CORPORATE SUPER ASSOCIATION

31 August 2006

Mr David Sullivan
Secretary
Parliamentary Joint Committee on Corporations and Financial Services
Suite SG.64
Parliament House
Canberra ACT 2600

By e-mail to corporations.joint@aph.gov.au

Dear Mr Sullivan

Inquiry into the Structure and Operation of the Superannuation Industry

The Corporate Superannuation Association welcomes the opportunity to participate in this inquiry.

We note that the inquiry's principal focus is the structure and operation of the *Superannuation Industry (Supervision) Act 1993* (***SIS Act***) and that there are 15 separate terms of reference.

We have provided some general comments below, followed by comment on certain points of reference that we believe to be of particular importance in the context. We have reserved more detailed comment on certain issues, such as investment choice and strategy and unit pricing.

General

Given that there is a focus on the SIS Act and that several terms of reference relate to the structure of trustees, we understand that the Committee may be considering the appropriateness of the SIS Act and related legislation as the principal regulatory legislation for superannuation in Australia, as well as whether it remains appropriate for funds to be governed under a trustee structure. These are useful matters to review at a time when major changes have affected the provision of superannuation support, and there is greater individual right, choice and responsibility associated with superannuation saving. In addition, the direct responsibility taken by employers for provision of superannuation structures has been waning and hence the traditional model is under question.

We note also that the most common collective investment structure adopted in Australia is a trust structure, adopted also by the majority of managed funds. One of the reasons this trust structure is adopted is the protection it provides to investors through quarantining the investment structure (the trust fund) from the other interests represented by an administering company operated for the profit of its owners (who are not

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generally the same as the investors). The use of a trust structure is suitable to assist in protecting the rights of investors by specifying the powers of the trustees, in particular the investment powers, and the rights and access of the beneficiaries to trust capital and income. Another reason for the use of a trust structure is the flexibility available in respect of investor rights and choices. This is discussed further below. The major difference between non-superannuation managed trust funds and superannuation funds is the SIS Act requirements. These are concerned with the robustness of the trustee structure and with ensuring that the invested assets are maintained appropriately, given the long-term structure of the liabilities and the dependence of the public on these funds for support at a time of life when the beneficiaries will be at their most vulnerable and without other substantial means of support. We see it as essential that these provisions be preserved in legislation regulating superannuation.

Alternative investment structures

An investment company (without an interposed trust) can be used as an investment vehicle, with the interest in the underlying investments denominated in shares. There are significant costs and regulatory issues associated with the company structure, and further regulatory requirements would need to be added to address the issues of long term savings and access, currently addressed by the SIS Act provisions. An investment company is traditionally considered to be a suitable vehicle for a single investor or group with similar goals and agreement on strategy. For collective investment in an environment where the individual investors require some choice of investment, have differing time horizons and differing requirements for income and capital growth, a trust (as generally constituted under Australian law) is generally a more flexible investment vehicle than a company, with regular use of multiple different unit types allowing for access to different investment strategies and rights.

Another potential investment structure involves an account held with an entity (such as an RSA arrangement). We note that RSA accounts are regulated under a combination of provisions in the RSA Act related to preservation and access (modelled on equivalent SIS Act provisions), and other regulatory legislation related to the entity providing the account. The investment flexibility of an RSA is very limited because it can only be operated as an interest bearing deposit and is therefore not ideal for long term investment. Bank deposits exhibit similar investment problems. The providers of these deposit accounts do not have the flexibility to offer the returns consistent with investor exposure to underlying broad based investments. Hence the higher returns, consistent with broader exposure and risk, are absent.

Strengths of the existing model

We submit that the interests of members of a superannuation fund are better served by a trustee structure specifically directed to the interests of the beneficiaries/investors, and with the enhanced safeguards and retirement income focus provided by the SIS Act. The trust structure has served the interest of members and the employers wishing to provide retirement benefits to employees well over an extended period of

time. It is tried and tested and has delivered. It provides great flexibility in an environment where members may wish to adopt different investment choices. Additionally, the existing regulatory and fund management processes have already been built to operate in the trust environment. A wholesale move away from the current structure would result in increased costs, and there would need to be compensating identifiable benefits. We have not been convinced that there is an efficient alternative that provides equivalent investor safeguards.

