Chapter 5

Capital requirements and other safety issues

5.1 A major theme in evidence during the inquiry was the importance of trustees addressing operational and governance risks before a fund experiences major difficulties that could threaten members' savings. The industry has placed a great deal of emphasis on prevention, which is a major premise of the current superannuation trustee licensing system. In addressing the issue of safeguarding superannuation savings, this chapter specifically addresses the following terms of reference:

- whether uniform capital requirements should apply to trustees (1);
- the relevance of Australian Prudential Regulation Authority (APRA) standards (3);
- whether funding arrangements for prudential regulation are adequate (10); and
- the level of compensation in the event of theft, fraud and employer insolvency (14).

5.2 Under the umbrella theme of safeguarding superannuation, this chapter also addresses two issues that are not formally part of the inquiry's terms of reference but were raised in evidence by a number of witnesses: identifying the owners of lost or unclaimed superannuation accounts and facilitating portability and the consolidation of multiple member accounts.

Capital requirements and unit pricing

5.3 Capital requirements have long been a feature of the prudential regulation of certain financial products, including for superannuation fund trustees that have a public offer entity licence under the SIS Act. Under section 29DA of the act, the capital requirements for licensees of registered superannuation entities (RSEs) can be met in a number of ways, including direct holding of the net tangible assets; approved guarantee; a combination for approved guarantee and net tangible assets; or meeting the custodian requirements. Trustees that hold an RSE licence of the non-public offer class are not subject to these, or any, specific capital conditions.

5.4 Section 29DA states specifically that to grant a licence, APRA must be satisfied that:

- the corporation's net tangible assets (NTA) is equal to or greater than the amount prescribed by regulations ($5 million);
- the corporation is entitled to an approved guarantee that is equal to or greater than the amount prescribed by regulations ($5 million);
- the corporation meets the requirements through a combination of net tangible assets and an approved guarantee ($5 million); or

- the corporation meets its requirements through custody of the fund's assets.

5.5 At the end of the RSE licensing period (30 June 2006), of the 121 applicants that had been granted a public offer or extended public offer licence, 41 met the capital requirements under the SIS Act with $5 million NTA, with a further 10 meeting the requirements by means of an approved guarantee of $5 million. The remainder met the capital requirements indirectly by having all assets held by custodial arrangement.[1]

5.6 According to advice issued by APRA, the capital requirements for the trustees of public offer funds have a threefold purpose:

- they provide some financial resources to act as a buffer against risk;
- they evidence a commitment on the part of the trustee to its superannuation business; and
- they act as an incentive to the trustee to manage the entity well.[2]

5.7 The issue of capital requirements for superannuation funds has been considered by the government on a number of occasions since the introduction of the SIS Act, most recently by the Superannuation Working Group (SWG) established in 2001 to inquire into options for improving the safety of superannuation. The issues paper released by the government gave three reasons for requiring all trustees to satisfy a capital requirement:

- to demonstrate financial substance and long-term commitment by the trustee;
- to have money at risk to provide an incentive to the trustee to manage the fund well; and
- to act as a ready buffer against operational or governance risk that may arise.

5.8 The SWG recommended that, as a part of the licensing process, APRA should determine the amount of resources, including capital, required to be held by each trustee to address the operational risks relevant to that trustee.[3] The government response supported, in principle, a risk-sensitive framework for the holding of capital to address operational risk. The government also indicated that it supported the retention of the status quo for capital requirements. This decision was, and continues to be, accepted by the industry as the appropriate response. The committee notes that

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1 APRA, *Submission 51*, p. 5.

2 Australian Prudential Regulation Authority, Superannuation guidance note SGN 150.1, *Capital requirements – net tangible assets*, July 2004, p. 5.

3 *Options for Improving the Safety of Superannuation*, Report of the Superannuation Working Group, Recommendation 16 'capital adequacy'.

the government's decision to maintain the status quo was based on the view that the need for capital in the future may be substantially reduced as other factors come into play to address operational risks.[4]

5.9 The committee notes that in its response to the SWG recommendations the government indicated that it would revisit the issue of capital requirements once the impact of the trustee licensing and risk management reforms could be assessed.[5]

5.10 The APRA submission noted that the licensing and risk management reforms introduced under the *Superannuation Safety Amendment Act 2004* included an operating standard that required all licensed trustees to have adequate resources, including adequate financial resources.[6] During the licensing period APRA assessed compliance with this operating standard by taking into account the nature, scale and complexity of each trustee's operations. According to APRA:

> …adequacy of financial resources was assessed on a risk basis tailored to each license applicant, rather than on a standard basis. In general, APRA maintained its previous practice of requiring public offer trustees that use the custodian option to meet the capital requirements of the SIS Act to have a minimum of $10,000 liquid assets available.[7]

Should uniform capital requirements apply to trustees?

5.11 Evidence before the committee demonstrated that 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 a number of industry funds made the valid point that the introduction of the APRA licensing regime imposed a uniform and comprehensive system of risk management across all superannuation funds and required all funds to demonstrate the adequacy of their resources.[8]

5.12 Industry Funds Forum (IFF) argued that the SIS Act requirement to hold an RSE licence and the standards applicable to trustees prescribed under Part 3 adequately address the main areas of risk faced by trustees. These operating standards include the following categories:

- 'fit and proper' test to ensure superannuation funds are managed and overseen competently by honest and trustworthy individuals;

4 Investment and Financial Services Association, *Submission 60*, p. 9.

5 Treasury, *Submission 55*, p. 10.

6 APRA, *Submission 51*, p. 5.

7 APRA, *Submission 51*, p. 5.

8 See, for example, Industry Super Network, *Submission 77*, p. 5.

- risk management strategies to identify, monitor and manage risks concerning governance and decision-making processes; outsourcing arrangements changes in legislation applicable to an RSE licensee; and risks of potential fraud and theft;
- outsourcing arrangements from the terms of the contract through to monitoring, auditing and reporting obligations; and
- adequacy of resources to ensure that an RSE licensee has adequate resources to undertake its licensed activities.[9]

5.13 The Association of Superannuation Funds of Australia (ASFA) submission made the strongest case against uniform capital requirements by drawing attention to international experience and the negative effect uniform capital requirements would have on large sections of the superannuation industry:

> Extending identical and onerous capital requirements to all superannuation or pension funds is virtually without precedent anywhere in the OECD and fundamentally undermines superannuation provided as an employment benefit. This would primarily impact on the corporate fund sector, and to a lesser degree on industry funds. Any dramatic changes in this area could signal the death knell for such funds. In particular it would significantly push up compliance costs for those funds. Such a suggestion seems at odds with the Government's current concern over reducing the regulatory burden on business.[10]

5.14 SuperRatings also made the valid point that no amount of capital backing would be sufficient to protect members' assets in the event that a board of trustees without adequate safety procedures sought to wilfully defraud members, or sustained a significant loss through inadequate safeguards.[11]

5.15 The peak association representing self-managed superannuation funds did not support the extension of either uniform or minimum capital requirements to SMSFs. The Self-Managed Super Funds Professionals' Association of Australia (SPAA) submission argued:

> SPAA considers little would be achieved by requiring a trustee of a self-managed superannuation fund to satisfy minimum capital requirements. The provisions of the SIS Act applying to the operation of a self-managed fund include rules which ensure the safety of the member's balances and provide significant disincentives and penalties for any breaches of the legislation.[12]

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9 IFF, *Submission 73*, pp. 11-12.

