pension Supervision*, 7 December 2006, Istanbul, Turkey, p. 2.

- consultation and cooperation: pension supervisory authorities should consult with the bodies they are overseeing and co-operate with other supervisory bodies;
- confidentiality: pension supervisory authorities should treat confidential information appropriately;
- transparency: pension supervisory authorities should conduct their operations in a transparent manner; and
- governance: the supervisory authority should adhere to its own governance code and should be accountable.<sup>50</sup>

2.59 APRA submitted that these principles could facilitate benchmarking across different superannuation systems, at least within countries that are members of IOPS.<sup>51</sup> To facilitate this process, APRA is currently involved in a joint IOPS and OECD working party project on private pensions relating to the development of licensing guidelines.

### ***Committee view***

2.60 The committee notes that no attempt has been made by the government to benchmark Australia against international practice and experience. It is difficult to compare Australia's compulsory, privately managed and prudentially regulated system with the wide variety of systems operating in other countries. The Parliamentary Library research paper found that when comparing the Australian industry and regulation with that of the UK and the US: 'due allowance has to be made for the significant differences between the retirement savings systems of each country'.<sup>52</sup> One particular area of difficulty relates to retirement savings products and the methods of charging for those products. The Association of Superannuation Funds of Australia (ASFA) submission noted that in some countries the remuneration of financial planners is bundled into the fees attached to retirement savings products, while in others the two are quite separate.<sup>53</sup>

2.61 There are currently no internationally agreed standards upon which to draw any firm conclusions. According to the Treasury submission, the difficulty arises in part because of '...the diversity of policy objectives, regulatory structures and historical development and the absence of internationally agreed standards upon which to base any international comparison'.<sup>54</sup> This is arguably the main reason why

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50 The International Organisation of Pension Supervisors, *IOPS Principles of Private Pension Supervision*, 7 December 2006, Istanbul, Turkey.

51 The IOPS currently has around 60 members and observers representing approximately 50 countries and territories worldwide.

52 Leslie Nielson, *Benchmarking Australian Superannuation Regulation and Practice*, Department of the Parliamentary Library, Economics Section, May 2007, p. 3.

53 ASFA, *Submission 68*, p. 42.

54 Treasury, *Submission 55*, p. 24.

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the committee received almost no evidence that addressed term of reference 13. The committee assumes that Treasury monitors international trends, especially through OECD processes. However, the government rightly relies on ASIC and APRA as the main regulators to focus on international trends and activities, which they do.

2.62 The committee notes APRA's view that there is nothing in the prudential regulation of superannuation in Australia that is contrary to trends in best practice that are beginning to emerge internationally, as reflected for example in the recently agreed IOPS principles. Treasury noted that Australia's 'three pillar' retirement income system is consistent with the multi-pillar design approach that the World Bank has endorsed as a more efficient and effective approach to deliver retirement incomes.<sup>55</sup> However, the committee believes that comparing Australia's superannuation system favourably with other systems is no excuse for the government or industry to discount international trends in superannuation policy. While few would contest the widely held 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.

2.63 ASFA highlighted one area where Australia does not score very highly on the international rankings, that being retirement income adequacy:

Australia's retirement income system delivers relatively good protection against poverty, but current and even prospective replacement rates of income and expenditure in retirements are not high by international standards. There would appear to be both scope and need to boost effective net contribution rates to superannuation so as to improve outcomes.<sup>56</sup>

2.64 The Parliamentary Library research paper also identified areas of Australia's retirement savings system that do not compare favourably with the equivalent UK and US systems. These include:

- the provision of retirement advice by advisers closely associated with the superannuation fund provider;
- superannuation fund trustees' responsibility to prudently manage fund assets in an environment of member investment choice;
- possible restrictions on employing foreign nationals on a temporary basis, arising from Australia's lack of a social security and superannuation agreement with other countries, notably the UK;
- whether Australian standards for a fit and proper person to be a superannuation fund trustee should include standards relating to prior or future convictions for offences against another person, or offences in relation to prohibited substances;

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55 Treasury, *Submission 55*, p. 24.

56 ASFA, *Submission 68*, pp. 41-42.

- whether the trustees of a superannuation fund should have the obligation to report missing contributions from an employer, instead of the ATO discovering this omission during its routine operations or having the matter raised by the affected individuals; and
- whether those trustees who only hold a Registrable Superannuation Entity licence should be required to maintain an appropriate internal dispute resolution mechanism, in the same way that trustees who are holders of an AFS licence are required to do.<sup>57</sup>

2.65 The committee is surprised that there has apparently not been any empirical research undertaken by either the industry or APRA on the superannuation systems of other countries. While the industry as a whole views Australia as setting international benchmarks in superannuation and retirement incomes policy, no attempt appears to have been made at an academic, regulatory or industry level to assess the retirement income systems of other countries in detail, and identify any features that might be relevant to Australia's superannuation system.

### **Recommendation 3**

**2.66 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, and that the findings be made publicly available. The aim is to develop a framework for benchmarking Australia's superannuation system against international best practice.**

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57 Leslie Nielson, *Benchmarking Australian Superannuation Regulation and Practice*, , Department of the Parliamentary Library, Economics Section, May 2007, pp. 3-4.