In the context of an employer sponsored fund, the existing trustee model, as provided for under the SIS Act, provides exceptional safeguards for members' interests. These safeguards flow from the requirements for equal representation in the trustee of employer and member representatives, enabling the trustee board to work in a cooperative way to achieve a balance between employer and member interests and between different skill sets and perspectives. These safeguards are not effectively provided under a public offer model. Equal representation is emasculated in the public model and the trustee is not required to ensure that equal representation of all employer/employee groups persists in policy committees. Hence, a divide inevitably develops between the interests of the public offer trustee and those of the members and the sponsoring employers. This divide does not assist in restraining conflicts of interest between trustee and member groups, and the trustee is subject to pressures from its commercial owners which are not necessarily in harmony with the best interests of the superannuation members.

The fact that Australians are being driven more and more into the public offer arena does not mean that the model adopted for employer sponsored superannuation was inferior. It simply means that it is being lost because other regulatory pressures are driving costs to a level where the model cannot survive.

Comments on terms of reference

We have set out below some initial views based on the terms of reference, so far as we believe we can assist and so far as the terms raise matters of immediate concern to our organisation. We have not commented on all terms of reference at this time. We have approached the issues from the point of view of not for profit employer sponsored superannuation. That model demonstrates a high standard of governance as a result of the equal representation of employers and members, the full support and involvement by employer sponsors, the observance of the trust principles on which superannuation in Australia has been built, and the absence of a profit motive in those involved in running the fund.

1. Whether uniform capital requirements should apply to trustees.

Before considering the appropriateness of a capital requirement for trustees, it is important to reflect on the distinction between the trustee and the trust structure within which the superannuation benefits are held. The reason that trustees do not currently hold capital (in general, setting aside regulatory requirements) is that their role is to administer a trust fund. In the past, there has been no perceived need for capital for the

trustee as a separate entity, as the trustee has had no other function and has not, in the basic model, existed as an operating entity in itself. This remains the case in the simple employer sponsored not for profit structure generally adopted by stand alone corporate funds. In this context, we note that the traditional approach has been to use a combination of right of indemnity from trust assets (in respect of liabilities where the trustee has acted within its powers and without fault) and trustee liability insurance (to cover other situations).

We understand that the principal purpose of any proposed universal capital requirement would be to provide protection in the event of major systems failure or trustee error.

We acknowledge that these are potentially damaging events for trustees, but we question whether the quarantining of a prescribed capital amount is a necessary or sufficient remedy. We acknowledge that the responsibility for systems stability and backup lies in the hands of the trustee, and that the trustee is also ultimately responsible for striving to avoid major error. However, we believe that the robustness of systems and trustee review, the outsourcing to reputable suppliers, and the prevalence of insurance against major failure and error events are more effective as safeguards than the existence of a capital balance for use as a buffer. In fact, the existence of a capital sum and the ability to call on this could discourage or reduce rigorous attention to systems integrity, care with outsourcing agreements and arranging for outsourcing of risk by way of appropriate insurance cover.

Robust systems

Systems and safeguards against loss of data are acknowledged to be crucial and will have been documented as part of the APRA licensing process. We would expect that trustees would have full documentation of the systems used, comprehensive data backups in separate locations and full disaster recovery plans. We note that the high level of audit to which trustees are subject adds to the degree of internal control. Many funds will have an internal audit function of some sort. All are subject to an external financial and prudential audit, the licence conditions are audited together with the RMP & RMS, the latter being a prospective focus on management of key risks.

In the absence of such safeguards the existence of buffer capital would be inadequate, as not only would there be potential costs of reinstatement of systems, there would be potential for loss of information about the ownership of assets and the level and attribution of liabilities. This would lead to loss of capital through failure to identify assets and inability to confirm or contest entitlements claimed by members.

Outsourcing to reputable suppliers

A greater or lesser degree of outsourcing of functions is inevitable as all but the largest funds gain efficiencies from utilising specialist suppliers of services. Where substantial functions are outsourced, we

accept that the trustee remains liable for ensuring the integrity of the services provided. However, outsourcing a function should bring a degree of outsourcing of risk through sharing of responsibilities. As APRA has recognised, the key to the appropriate management of risk in an outsourcing arrangement lies in the contracts between the suppliers of services and the trustees. An appropriate agreement can minimise trustee risk, whilst an inadequate agreement can increase it. Again this is an important area reviewed under the licensing process and subject to ongoing scrutiny.