10 ASFA, *Submission 68*, p. 7.

11 SuperRatings, *Submission 49*, p. 3.

12 SPAA, *Submission 70*, p. 5.

5.16 The Institute of Chartered Accountants in Australia suggested that APRA develop guidelines clarifying the method of determining the quantum of the reserve and the rules governing the operation of the reserves.[13]

5.17 The submission from MLC argued that consideration should be given to removing the custodial option for trustees on the grounds that custodial arrangements have the potential to compromise the ongoing viability of the fund and the investments to members. This is because a requirement for all fund assets to be held by the custodian: '…does not provide security or consumer protection for losses resulting from operational risk, trustee malfeasance or incompetence'.[14]

5.18 The Mercer Human Resource Consulting submission summarised a range of options to cover or partially cover the potential costs involved in adverse events that are totally outside the control of the trustee. However, it noted that not all of the cost mitigation options are available to all funds. Each fund would need to consider the most appropriate option when designing its risk management strategy. Of particular interest to the committee was the argument by Mercer that it would be inappropriate to concentrate on capital requirements as a potential remedy as it does not provide a total or practical solution:

> We consider that extending the capital requirements to all funds would result in:
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> - The demise of corporate funds, and possibly some industry funds, with a consequent reduction in competition;
> - SMSFs becoming non-viable with a further reduction in competition.[15]

5.19 A lone voice in support of uniform capital requirements was provided in evidence by the Association of Financial Advisers (AFA). The submission stated without qualification that association members hold the view that trustees of all commercial funds should be required to have the same capital adequacy requirements of their trustees:

> …all providers of superannuation funds that are classed as public offer funds should be required to have the same standards of capital adequacy…The need to have funds [to] provide capital reserves for the management of operational risk should be paramount.
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> No discrimination is to be allowed as this may cause a future failure and thus undermine public confidence in the regulator and the whole program of retirement savings.[16]

13 Institute of Chartered Accountants, *Submission 43*, p. 2.

14 MLC, *Submission 83*, p. 4.

15 Mercer Human Resource Consulting, *Submission 71*, p. 5.

16 AFA, *Submission 62*, p. 3.

Unit pricing

5.20 Evidence from MLC drew the committee's attention to unit pricing as a significant function undertaken by most retail and commercial superannuation funds and the role that capital can have in the event that unit pricing errors occur. Within the financial services industry a collective investment is often 'unitised'. In the case of superannuation funds, this means that a member's holdings are expressed in the number of units held in the fund and the cumulative value of those units. Unit pricing essentially refers to the method of fund valuation which, according to MLC:

> …is used for the equitable apportionment of investment earnings or losses in accumulation funds. It is used to calculate the unit price for members entering the fund and members realising their investment at the point of exit.[17]

5.21 MLC told the committee of a 2001 unit pricing error involving several national wealth management companies that remained undetected for a number of years.[18] Apparently, the companies made unit price reductions which, in association with other unit pricing errors, adversely affected a large number of investors. The companies entered into an enforceable undertaking with ASIC and APRA and put in place comprehensive investor compensation and remedial action programs.[19] MLC told the committee: 'It was a small error that affected a large number of accounts, which was quite a big problem in the end—over $70 million, which was made good back to the investors from the shareholders'.

5.22 MLC argued that the $5 million minimum capital adequacy pales into insignificance in the context of a unit pricing error of this magnitude: 'With respect to the $5 million figure, quite frankly, if you end up with a unit pricing error of the magnitude of ours, it is not going to get you anywhere'.[20] Mr Tucker told the committee of a reported $750 million of unit pricing errors in the superannuation industry over the last few years, all of which have occurred in retail funds with the capital backing of institutions.[21]

Committee view

5.23 The committee accepts that trustee licensing requires trustees to have prudential risk management strategies and risk management policies on 'fit and proper' persons, outsourcing and adequacy of resources. Trustees are also required to develop

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17 MLC, *Submission 83*, p. 6.

18 MLC Nominees, National Australia Financial Management and National Australia Superannuation Pty Ltd

19 MLC, *Submission 83*, p. 8.

20 Mr Steve Tucker, Chief Executive Officer, MLC, *Committee Hansard*, 7 March 2007, Sydney, p. 76.

21 Mr Steve Tucker, Chief Executive Officer, MLC, *Committee Hansard*, 7 March 2007, Sydney, p. 75.

and maintain detailed risk management documentation. The committee notes further that the policies and risk compliance frameworks adopted by trustees are subject to auditing and regular review by APRA.

5.24 The committee accepts the widely held view in the industry that capital requirements can be a crude mechanism for preventing operational and governance risks. While it is important that all funds adopt a strong risk management process and strategy, the committee recognises that there are various ways for funds to manage risk and mitigate the potential costs from any adverse events that may occur. The committee is of the view that a number of regulatory developments over recent years have made uniform capital requirements unnecessary, at least in the short term. In particular, the introduction of a universal licensing regime has significantly raised the barrier to entry for trustee entities.

5.25 The policies and procedures adhered to by trustees have provided APRA with information to identify and mitigate operational and governance risks that is more precise and timely than the existence of capital. This view also appears to be consistent with international debates concerning the role of capital in financial services regulation. As already noted by ASFA and others, any attempt to impose a 'one size fits all' capital requirement on superannuation funds is inconsistent with choice and competition as it may result in a further rationalisation of superannuation funds. In relation to the last point, the committee notes in particular the concerns expressed by industry funds and corporate funds. It accepts the view that it would be very difficult for employer organisations and unions to satisfy anything other than a nominal capital requirement.

Recommendation 12

5.26 The committee recommends that superannuation funds improve the disclosure of their capital backing and/or the risk protection of capital and that APRA assist the industry with the development of disclosure of risk management systems to protect superannuation investors' funds.

5.27 The committee is concerned by the magnitude of unit pricing errors involving retail funds with the capital backing of institutions, which has reached a total of $750 million. As the MLC experience has demonstrated, unit pricing errors can remain undetected for a number of years and have significant adverse consequences for large number of investors. However, the committee notes that according to APRA the number and size of new unit pricing errors had declined considerably over the past 12 months, and those that did occur were corrected at no cost to investors.[22] According to APRA, since the release of the joint ASIC/APRA good practice guide on unit pricing in November 2005 there has been a reduction in the frequency and size of unit pricing errors.[23]

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22 Greg Bright, 'APRA "warns" funds on capital adequacy after unit pricing errors hit $750m'.