The use of custodians also minimises risk and is an alternative to financial capital.

Trustee insurance policies

The purpose of insurance is the spreading of risk over time and over entities, and in terms of equity to members we see this feature as being crucial. The occurrence of an uninsured catastrophic event places immediate heavy burdens on the members of the fund at the time of the occurrence, regardless that there may be a cash sum available to meet immediate expense. In contrast, if an event is insured, a small expense (insurance premiums) is incurred on a regular basis, the impact is felt on member accounts in a small measure over a long period, and thus greater equity between fund members is achieved over time.

We note that those of our funds that self-administer typically carry cover against systems failure, business interruption, and costs of disaster recovery. Those that outsource will as a matter of good practice review the adequacy of protection against such events in the service provider.

Relative risk in single corporate employer sponsored funds

We note that the degree of risk for trustees is significantly higher in the multi-employer environment than for the stand-alone employer fund. This is largely due to the nature of the relationships. The trustee of an stand alone corporate fund is familiar with the employer, the employer's business and the employees, and generally has excellent access and communication with the employer. This is reinforced by the trustee structure with a balance of employer and employee representatives. This leads to significant reduction of conflict and risk. This feature of stand alone funds has been appropriately recognised in the existing arrangements where the trustee is not required to have the capital backing required for approved trustees, and where there are separate classes of APRA licences and separate risk evaluation processes for trustees of single employer and multi employer funds.

Trustee concerns

In the context of the current structure of stand-alone corporate superannuation funds, to establish trustee capital would pose some significant problems. Access to members' assets, to provide buffer capital, could give rise to breaches of the trusts under which the funds typically are established, and certainly gives rise to

equity concerns as highlighted above. Use of employer-sponsors' capital is likely to cause business strain and may well lead to closure of funds.

Other potential reasons for minimum capital requirements

We understand that it is the operational risk aspect discussed above which is driving the current discussion of universal capital backing for trustees. For the sake of completeness, we have reviewed the other reasons for requiring capital which were put forward five years ago.

We note that, when Mr Joe Hockey promulgated the Safety of Superannuation Issues Paper late in 2001[1], the imposition of uniform capital requirements was canvassed as posing a potential effective barrier to entry for trustee entities, where there was at that time very little in the way of effective barriers to would-be trustees. We submit that the barrier has well and truly been raised through the universal licensing regime and that the trustee licensing and fund registration requirements currently in force were determined under a program of consultation, under which the proposal to impose capital requirements was rejected as doing little to increase integrity. Rather, it was determined that such a requirement would exclude certain viable trustee entities on grounds of absence of financial backing, rather than on appropriate grounds of integrity. Hence, mandatory minimum capital was determined to be inappropriate as such a barrier.

We are concerned that the matter of capital backing for trustees may also have been raised in part because of confusion about the function of superannuation funds and that of deposit taking institutions and insurance companies. We have appended a discussion of the nature of the liabilities of superannuation funds and the specific and distinct role of capital in banks and insurers (Appendix A).

Finally, it should be noted that:

(a) The present corporate model, which is similar to the industry fund model (but arguably more reliable) significantly out performs the for-profit trustees. There are number of reasons for this, but a trustee with capital is required to service that capital. Accordingly it seeks a fee in excess of the costs of running a fund. In some cases, this is reflected in a discrete fee paid to the trustee for its services. In other cases, the arrangement is not at all transparent and whilst the trustee may be said to be acting for no fee, it in fact engages related body corporates to provide services to the trustee for a fee which more adequately covers the cost of servicing the capital of the trustee.

1 Issues Paper, *Options for Improving the Safety of Superannuation,* issued by Joe Hockey, then Minister for Financial Services and Regulation, on 2 October 2001.

(b) If the uniform capital requirement were introduced, the not-profit trustee could not survive. This would have a significant impact on competition and will, in the short term, lead to significantly higher costs being borne by superannuation fund members.

(c) Given the consolidation in the industry and the size of the funds being managed, any meaningful capital requirement would have to be significant indeed. At the present level of $5 million is, in many cases, dwarfed by the funds managed by trustees in most cases. If a uniform capital requirement were to be introduced, to have any purpose other than to drive the not-for profit providers out of the market, the capital requirement would have to be on a level significantly higher than $5 million. If that were the case, it would be expected that only the major financial institutions would be able to support such a requirement.

It is submitted that the costs to superannuation fund members of introducing a uniform capital requirement will be significant indeed and is not justified by the risks which are perceived to exist in the present arrangements.

2. Whether all trustees should be required to be public companies.

We understand that the requirement that trustees should be public companies would have effects as follows:

- Trustee company disclosure: The financial statement s of the trustees would be available for public scrutiny.
- There would be a requirement for the trustee company to hold an Annual General Meeting open to shareholders of the trustee company.
- Compliance costs would increase because of public company reporting and other compliance requirements.

We note that at the time when the Superannuation Working Group was considering enhancing the Safety of Superannuation in 2002 to 2003, the issue of public disclosure of the accounts of superannuation funds and the holding of annual general meetings was canvassed, in the Issues Paper (Item 1.6.3) and in subsequent discussion documents, and was abandoned after consultation. If the objective is to revive these proposals, a fundamental point for clarification would be whether the objective is to open the financial statements of the funds themselves, or those of their trustees, to public scrutiny.

It may be that it is seen as an important requirement for the integrity of trustee companies that they be subjected to the full regime of public company disclosure. However, given the current regime of APRA trustee licensing and review, we question whether there is need for such an additional measure, other than

as a further financial barrier to entry to trustee status and a means of increasing costs of running superannuation without enhancing its safety and benefits.

If the objective is to allow fund members access to trustee AGMs, this would have to be achieved by means other than making the trustee company a public company, as only shareholders in the trustee would be entitled to be present at a trustee company AGM. If the objective is to place fund financial statements on formal public record, the filing of trustee financial statements would not provide full and meaningful information about the financial affairs of the funds. To require the level of disclosure necessary at trustee level would probably require a law change to achieve for the purposes of *Corporations Act 2001* (***Corporations Act***) and Accounting Standards.

We opposed the proposal for member Annual General Meetings at the time of the Superannuation Working Group's consultations, for the following reasons, which remain valid, in our view:

The cost of running public company AGMs is significant and is justifiable only in terms of the potential benefit to company shareholders of general input into the macro direction of company resources. Whereas in a company directed towards profit for the shareholders, the range of potential activities and policies is extremely wide, the direction of superannuation fund resources is specific and restricted. Superannuation funds must be directed towards providing benefits to members. The main activities are not subject to change or discretion. These are the receipt and investment of capital, the administration of member accounts and interests and the payment of benefits to members.

We note that members have access to annual reports for the funds of which they are members and that there are ample avenues for representation through the trustee, and through formal inquiry and complaints procedures. In addition, many not for profit funds have internet sites which provide access to fund accounts.

It is unclear what further level of protection should usefully be provided for fund members, given that the trustee currently must be a licensed entity and hence subject to approval and ongoing APRA scrutiny. Under APRA's regulation, the SIS Act currently provides standards for trustees and equal representation requirements. The equal representation model comes closer to the European model of worker boards, in our case member involvement as it provides shop floor representation and member access in a way not found in Public Companies.

As always, the issue of costs and benefits must be considered and whether the substantial increase in costs resulting from public company reporting would bring any compensating benefits to fund members.

4. The role of advice in superannuation.

Under recent refinements to the Corporations Act, unlicensed funds have been provided with significant relief as a result of the narrowing of the definition of general advice to exclude the provision of general information about the fund. However, we are aware that funds can still encounter difficulties where attempting to provide the type of fund information which might be interpreted as personal advice in its context. This is particularly so where the fund is aware of personal information about the member. We have attached as Appendix B, a table indicating areas (under the column headed "response option (3)") where we believe there is uncertainty as to whether information/ assistance to members may constitute personal advice. This table has been adapted from a similar document provided to the Corporations and Financial Services Division of the Treasury as part of comment on the Corporate and Financial Services Regulation Review Consultation Paper issued in May 2006.