23 Mr Ross Jones, Deputy Chairman, APRA, *Committee Hansard*, 7 March 2007, Sydney, p. 94.

5.28 The committee notes that the accuracy and method of fund asset valuation is critical to the integrity of the investment process and ultimately investor confidence. Submissions from MLC and IFSA made a strong case for a mandatory unit pricing methodology.[24] Fund choice and portability rules have contributed to inter-fund membership flows, which increases the need for funds to accurately price members' savings. According to IFSA:

> [unit pricing] is the most equitable structure as an investor gets credited with the actual investment amount earned on their assets. It also gives the investor certainty as to what their account balance is at any point in time.[25]

5.29 Chief Executive Officer of MLC, Mr Steve Tucker, also told the committee that unit pricing is the best model to ensure that equity and fairness remain features of the superannuation system. Therefore, all public offer superannuation funds should operate under a daily unit pricing structure:

> We think that unit pricing – and it is quite clearly agreed with by APRA and ASIC in their best practice guides – is the best way to ensure equity amongst members coming and going from funds. The move to a unit pricing system allows people to come in and leave at the right price every day. It is a fair, if not slightly complex, way of making sure that there is equity amongst members.[26]

5.30 APRA told the committee there is currently an industry-wide trend towards unit pricing.[27]

5.31 The joint ASIC and APRA good practice guide on unit pricing made the following positive comments on the benefits of unit pricing:

> …unitisation provides a more direct link to movements in asset values, investment income and transaction costs, as unit process are calculated at, or closer to, the time unit holders acquire or dispose of products. Unit pricing avoids transferring investment returns between entering, leaving and ongoing unit holders (generations of unit holders). That is, unitisation may be perceived as providing more transparency and resulting in more equitable treatment of beneficiaries and fund members…[28]

5.32 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. Unit pricing should be mandatory, at least for all public offer superannuation funds.

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24 MLC, *Submission 83*, pp. 5-7; IFSA, *Submission 60*, pp. 39-40.

25 IFSA, *Submission 60*, p. 39.

26 Mr Steve Tucker, MLC, *Committee Hansard*, 7 March 2007, Sydney, p. 74.

27 Mr Ross Jones, Deputy Chairman, APRA, *Committee Hansard*, 7 March 2007, Sydney, p. 94.

28 *Unit pricing: Guide to good practice*, Joint ASIC and APRA guide, November 2005, p. 18.

Recommendation 13

5.33 The committee recommends that the government mandate a uniform unit pricing methodology for all public offer superannuation funds, including any transitional arrangements. The committee also recommends that where unit pricing is utilised improved operational risk parameters are identified and implemented by APRA.

APRA standards

5.34 APRA does not have the power to make prudential standards in relation to the superannuation industry. The government previously rejected a recommendation by the Superannuation Working Group that APRA be given this power. The government considered that APRA could achieve all its objectives within the existing regulatory framework once the trustee licensing regime was implemented.[29] The APRA submission stated that its guidance is 'non-binding'. Its aim is to:

> …assist trustees of APRA-regulated superannuation entities to comply with legislative requirements and, more generally, to encourage prudential good practices in relation to specific issues. APRA has an active program to ensure that this material is updated to reflect changed requirements flowing from amended legislation and/or to provide further guidance in response to industry developments.[30]

5.35 As previously noted, SIS regulations included several operating standards that establish minimum standards in relation to key aspects of a trustee's operations. The operating standards are generally regarded in the industry as appropriate and necessary for the proper and prudential management of superannuation funds. Thus there was widespread agreement with the Australian Institute of Superannuation Trustees' view that the standards provide a strong framework for the protection of members' superannuation:

> The range of Operating Standards set the framework within which a superannuation fund trustee must operate its business and to set appropriate parameters and guidelines on such matters as how members can contribute to superannuation, gain access to superannuation, the payment and preservation of benefits and other operational matters of superannuation funds, including investments, solvency of Trustees, and the winding up of superannuation funds.[31]

5.36 In addition to the operating standards, APRA provides general guidance to superannuation funds on how it interprets and administers relevant legislation. This guidance is provided in the form of superannuation circulars, frequently asked

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29 Mr Steve Tucker, Chief Executive Officer, MLC, *Committee Hansard*, 7 March 2007, Sydney, p. 74.

30 APRA, *Submission 51*, p. 7.

31 Australian Institute of Superannuation Trustees, *Submission 79*, p. 13.

questions, superannuation guidance notes and other information for RSE licensees. The Treasury submission noted that the government's Regulation Taskforce recommended that APRA review its guidance material '…to ensure it provides effective guidance on good practice in meeting regulatory requirements and does not impose additional or inflexible regulatory requirements'.[32] The government has referred this recommendation to APRA for its consideration.

Criticism of APRA's guidance

5.37 APRA's standards and circulars are generally regarded in the superannuation industry as providing useful guidance in clarifying APRA's interpretation of the law and how they will regulate it. As noted in the previous chapter, there are major concerns in the industry over APRA's legal interpretation of the role of trustees in a member investment choice situation, as contained in Superannuation Circular II.D.1. Criticism of APRA's guidance, however, extends beyond the specifics of member investment choice.

5.38 A number of organisations expressed concern about how APRA's guidance is used in practice, the lack of consultation with industry and the apparent lack of coordination and consistent interpretation between the regulators (on the issue of regulatory overlap see the discussion in Chapter 3). The Law Council of Australia submission argued that, in the experience of its members, the SIS Act is worded in such a way as to give APRA a de-facto standard making power that amounts to imposing new legislative requirements. Specifically:

> We endorse the principle of APRA assisting trustees in managing prudential risk but believe that APRA's powers have been, in effect, inappropriately extended through the standard-making power so that APRA can achieve through non-legislative means results which are not expressly allowed or intended by the SIS Act or by announced Government policy.[33]

5.39 SuperPartners agreed arguing that APRA's superannuation guidance notes go further than the scope of the regulations they purport to interpret:

> For instance, the APRA Outsourcing Standard states an outsourcing agreement should provide that breach of confidentiality may result in penalties or termination of the agreement, in contrast with the Regulations which state that the agreement must provide for confidentiality.[34]

5.40 SuperPartners expressed concern that the prescriptive detail of APRA's standards disguises the fact that they operate as de facto regulations and, therefore, as preconditions to obtaining an APRA licence. As previously noted, while APRA stated that its guidance material has no legal status or legal effect, sections of the industry believe that compliance with APRA's guidance is expected for a licence application to

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32 Treasury, *Submission 55*, p. 12.

33 Law Council of Australia, *Submission 76*, p. 3.

34 SuperPartners, *Submission 67*, p. 9.

succeed. The Investment and Financial Services Association (IFSA) submission noted that APRA's guidance notes and circulars are effectively administered as law, but without parliamentary scrutiny.[35]

5.41 The Law Council of Australia agreed, noting that anecdotal evidence suggests that some funds have viewed the prospect of their licence being withheld or revoked unless they accept APRA's guidance, as an 'implied threat':

> Quite often what happens is that once you have your licence and you are up and running, there are times where funds may very well take a view that they do not agree with the approach being taken by APRA, but nonetheless they do not believe that they can use members' money to contest that view, so quite often they acquiesce and go along. While this is not intended to be a criticism of APRA…it is just that in certain areas I think that they need to have greater dialogue with the industry prior to actually producing and introducing guidelines and about how they actually apply them.[36]

5.42 On the issue of dialogue between APRA and the industry, the IFSA submission noted that the law does not require any meaningful consultation to occur and, even where it does, there is no effective mechanism to ensure that industry concerns are properly considered by APRA. This is why IFSA recommended a more effective consultative process to be spearheaded by a new advisory body, the Financial Services Committee. IFSA also recommended that there should be greater emphasis and reliance on the development of industry codes of practice and self-enforcement and on the analysis of the costs and benefits of regulatory proposals.[37]

5.43 There is some industry support for there to be statutory recognition of APRA standards, most likely in the form of operating standards under existing powers. SuperPartners argued that this has become necessary in order to control APRA's powers and to achieve consistency with subordinate legislation.

Funding prudential regulation

5.44 Unlike insurers or approved deposit taking institutions that are governed by regulators funded out of consolidated revenue, superannuation trustees (as well as other financial sector organisations) pay for their own regulation via a levy provided for under the *Superannuation Supervisory Levy Imposition Act 1998*. The levy is set with the aim of covering the operational costs of APRA and certain market integrity and consumer protection functions undertaken by ASIC and the ATO. The remainder of APRA's costs are recouped through direct fees and charges. The levy is determined by the Minister for Revenue and Assistant Treasurer after consultation with various representative industry bodies.

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35 IFSA, *Submission 60*, p. 10.

36 Mr Terry Brigden, Member, Superannuation Committee, Law Council of Australia, *Committee Hansard*, 7 March 2007, Sydney, p. 55.

37 IFSA, *Submission 60*, pp. 10-11.

5.45 According to Treasury, there are a number of methods for recovering the costs of prudential supervision from industry. These range from individualised fee-for-service arrangements to broad based funding from the financial sector as a whole, ignoring the individual costs of regulating particular industry sectors or institutions. Apparently, the last review of levies found problems with both these models and industry did not support them.[38] It is widely recognised that the current levy arrangements have their genesis in recommendations of the Wallis Inquiry, which proposed that charges be made by the regulators for services directly provided and general expenses be recovered by way of a levy on relevant financial institutions.[39]

5.46 Levies for different industry sectors are based on the total value of the assets of regulated institutions. According to Treasury:

> Total assets are considered to be correlated with the level and cost of prudential supervision by the regulator, an institution's capacity to pay, the impact on the system of its possible failure and the institution's stake in a stable financial system.[40]

5.47 The current financial sector levy rates were released by the Assistant Treasurer and Minister for Revenue in July 2006 after a process of industry consultation on a paper entitled 'Proposed Financial Sector Levies for 2006-07'. It was noted at the time that due to the significant structural changes experienced by the superannuation industry, the transitional levy arrangements that applied to superannuation entities in 2005-06 would be extended in 2006-07.[41] The committee notes that Treasury and APRA are currently examining the long term effect of the decline in the number of superannuation funds on prudential regulation and financial sector levies, with a view to consulting with industry on these issues.

5.48 The estimated funding for superannuation supervision for 2006-07 is $46.2 million, comprising $34.2 million for APRA funding, $8.2 million in costs relating to work undertaken by ASIC and $3.8 million in costs relating to work undertaken by the ATO. This amount represents 43.9 per cent of the total levy.[42] APRA told the committee at a hearing that its share of the levy in terms of ongoing supervision costs is less that three cents per week per member account compared to administration costs incurred by the superannuation industry in 2006 of $1.85 per week per member account.[43]

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38 Treasury, *Submission 55*, p. 21.

39 ASFA, Submission 68, p. 36.

40 Treasury, *Submission 51*, p. 22.

41 Treasury, *Submission 51*, p. 10.

42 Australian Institute of Superannuation Trustees, *Submission 79*, p. 34.

43 Mr Ross Jones, Deputy Chairman, Australian Prudential Regulation Authority, *Committee Hansard*, 7 March 2007, Sydney, pp. 93, 103.

Are current funding arrangements equitable?

5.49 An important issue that came to light during the inquiry is that following the introduction of RSE licensing the number of superannuation trustees to fund the levy has reduced considerably. This has given rise to different views among industry players as to the equity or otherwise of the current funding arrangements. Some existing funds believe they are bearing a larger proportion of the costs of prudential regulation. REST superannuation, for example, argued in its submission that the average account of its members is approximately $6000, which means the fund is bearing a greater financial burden than before.[44] Hence there is some support in the industry for a more equitable distribution of regulatory costs based on the size of individual funds.

5.50 REST Superannuation told the committee the fund paid APRA in excess of $300,000 in 2005 for the purpose of prudential regulation. It argued that:

> …there is potentially a better way that is partly asset test because assets are some surrogate for risk. But there should also be a specific levy or assessment of risk so that there is incentive for trustees to be governed appropriately. So instead of larger funds subsidising the cost of supervision of smaller funds, there is a failure to differentiate between high-risk and low-risk funds. With the introduction of RSE licensing, the number of trustees available to fund the levy has vastly reduced. This means that a small number of existing funds are bearing a larger proportion of the costs.[45]

5.51 Others in the industry agreed by highlighting the inequity in funding arrangements that work against the interests of the larger funds. The submission from Industry Funds Forum argued for a fundamental rethink of funding arrangements to remove cross subsidies from the calculation of the levy in which larger funds subsidise the cost of regulating smaller funds. This would be achieved by shifting the focus of how the levy is calculated from the size of a fund to an assessment based on risk and compliance, a move that appears consistent with the evidence from REST. Calculating the levy based partially on an assessment of risk was also supported in evidence by Equipsuper, IFSA and the Corporate Superannuation Association.[46] According to Industry Funds Forum:

> Funds that do comply and can demonstrate an ongoing commitment to compliance should be rewarded rather than penalised for their efforts. IFF recommends that the Government consider a more innovative approach, which not only facilitates supervision but also promotes compliance. For example a reduction of the levy for funds which meet appropriate

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44 REST Superannuation, *Submission 54*, p. 8.

45 Mr Damian Hill, Chief Executive Officer, REST Superannuation, *Committee Hansard*, 24 October 2006, Sydney, p. 58.

46 Equipsuper, *Submission 30*, p. 16; IFSA, *Submission 60*, p. 29; Corporate Superannuation Association, *Submission 28*, p. 11.

> compliance obligations, can demonstrate a compliance culture and effective controls. Those that fail to measure up conversely would incur a higher levy based on a level of risk that their non-compliance creates[47]

5.52 Mercer Human Resource Consulting made a similar case by highlighting the significant costs involved in regulating the industry, especially for large superannuation funds. It argued that the annual levy can exceed $150,000 which can significantly exceed the cost of directly monitoring that particular fund. A high levy will result in either higher fees or lower investment returns for fund members.[48] The Mercer submission recommended that the cost of regulation should be largely borne from consolidated revenue.

5.53 Others in the industry argued in favour of the status quo on the grounds that the current framework is equitable and ensures accountability, efficiency and transparency. The Australian Institute of Superannuation Trustees argued that basing the current funding framework on the assets of a superannuation fund is fair because larger funds should pay more than small funds. It argued further that:

> The levy, as it stands, arguably encourages superannuation fund Trustees to perform better, as they know that any increase in regulator activity will need to be funded, and as the levy is paid directly by the Trustees, there is some incentive to perform in accordance with the Regulator's expectations…[49]

Committee view

5.54 The committee has some sympathy for the view that the levy should reflect the actual costs incurred in supervising superannuation entities regardless of asset size. However, the committee accepts the counter-argument that it would be impractical for the levy to be set in accordance with the amount of time APRA spent regulating particular funds. Nor does the committee support using the risk profile of funds as a criterion for setting the levy. While the committee accepts there is some cross subsidisation by the larger funds trustees, it believes that the current method of funding arrangements for prudential regulation ensure transparency, relative equity and ease of administration by APRA. The committee therefore does not believe that another review of the levy issue is warranted at this point in time. Overall, the committee accepts 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.

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47 Industry Funds Forum, *Submission 73*, p. 39.