We believe that it is greatly in the interests of fund members that they should be informed about their options by parties whose interests in providing information about the fund are not commercial. The provision of information about a fund by a party that stands to gain through commissions or fees from the participation of a person in a fund, cannot be in the best interest of a member or of the public in general, as the advice will not be impartial.

We are aware that the current prevalence amongst providers of "advice" of persons whose remuneration is driven by commission on sales, or who are related to parties who would stand to gain from bringing additional assets under management by a party related to a recommended investment, also works to the detriment of not for profit employer sponsored vehicles. The advisers do not have the employer sponsored funds on their "recommended" lists, are not well informed on their advantages, and are not in a position, because of lack of access to appropriate research and other constraints, to inform the public appropriately about the features of employer sponsored superannuation which may well provide superior benefits to those on offer from other (recommended) sources.

5. The meaning of member investment choice, and

6. The responsibility of the trustee in a member investment choice situation.

We are aware that there is in theory, a tension between:

- permitting member choice of investment, even to the extent of allowing a member to choose single asset class investment streams (in some cases, individual assets); and
- the requirement that the trustee should adopt an investment strategy for the fund as a whole.

This tension was highlighted in the recently re-issued APRA circular on the topic of investment strategy and member investment choice. The current state of the law is set out in SIS Act s 52(2) (f) which requires the trustee to formulate and give effect to an investment strategy that has regard to the whole of the circumstances of the entity; this paragraph is then affected by s 52(4) which states that an investment strategy is taken to be in accordance with paragraph (2)(f) even if it provides for a specified beneficiary or a specified class of beneficiaries to give directions to the trustee, where:

(a) the directions relate to the strategy to be followed by the trustee in relation to the investment of a particular asset or assets of the entity; and

(b) the directions are given in circumstances covered by regulations made for the purposes of this paragraph. (We are not aware of any regulations issued for this purpose).

Subsection 55 (5) then states that it is a defence to an action for loss or damage suffered by a person as a result of the making of an investment by or on behalf of a trustee of a superannuation entity if the defendant establishes that the investment was made in accordance with an investment strategy formulated under a covenant referred to in paragraph 52(2)(f) (which would then include actions taken affected by s 52(4)).

APRA's concerns in the recent Circular, as we understand, relate to potential conflict between the need to maintain a responsible investment strategy and the impetus to provide investment choice. The broader the investment choice facility, the further members stray from the benefits of collective investment. In addition, as we understand, there are concerns that if enough members ("narrow investment choice members") adopt a particular specialised approach involving a narrow class of shares, this could put the savings of other fund members at risk because of the requirement that the trustee re-balance the portfolio thereby reducing the exposure of the other members to the class of stocks specifically chosen by the narrow investment choice members.

We presume that the perceived difficulty could be overcome by specifying a sub-strategy within the overall strategy which relates to the narrow investment choice members and which acknowledges that their liquidity and other requirements under s 52(2)(f) fall into a sub-class. The trustee's actions and risk in relation to these members are defended under s 52(4) and 55(5). We believe that the requirement under s 52(2)(f) to formulate and give effect to an investment strategy that has regard to the whole of the circumstances of the entity does not rule out such an approach involving sub-strategies. We believe that this is the only rational way in which the difficulties can, theoretically, be managed. We note, however, that in practice, funds generally report a low level of uptake of investment strategies outside the default, so that problems relating to balancing the portfolio (as a whole) do not in practice, at present, arise.

8. The demise of defined benefit funds and the use of accumulation funds as the industry standard fund.

This is a matter of huge concern, particularly in the context of an ageing population with increasing longevity and spiraling health costs. With the forward potential for flattening or reduction in investment returns, the focus will turn to exposure to risk of inadequacy of retirement savings. In defined benefit funds, the employer sustained these risks, and generally provided benefits well in excess of the SG minimum. Regulatory changes and focus over the last decade have made it virtually impossible for employers to maintain open defined benefit sections. The use of defined benefits requires commitment from employers, which recent trends and regulatory costs have eroded.