48 Mercer Human Resource Consulting, *Submission 71*, p. 23.

49 Australian Institute of Superannuation Trustees, *Submission 79*, p. 35.

Compensation arrangements

Theft and fraud

5.55 Under current arrangements, Part 23 of the SIS Act enables the trustee of a superannuation fund to apply to the Minister for a grant of financial assistance where the fund has suffered loss as a result of fraudulent conduct or theft that leads to 'substantial diminution of the fund leading to difficulties in the payment of benefits'. The minister has discretion to compensate up to 100 per cent of a loss suffered due to fraudulent conduct or theft. According to Treasury, it has been long-standing government policy to cap financial assistance at 90 per cent of the eligible loss. It argued that the capping of financial assistance is consistent with international best practice, has the support of industry, reduces the risk of moral hazards and promotes an equitable outcome between members suffering losses:

> The 90 per cent cap is intended to assist in ameliorating the risks of moral hazard by providing incentives for superannuation fund members to ensure that their fund is being managed in a prudent manner. The Government considers that the provision of financial assistance for the full eligible loss would not reflect that fact that members bear the full risks of their superannuation investments and would undermine the financial incentives for superannuation fund managers to monitor and take an active interest in the management of their retirement savings.
>
> The capping of financial assistance for eligible losses is consistent with international best practice and with other major Government assistance programmes in Australia. Financial assistance schemes overseas generally limit the compensation paid through either a percentage or a monetary cap.[50]

5.56 The cost of providing financial assistance under Part 23 of SIS is recouped through an industry levy imposed on all superannuation funds eligible for financial assistance.

5.57 APRA plays a key role in the provision of compensation under Part 23. Its main role is to provide advice to the minister in relation to an application for assistance, and to administer the *Superannuation (Financial Assistance Funding) Levy Act 1993* and the Superannuation (Financial Assistance Funding) Levy and Collection Regulations 2005. The submission from APRA noted that as of September 2006 it had administered three separate collections for the recovery of amounts paid out as financial assistance under Part 23: 'A total of $44.7 million in compensation payments has been recovered from industry over three financial years (2001-2002 to 2002-2004)'.[51]

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50 Treasury, *Submission 55*, p. 25.

51 APRA, *Submission 51*, p. 13.

5.58 In considering the current arrangements for compensation several important questions arise: what circumstances should be covered by a compensation scheme? Who should fund a superannuation compensation system? And, what level of compensation should apply? The submission from Trowbridge Deloitte argued that coverage by the Superannuation Protection Account should include negligence, catastrophic claims or investment performance. It also suggested that the cover could be extended by defining or interpreting 'substantial diminution' to mean any catastrophic losses that exceeded a particular percentage of the fund's assets. However, it noted that such extended coverage could become particularly expensive to administer and subject to moral hazards: '…all stakeholders might become more lax knowing that they would be compensated. The costs would be likely to fall on well managed funds'.[52]

5.59 There is some concern in the industry that the current levy arrangements discriminate against members in funds that have to meet the cost of any compensation. It is for this reason that some organisations recommended that the financing of compensation should be met from consolidated revenue rather than by other better managed funds. Mercer, for example, stated that

> With the reduction in the number of funds, a failure in one large fund could result in a very significant level of compensation being funded by members of other funds. This itself could lead to a loss of confidence where members of funds that have performed well are potentially significantly reduced.[53]

5.60 There does not appear to be much support in the industry for either establishing new levies as a tool for compensation in the event of theft and fraud, or introducing any broader compensation arrangements for institutional failure. Industry Funds Forum argued that compensation levies are inappropriate and by their very nature regressive because they have the greatest effect on the members who have small account balances and are therefore least able to afford it.[54] The IFSA submission made a strong case against the introduction of any explicit industry funded guarantee scheme. It argued that schemes of this nature result in increased costs to consumer; reduce standards by underwriting inefficiency and complacency; increase the risk of failure; result in more claims on a fund because customers have less incentive to be risk averse; and diminish trust in the industry.[55]

5.61 The ASFA submission advocated replacement of the 90 per cent compensation cap with a sliding scale based on the losses of individual members within a fund. It suggested that under such a scheme compensation would be paid as follows:

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52 Trowbridge Deloitte, *Submission 80*, p. 9.

53 Mercer Human Resource Consulting, *Submission 71*, p. 30.

54 Industry Funds Forum, *Submission 73*, p. 45.

55 IFSA, *Submission 60*, p. 36.

- 100 per cent compensation for losses incurred on amounts up to an individual member's tax-free threshold;
- 80-90 per cent compensation for losses incurred on amounts between an individual member's tax-free threshold and an individual member's pension Reasonable Benefit Limit (RBL); and
- no compensation paid for losses incurred on amounts above an individual member's pension RBL.[56]

Employer insolvency

5.62 There is currently no mechanism to enable a fund to notify its members in the event that an employer fails to pay its superannuation liabilities due to the state of their business, including in the event of employer insolvency.[57] A fund is only able to legally pursue any unpaid superannuation contributions where there is a written agreement between the trustee and the employer sponsor requiring the payment of contributions and specifying when such contributions should be made.[58]

5.63 SuperRatings argued that members should be better educated to regularly monitor their employer's quarterly contributions. The research firm further argued that in the event of employer insolvency: '…employee superannuation contributions should rank ahead of all creditors as they are effectively part of an employee's income which should have already been earned and paid'.[59]

5.64 There is also some support within the industry to mandate that employer contributions be paid monthly and not quarterly.[60] According to the Australian Council of Trade Unions (ACTU), the requirement for Superannuation Guarantee contributions to be paid into a fund every quarter is an improvement:

> …the reality is that when an employer becomes insolvent the likelihood is that employees' superannuation contributions will be in arrears, together with members' own voluntary contributions and/or any additional amounts payable through salary sacrifice.[61]

5.65 AIST told the committee that monthly payments will help guard against employer insolvency and the loss of members' retirement benefits:

> Implementing a legislative provision to require employers to pay their SG contributions monthly will help prevent the loss of members' retirement

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56 ASFA, *Submission 68*, p. 44.

57 SuperRatings, *Submission 49*, p. 11.

58 Industry Funds Forum, *Submission 73*, p. 46.

59 SuperRatings, *Submission 49*, p. 11.

60 Employers are required to pay their Superannuation Guarantee (SG) contributions on behalf of employees with 28 days of the end of the quarter in which the SG contributions are due.

61 ACTU, *Submission 72*, p. 17.

> benefits and guard against the risk of employees losing their superannuation entitlements due to employer insolvency.[62]

5.66 The Australian Chamber of Commerce and Industry (ACCI) submission noted that better data is needed on the extent to which an employer's superannuation obligations are not met as a result of insolvency. While it suggested that some of this data may be available through the operation of the General Employee Entitlements and Redundancy Scheme (GEERS), ACCI does not support any extension of GEERS to cover unpaid superannuation contributions.[63]

5.67 This view was not supported by submissions from Mercer, the ACTU and ASFA, which argued that GEERS should be broadened to cover unpaid superannuation contributions, not only because superannuation contributions are compulsory, but also because they form a basic part of employees' overall remuneration.[64] The ASFA submission also supported granting additional powers to the ATO to pursue outstanding SG payments for employees and former employees, and placing restrictions on the Deeds of Company Arrangement being used to reduce employee superannuation entitlements.[65]

Committee view

5.68 The committee accepts that it is impossible for the superannuation industry, which has now surpassed $1 trillion in savings, to completely insulate itself against the fraudulent activities of unscrupulous operators. The Managing Director of SuperRatings conveyed this message directly to the committee when he said the superannuation industry is going to attract fraud and malpractice because of the volume of assets under management: 'People will get ripped off, no matter what regulations you have in place'.[66] This is why member protection on the whole is reliant on diligent trustees, effective prudential regulation and workable compensation mechanisms. While the extent of losses stemming from illegal behaviour is reported to have been as low as 1 per cent over a 13 year period, compensation in the event of fraud or theft is widely regarded as critical component of a compulsory savings system which, in turn, is an important part of the national economy. As the submission from Mercer noted:

> If there was no compensation in the event of a major superannuation fund fraud, then there could be a major loss of community confidence. This

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62 Australian Institute of Superannuation Trustees, *Submission 79*, p. 43.

63 ACCI, *Submission 66*, p. 8.

64 Mercer Human Resource Consulting, *Submission 71*, p. 31; ACTU, *Submission 72*, p. 18.

65 ASFA, *Submission 68*, p. 43.

66 Mr Jeff Bresnaham, Managing Director, SuperRatings, *Committee Hansard*, 7 March 2007, Sydney, p. 14.

> would be undesirable from the point of view of the Government, members, employers and the general community.[67]

5.69 The committee accepts the view that the compulsory nature of superannuation demands a high degree of community confidence in the integrity of the system. Confidence is guaranteed in part by the existence of robust mechanisms to deal with instances of theft and fraud. This is why the committee believes that the existing compensation arrangements under Part 25 of SIS for theft and fraud are an appropriate regulatory response to criminal activity of this nature. The committee is comfortable with the current levy arrangements, the amount of which is determined after an event involving theft or fraud has occurred. The committee believes that the amount of any so-called 'pre-event' levy would be difficult to determine and could potentially impose an unacceptably high cost on the industry.

Recommendation 14

5.70 The committee recommends that the government examine whether employee salary sacrifice should be paid by the employer at a minimum at the same time as the compulsory SG, and whether employer SG contributions should be paid on the pre-salary sacrifice income.

5.71 The committee notes the arguments for monthly rather than quarterly payments to help guard against the loss of employee entitlements in the event of employer insolvency, and for GEERS to be extended to cover superannuation entitlements. However, the committee believes it is premature to make any recommendations that address these specific concerns. The committee has previously formed the view that better data on the extent to which employers are unable to meet their superannuation obligations as a result of insolvency is needed, including in circumstances where there were insufficient company records. In its March 2007 report on draft insolvency laws, the committee voiced concern that some employers who are entitled to recover money under GEERS, including superannuation entitlements, are unable to do so because the company did not keep any paperwork. The committee supported practical and cost-effective measures to improve record keeping and the level of information that is provided to administrators. It also recommended that the government compile data on the incidence of employees who are unable to receive their entitlements under GEERS due to a lack of company records. The committee has not changed its view on these matters.[68]

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67 Mercer Human Resource Consulting, *Submission 71*, p. 30.

68 Parliamentary Joint Committee on Corporations and Financial Services, *Corporations Amendment (Insolvency) Bill 2007 [Exposure Draft]*, Report, March 2007, p. 20.

Portability and exit fees

Portability

5.72 Over recent years, the portability and choice of superannuation fund for investors has been extended. Portability of superannuation refers to the ability of superannuation fund members to roll over and transfer existing superannuation benefits from one regulated superannuation fund, approved deposit fund or retirement savings account to another, whereas choice of superannuation fund refers to the ability of employees to choose the fund to which their employer directs future superannuation guarantee contributions.

5.73 The committee notes that the government has introduced further measures to simplify the transfer of superannuation benefits between funds and improve arrangements in respect of lost and unclaimed superannuation.[69] Two initiatives will make it easier for individuals to transfer superannuation benefits between funds and take more control of their superannuation, and reduce processing delays.

5.74 Funds are required to use a new standardised form for portability to facilitate the transfer of benefits between funds. This includes standard proof of identity requirements to ensure uniformity between funds. The maximum time period in which this transfer must occur has been reduced from 90 days to 30 days. The 30 day period commences after a person has provided all necessary information. Trustees are required to follow up incomplete requests for transfers promptly. These new arrangements came into operation on 1 July 2007.

5.75 Notwithstanding these new measures, the committee heard evidence in relation to a number of shortcomings with the consolidation process. Much of the discussion on portability during the committee's hearings focused on the ease and speed of the process as it occurs between funds. The difficulty for investors of obtaining good and affordable advice about consolidating funds was a particular concern of witnesses. Mercer Human Resource Consulting submitted that:

> [W]hen somebody has three or four funds, and says, ‘I want to bring them all together; which fund should I go to?’ a piece of advice is needed there. I think that advice is not currently being given because it is too hard to get, too expensive, and the financial planners are not interested.
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> …
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> It is like, what does insurance mean? Does this fund offer insurance? It is a more contained piece of advice, and the appropriate disclosure is, ‘I am not doing a full financial statement of advice to you; instead your scope of job was, “Which fund of these three should I merge into?” I have looked at

69 Tax Laws Amendment (Simplified Superannuation) Bill 2006 and related bills.

> these three funds, which has taken me an hour, because they are all on my database; I will charge you $50 for it, or $100, but not $700.'[70]

5.76 The committee expressed particular interest in the ease and speed with which accounts are able to be consolidated. It was submitted that some funds were not releasing funds as quickly as they were able to, as a result of administrative formalities imposed by the fund or deliberate stalling. In many cases, fund members gave up trying to get proceeds released altogether. During a hearing, a committee member commented:

> The lesson is that employee relationships and the ability to get information out of them is limited. I am saying to you as corporates, you want to hang on to other people's money, and it is not helping them move it. They know that if they put enough impediments, people will just give up and the money stays. This is a classic corporate activity. It happens all over the world. Companies develop systems to ensure that they get a bit of cash flow through paying people late or whatever. It is well known in the business world. I am saying that it is happening in portability with respect to forms and the way in which people operate.[71]

5.77 No witnesses reported having direct knowledge of these practices, although it was acknowledged that verification procedures could be time consuming.[72] Rainmaker Information commented that part of the reason funds may take time in releasing funds was the lack of clear regulatory guidance about the procedures to be followed when doing so:

> What we also need is regulation that facilitates it, because one of the things the trustees will say is that, 'Well, the rules say that as the trustee we have got to make sure we do the right thing,' and some trustees genuinely believe that if someone rings up and says, 'I'm with low-cost fund X and I want to move my money to master trust Y,' they go, 'Hang on. That doesn't sound right. I've got to make sure that Alex is trying to do the right thing here.' So they go into this process of, 'How do we know Alex is making the right decision?'[73]

5.78 Choice summarised a research paper that investigated the high cost to consumers of multiple accounts.[74] It submitted that consumers were insufficiently aware of the higher costs involved in maintaining multiple accounts. However, the barriers to consolidation did not stop there:

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70 Mr David Knox, Principal, *Committee* Hansard, 25 October 2006, Melbourne, p. 77.

71 Senator Andrew Murray, *Committee Hansard,* Melbourne, 25 October 2006, p. 81.

72 See, for example, Mr John Ward and Mr David Knox, Mercer Resource Consulting, *Committee Hansard*, 25 October 2006, Melbourne, pp. 80-81.

73 Mr Alex Dunnin, *Committee Hansard*, 24 October 2006, Sydney, p. 88.

74 *The Super Secret: How Multiple Accounts Cost Consumers Billions*, A Choice Research Report, November 2006.