9. Cost of compliance, and

10. The appropriateness of the funding arrangements for prudential regulation.

Our funds perceive that the cost of compliance is rising and we are keen to ensure that there are benefits arising from the increases in costs.

There are several components to the cost increases. The major components are:

1. the costs our funds encounter in ensuring that we comply with legislation; and

2. the levies we pay, to fund regulatory activities.

We are keen to ensure that our funds comply with legislation directed to safeguarding the benefits of our members. We are not so eager to support regulation that is duplicated, misdirected, or which is appropriately directed to funds with radically different risk profiles from our own.

Regulatory levies

We support an approach that the underlying risk associated with a regulated entity should have a direct effect on the amount of levies raised. In particular, we would support different regulatory levy rates and structures for public offer funds versus non-profit corporate funds. We believe that experience indicates that the risk associated with an entity increases with the involvement of a "for profit" motive in offering the superannuation interests.

We are keen that regulators should avoid duplication of effort, both for their own activities and for the trustees who endeavour to comply with their requirements. For example, we are concerned by APRA's recent Superannuation Research Questionnaires and the degree to which these seek data already gleaned in the licensing process.

12. The meaning of the concepts "not for profit" and "all profits go to members".

We are aware that these terms have different meanings for different groups. To us, in general "all profits go to members" indicates some form of co-operative mutual or credit union where profits are part of an unallocated corpus and " not for profit" indicates that there is no build up of a corpus which individual members may never realise. As far as stand alone corporate employer-sponsored funds are concerned, the term "Not for Profit" relates to the fact that the trustee entity is not owned by a financial institution or any other body that stands to benefit financially from running or providing services to the fund, and there is no member corpus other than perhaps in a minority of cases a smoothing reserve.

We believe that the trustee board of an employer sponsored Not For Profit fund has superior governance characteristics. There is a focus on equal representation by members and employer representatives and there is undivided focus on carrying out the fiduciary duty to protect the interests of members. By contrast, the governance model of a For Profit trustee board is a weaker model where the fiduciary duty may be compromised by commercial imperatives to earn profit for the trustee and related entities, through trustee fees, fee for funds under management, and commissions.

In the outsourced professional trustee model, employers and employees lose legal control over the trustee. While professional trustees provide varying but mainly policy committee input this is advisory only and has no legal status in trustee decision making.

More serious, from a corporate governance point of view, is that where entities connected to the commercial trustee are in turn also potential service providers to the trustee, then the objectivity of the trustee board may be seriously compromised and potential conflicts of interest may become apparent.

The high cost of regulatory compliance, member investment and fund choice has seen a substantial inflow of funds into commercial master trusts. The trustee within a master trust lacks the independence of equal representation of employee and employer representation, in fact the board lacks the level of independence regarded as best practice by the regulator, lacks transparency to members and is compromised when purchasing administration services and investment advice from within the same ultimate shareholding group. For these reasons we believe that a majority of the directors of a trustee of a master trust should be independent of the fund sponsor and related entities.

We believe that, in a well-run stand alone employer sponsored fund with sufficient resources and care devoted its in-house trustee function, the risk associated with using non-specialist trustees is amply compensated for by the benefits of using a trustee which is intimately acquainted with the fund, its members and with the business in which the employer-sponsor operates.

By contrast, we are of the view that a commercial trustee, operating in the capacity of trustee for a number and variety of different funds, is exposed to a greater variety of risks than the trustee body which operates as the trustee for one fund only. These risks arise from a variety of reasons. For example the trustee needs:

- adequacy and sufficient diversity of resources to service the number and variety of funds serviced;
- knowledge of the industry in which each particular fund operates and the needs of the members;
- a full understanding of the structure and benefits provided by each fund served; and
- an ability to erect Chinese walls between the various entities it serves and between the trustee function and any other functions it performs.

In relation to commercial trustees we believe that it should also be mandatory that a majority of directors be truly independent including the chairman.