> The overwhelming evidence that came in from our research was that there were significant problems with transferring superannuation and consumers not knowing the requirements on them to transfer their superannuation. It became very much a hit and miss sort of thing. They would get 90 points of identification as proof of identification to be able to consolidate their super into one area and then the super fund would not tell them what they needed for the additional 10 points. It is that level of communication that became a problem. Also it is a paper based portability system. It takes a lot of time to do. We cannot see why, in this day and age, it cannot be done real-time and online as a much more efficient process. I think that efficiency of portability will make it easier for consumers to take charge and then be able to consolidate their super. [75]

5.79 IFSA agreed that consolidation could be made easier, and not just in the case of superannuation. While acknowledging that superannuation and life insurance regimes do contain mechanisms enabling product rationalisation, IFSA argued that the respective regimes tend to involve lengthy and costly processes that in fact inhibit product rationalisation. It called for the continued reform of the financial services industry through an extension of financial services reform legislation. The aim would be to introduce a single legislative mechanism to assist financial product providers to maintain modern infrastructure systems to enable their operations to meet the needs of investors.

Exit Fees

5.80 Exit fees have long been identified as a possible barrier to consolidation. In a 2003 report the Senate Select Committee on Superannuation noted strong disagreement over the effect of exit fees on portability, but saw virtue in limiting such fees to the reasonable administrative cost and redemption cost of a rollover/transfer. The committee suggested a role for the Superannuation Complaints Tribunal in keeping exit fees in check.[76]

5.81 During the inquiry the committee heard some evidence of excessive exit fees being levied on accounts, particularly where investors are seeking to leave a relatively old financial product.[77] Choice called for the removal of all exit fees, on the basis that they undermine competition.[78] Representatives from Treasury submitted that, while there was not active consideration being given to their abolition, exit fees were a

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75 Dr Nicholas Coates, Senior Policy Officer, Choice, *Committee Hansard*, 7 March 2007, Sydney, p. 42.

76 Senate Select Committee on Superannuation, *Draft Superannuation Industry (Supervision) Amendment Regulations 2003 and draft Retirement Savings Accounts Amendment Regulations 2003,* September 2003, p. 86.

77 See, for example, Mr Graham McDonald, Chairperson, Superannuation Complaints Tribunal, *Committee Hansard*, 5 March 2007, Melbourne, p. 4.

78 Dr Nicholas Coates, Senior Policy Officer, Choice, *Committee Hansard*, 7 March 2007, Sydney, p. 42.

matter of ongoing discussion in the banking sector overseas. Treasury went on to argue that some exit fees are more justifiable than others:

> There are some exit fees, not just in Australia per se but in another jurisdiction, that are not related to any real administrative cost. There are other exit fees which may well be related to administrative cost or penalties incurred by the bank when you unwind certain investments—and these probably genuinely need to be paid. I have not done the work on this yet. I accept that it is an important issue, but I think you have to ask those questions in the super area as well—whether there are investments being unwound that justify different penalties over time.[79]

Committee view

5.82 The committee is concerned at anecdotal evidence of some funds deliberately slowing the process of super transfer and encourages APRA to be conscientious in enforcing the new 30 day limit on funds transfers.

5.83 The committee is convinced of the potential for exit fees to undermine competition and discourage portability. The committee believes that exit fees that bear no apparent relationship to exiting a fund should be banned.

Recommendation 15

5.84 The committee recommends that exit fees that exceed the administrative cost of transfer should be prohibited prospectively.

Safeguarding lost superannuation

5.85 Superannuation can become 'lost' when employees change jobs and forget about their old account. When a superannuation fund has not received a contribution from a member for more than two years, or when two written communications have been returned to the fund, the fund must notify the ATO which will then place the name of the account's owner on the Lost Members Register (LMR). The money in such funds is not transferred to the ATO nor any other central fund. It remains with the original super fund or may sometimes be transferred to an Eligible Rollover Fund (ERF) operated either by a super fund or another organisation. Any superannuation monies that are not claimed by the time the consumer reaches age 65 or dies is transferred to state and territory government agencies as unclaimed money.

5.86 According to ATO figures, there were 5,675,510 lost accounts valued at $9.7 billion at 30 June 2006.[80]

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79 Mr Chris Legg, General Manager, Financial System Division, Treasury, *Committee Hansard*, Canberra, 20 November 2006, p. 23.

80 Australian Tax Office, *2005-06 Annual Report*, p. 91.

5.87 The ATO has improved the operation and effectiveness of the current lost member arrangements. A number of measures will be phased in to improve the operation of the LMR and reduce the number of people listed on it, including:

- rationalising existing processes to identify actual lost members including redefining lost members to exclude inactive accounts and more comprehensive reporting from funds;
- allowing accounts of less than $200 to be paid tax free;
- an extensive letter campaign to lost members commencing in 2007 with lost account reviews to be conducted over a four year period through a combination of phone calls and letters;
- establishing a web-based tool through which members can locate their lost accounts using their TFN; and
- by 2009-10, enabling members to electronically request consolidation of their accounts through the ATO website.[81]

Eligible Rollover Funds

5.88 A super fund may transfer the balance of an account into an ERF where it is low, usually about $1000 or less, and where the conditions for super to be considered 'lost' have been met. Where an owner is unable to be contacted, balances of more than $1000 may also be sent to an ERF.

5.89 ERFs were devised as a temporary holding mechanism until a low balance could be rolled over to another super account. While one of the primary purposes of ERFs is to preserve the balance with minimal or no principal reduction due to management fees, information published by Choice indicates that some funds are charging fees of up to 2 per cent. This is considered excessive, given that ERF investment strategies are typically very conservative, and effectively capital guaranteed in their risk profile.[82]

5.90 APRA's most recent June 2006 statistics indicate that total assets in ERFs have risen from $0.7 billion to $5.5 billion since June 1996, increasing as a proportion of total superannuation assets from 0.3 per cent to 0.6 per cent.[83] For the period from June 1997 to June 2006 ERFs achieved an average rate of return of 5.4 per cent. This

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81 The Association of Superannuation Funds of Australia Limited, *Aggregate and individual costs of multiple superannuation accounts*, February 2007, p. 22.

82 *The Super Secret: How Multiple Accounts Cost Consumers Billions*, A CHOICE Research Report, November 2006, pp.25-26, drawing on *Eligible rollover fund disclosure campaign, Final Report*, ASIC, January 2004.

83 APRA, *Insight*, 'Celebrating 10 years of superannuation data collection', Issue 2 2007, Table 1, p. 18.

was less than all other sectors except the retail fund sector, which had 5.3 per cent average returns. The industry-wide average was 6.7 per cent.[84]

5.91 ASIC's November 2006 report titled 'Monitoring superannuation fees and costs' indicated that the costs associated with ERFs are higher than all other types of funds except retail funds, which exhibited the highest average costs.[85]

5.92 Choice cited a report by ASIC that reported most ERFs were not actively looking for the owners of the money they held, and that disclosure details were inadequate. IFF noted that ERFs have no obligation to contact members or transfer a member's accumulated benefit into their active account. It submitted that this is a perverse incentive for ERFs to sit on account proceeds. IFF called for trustees to proactively facilitate consolidation of members’ accounts, and for the establishment of a centralised ERF, managed by the government, for the purposes of receiving all lost member accounts.[86]

The Lost Member Register

5.93 The ATO has maintained a register of lost members since 1996. Choice argued that application of the rules regarding lost super by funds is inconsistent, and that partly as a result of this, the data held by the ATO on the LMR is not as good as it could be. These problems make it harder for lost super to be matched with its owner.[87]

5.94 IFF submitted that the ATO needs to more actively and continuously manage the LMR, supported by education and automatic electronic consolidation processes. IFF did not support the reporting of member details to the LMR for members who have been inactive for more than two years where the fund has a current address on file. Where this is the case the member may be inactive, but clearly is not lost and should remain with the fund. This would assist in reducing the number of members treated as lost and ensure that the LMR is used appropriately.

5.95 The need to exercise care in categorising an account as 'lost' was also raised in evidence. REST Superannuation reminded the committee that:

> … [M]any inactive members know where their super is and are actively not making the choice to move it. They do not consider themselves lost, so they

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84 APRA, *Insight*, 'Celebrating 10 years of superannuation data collection', Issue 2 2007, Table 1, p. 41. Figures are for entities with at least $100 million in assets.

85 ASIC, *Report 84*, 'Monitoring superannuation fees and costs', November 2006, p. 10. The figures ASIC reported assume a balance of $50,000 invested in the balanced option with $5,000 invested for the year.

86 IFF, *Submission* 73, p. 48.

87 *The Super Secret: How Multiple Accounts Cost Consumers Billions*, A CHOICE Research Report, November 2006, p. 27.

> are surprised when they are categorised as lost in many circumstances. That is responsible for potentially overstating what is a lost member.[88]

Tax file number matching

5.96 At present, about 76 per cent of super accounts carry with them a nominated tax file number (TFN).[89] The committee heard evidence that in some cases the ATO has matched an individual with a TFN, but the individual's super statement is submitted by the fund without the number being listed. Currently, privacy legislation stipulates that the ATO is unable to provide that number to the fund. The ATO submitted that it was working with the Privacy Commissioner on a solution to the problem:

> There are quite specific provisions that enable us to provide that information to the relevant agencies. We just do not have the legislation that would allow us to provide the information to the funds without breaching privacy … [W]e are looking at whether we can do it in a more streamlined manner. We can certainly write to people and say, 'We've got your tax file number, your fund does not appear to be aware of it and you should let them know.' I would like to do it in a way, as I said, that maximises the number so that we do not necessarily have to rely on people coming back to us. My aim would be to get permission to say, 'If you don't contact us, we'll provide the number to your fund.'[90]

5.97 The utility of the ATO being permitted to pass on TFNs to funds was also acknowledged by Mercer Human Resource Consulting and REST, who summarised the scenario thus:

> That would be the optimal situation to ensure less work for all in the industry, including the tax office, and less downside for members in the withholding of tax.[91]

5.98 In May 2007, the Minister for Revenue and Assistant Treasurer, the Hon. Mr Peter Dutton MP, announced that the Tax Office will be writing to 1.85 million people whose superannuation fund or retirement savings account does not have their TFN. The letter will advise that the Tax Office will provide their TFN to their superannuation fund or retirement savings account:

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88 Mr Damian Hill, Chief Executive Officer, REST Superannuation, *Committee Hansard*, 24 October 2006, Sydney, p. 70.

89 Ms Raelene Vivian, Deputy Commissioner, ATO, *Committee Hansard*, 20 November 2006, Canberra, p. 41.

90 Ms Raelene Vivian, Deputy Commissioner, ATO, *Committee Hansard*, 20 November 2006, Canberra, pp. 46-7.

91 Mr Damian Hill, Chief Executive Officer, REST Superannuation, *Committee Hansard*, 24 October 2006, Sydney, p. 69.

> People who receive these letters don't have to do anything. The ATO is simply letting them know they will provide their TFN to the super fund or retirement saving account for them.
>
> Anyone who would prefer the ATO didn't do this, needs to contact them within 28 days from receiving the letter.[92]

5.99 In addition to this recent initiative, the ATO informed the committee of some of the strategies being used to increase the number of super accounts for which TFNs are recorded. It reported that user testing had taken place to understand why TFNs were not being passed by employees to employers, or to funds. One of the most significant reasons is also one of the simplest:

> One of the reasons we have looked at—and this will be changed—is that, at the moment, when an employee starts with an employer, they have to quite specifically elect that the employer has the right to pass the tax file number through. That will be changed so the employee will have to specifically elect that they do not want their tax file number passed through. So, with new employees, that should see a reduction in the number of tax file numbers not passed through.[93]

5.100 The committee was mindful that new government measures from 1 July 2007 will result in 'no-TFN' accounts being taxed at top marginal rate of 46.5 per cent, compared with 15 per cent concessional tax for accounts for which a TFN has been supplied. Representatives from the ATO reported that they were keen to match as many no-TFN accounts as possible, and that an active campaign to employers was being planned:

> We have already started having some very early discussions with some of the clearing houses that provide the funding and some of the payroll providers that the employers use. If, through the way that they do their business, it becomes a natural part of it to provide the tax file number, that will give us the greatest leverage. In terms of the compliance, I suppose the second part is that we would take compliance action against the employers. We are still working out what our compliance strategies might be. But some of the early thinking is that we would start to do some analysis across the member contribution statements, look at where you have large numbers of tax file numbers not coming in from certain employers and use that to guide our risk strategies.[94]

5.101 REST outlined some of the measures his fund had used to get TFNs for members:

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92 'Tax Office to provide tax file numbers to super accounts', Press Release No. 063, 16 May 2007.

93 Ms Raelene Vivian, Deputy Commissioner, ATO, *Committee Hansard*, 20 November 2006, Canberra, p. 44.

94 Ms Raelene Vivian, Deputy Commissioner, ATO, *Committee Hansard*, 20 November 2006, Canberra, p. 51.

> We have a number of programs that we have been employing, including allowing members to quote that via their product disclosure statements when they first join. Not all members initially fill out a product disclosure statement. Their employer may join them but the employer may not provide the tax file number. We have recently undertaken an exercise where we approached 6 000 of our members who paid a voluntary contribution last year and had not provided us with a tax file number. We provided opportunities via the phone system, via the web and via paper to respond and give us their tax file number. These members, as a result, if they do not give us a tax file number would not be eligible for any co-contributions going forward, despite making voluntary contributions and being otherwise eligible. Just over 2 000 of them provided their tax file number out of 6000.[95]

Committee view

5.102 The committee believes that new government measures will help to reduce the number of super accounts not linked to TFNs, an outcome made especially pressing as tax penalties are levied on no-TFN accounts. The committee in particular welcomes the recent announcement that the Tax Office will be providing TFNs to superannuation accounts for nearly two million people.

5.103 There are 30 million superannuation accounts currently in existence, which is an average of 3 per employed person, including 5.7 million lost accounts containing almost $10 billion. This represents a major structural weakness and inefficiency in the superannuation system that requires an active default solution.

5.104 Nevertheless, 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.

Recommendation 16

5.105 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. The member should have the right to opt out of the system if they wish. This automatic system should not apply to a defined benefit account or an account with a significant exit fee.

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95 Mr Damian Hill, Chief Executive Officer, REST Superannuation, *Committee Hansard*, Sydney, 24 October 2006, p.68. A similar response was reported by Mercer Human Resource Consulting, *Committee Hansard*, Melbourne, 25 October 2006, p. 82.