14. Level of compensation in the event of theft, fraud and employer insolvency.

We accept that the provision of a safety net for fund collapses is important. We are concerned, however, that all the levies collected under the existing system relate to difficulties experienced by Small APRA Funds. We submit that these funds are in nature self managed funds which for a variety of reasons cannot or have chosen not to provide their own trustees. These funds have greater investment risk and higher risk of collapse than that applicable to funds where the trustee's decisions are made by a body separate from but accountable to members. We believe that it is inappropriate that the whole industry should bear the specialised risk associated with the decisions made by the members of these funds, and we would support the removal of these funds from the financial assistance funding arrangements or the adoption of a separate pool for assistance of these funds.

15. Any other relevant matters: Unit pricing.

We note that unit pricing continues to be an issue of concern to the regulators, and that there is some impetus to require daily unit pricing (on a par with that often provided by public offer superannuation and other investment vehicles). We comment briefly here that if the objective is equity between members then except for the very simplest of funds, unit pricing cannot provide perfect accuracy, due to factors such as the increasing and necessary exposure of funds to non-market traded investments and the absence of immediate detailed information on matters such as tax liabilities. We note that there are risks for the parties inherent in trading at an "old" price in the context of a rapidly rising or falling market. However, given the uncertainties inherent in the pricing process, it is debatable whether daily pricing provides greater accuracy than would pricing at a longer interval, based on typical transaction timing (e.g. coinciding with fortnightly payroll input or withdrawal).

Forward pricing is an alternative practice supported by the regulators. The issue with this is that transactions would take place based on a "fairer" unit price arrived at on the basis of better knowledge of underlying investment prices. However, the issue arising from non-market traded investments would remain. In addition the consumer issue arises that people are unable to trade instantly or at a known price. Storing of transaction requests can give rise to issues. We are not convinced that this approach gives rise to a better result than fortnightly pricing.

Please contact me on 03 9613 8872, Bruce McBain on 03 9620 5155 or Liz Goddard on 03 9504 8399 if you wish to discuss any aspects of the above.

Yours sincerely

Mark N. Cerché
Chairman

APPENDIX A

Extract from previous submission to SWG, January 2002

Practical purposes for establishing capital pools and reserves

The function which is performed by reserve capital, as opposed to liabilities, in various financial institutions, is considered below. It does not appear that reserve capital would play a comparable role in a superannuation fund. Superannuation funds do not share the particular operational risks which give rise to the need for substantial capital and reserving requirements in banks and insurers.

Capital requirements for banks, credit unions and other deposit taking institutions

The nature of banking business is that of taking deposits, and then lending and otherwise investing the proceeds. Risks which arise involve:

- difficulty in matching timing of assets and liabilities. Liabilities include many short term and "at call" deposits. Long term capital commitment to certain assets, e.g. long term loans, means that liquidity needs to be carefully managed;
- loss of invested capital. Certain types of high risk investments, such as mortgages, cause particular exposure; and
- unpredictability of volume of withdrawals of deposits.

The capital requirements for banks are in place for the above reasons. A cushion is needed to ensure that liquidity is available when required.

Contrasts between the capital situations of banks and superannuation funds

- Most superannuation funds, with the exception of short term institutions such as RSAs and ERFs, are long term by nature and do not operate an "at call" deposit taking function. Instead:
  - ➢ Access to entitlements follows a statistically predictable pattern, in view of the age retirement function of the funds.
  - ➢ Statutory preservation entitlements also restrict withdrawals and make their timing more predictable.
- In the particular circumstances of defined benefit schemes, the comparison to a deposit taking institution fails altogether. Liabilities are not set out in the form of members' accumulation accounts, but as obligations to pay specified benefits as and when specified events occur. The

entity primarily at risk in funding the benefits is not so much the fund's trustee as the sponsoring employer, who is responsible for supporting the fund. In the defined benefit context, it is particularly difficult to support an argument for a minimum capital requirement in the fund.

- It is practical, and a legal requirement under paragraph 52(2)(f) of the SIS Act, to tailor the investment strategy so that long term and short term liabilities are substantially matched.
- Certain strategies which can result in higher investment risk exposure are not adopted by superannuation funds.
    - Gearing is not permitted.
    - Derivative transactions are restricted.
    - Because of diversification requirements, trustees are obliged to avoid a high level of exposure to the high-risk end of the lending market (this is less avoidable by banks because it is their business to lend to businesses and to provide property finance).

Capital requirements for insurers

The primary risks for insurers are:

- as for banks, that the timing and incidence of calls on capital, e.g. claims and investment policy exits, will be out of phase with the availability of liquid funds; and
- the particular risks associated with underwriting. These require specialist assessment and reserving policies.

Distinctions between insurers and superannuation funds

- As discussed above in the banking context, calls on capital for super funds are statistically more predictable, because of the age retirement function of the funds and statutory access restrictions.
- No significant underwriting risk arises, except in the highly restricted and controlled situation where funds self insure death cover.

Reserve against losses arising from systems failure

Superannuation funds do not share the requirement for reserve capital arising from fluctuating and partly unpredictable demands for liquid assets.

However, in the Draft Report of the Productivity Commission, a case was put forward for reserving to provide a cushion of capital from which losses could be met arising from systems failure.

Systems failure is a specific risk faced by superannuation funds. However, in many cases the risk is carried by external service providers. In others, it may be appropriate and practical to carry insurance against the risk of such losses. The level of such insurance will vary depending on the potential losses arising from such failure.

Practical aspects of capital reserving

In a "Not For Profit" fund, there would be significant difficulty in establishing an operational reserve in an entity where there is no pool of profits separate from members' benefits. Setting aside a capital reserve for the first time would have a detrimental impact on current members' entitlements and would be inequitable.

APPENDIX B

Areas of uncertainty where personal advice may be being given

Areas in which members typically seek guidance from trustees	Response options		
Topic	**Information**	**Likely "advice"**	**Member guidance/education: implications unclear**
Benefits and statements	Factual detail and additional information relating to the member's benefits		Assistance with interpreting information on benefit statements and relating it to the member's situation; "what if" questions
	Information on how defined benefits are calculated		
	Information on current benefits/balances		
	Information on how benefits are affected by switching from part time to full time work and vice versa	Recommendation of specific strategies	Discussion of optimum timing and useful strategies
	Provision of information on strategies which would be likely to maximise defined benefits: e.g. by making certain contributions	Recommendation of specific strategies or benefit choices	Discussion of optimum strategies; Targeting specific members who are not using strategies to optimize their benefits and providing information about how they might do so
	Where a DB plan requires member contributions, information enabling member to compare costs and benefits of DB plan membership with costs and benefits of membership of minimum SG /award plan	Opinion as to whether membership is worthwhile compared with membership of minimum SG /award plan	Discussion of potential gains and losses from specific actions; discussion of member's specific situation

Areas in which members typically seek guidance from trustees	Response options		
Topic	**Information**	**Likely "advice"**	**Member guidance/education: implications unclear**
Insurance	Information on insurance cover provided by the fund		
	Information on potential costs and benefits of taking out optional extra insurance cover	Recommendation as to whether or not to take out additional cover or expression of view that additional cover will be beneficial for the member	Discussion of member's situation and outline advantages of specific courses of action
	Information on salary continuance and TPD benefits for members on sick leave		Discussion on when to make a claim
Binding death benefit nomination	Information on method of making a binding death benefit nomination	Opinion on value to the member of making a binding death benefit nomination	Outline of general benefits/ disadvantages of making a binding death benefit nomination
Investment choice	Information on member investment choices available; general information on asset allocation; information on the risk/return profile of specific investment classes, e.g. equities	Recommendation of a specific investment choice for an individual	Discussion of member's situation, cash needs, time horizon, highlighting relevant considerations and listing of a range of suitable choices
Salary sacrifice/Additional voluntary contributions	Information on mechanism for making salary sacrifice contributions. Outline of pros and cons	Opinion on value of salary sacrifice to the person	Statement that salary sacrifice may be beneficial in certain (specified) circumstances; discussion with member in general terms
	Information on mechanism for making additional voluntary contributions. Outline of pros and cons	Opinion on value of making additional voluntary contributions	Statement that additional voluntary contributions may be beneficial in certain (specified) circumstances; discussion with member in general terms
Rollovers/ deferral of benefits in fund	Information on mechanism for rolling existing super balances from elsewhere into the fund	Opinion that it is desirable to roll existing super balances from elsewhere into the fund	Discussion with members as to whether or not to rollover monies into the fund; outline of circumstances where there will be benefits in doing so

Areas in which members typically seek guidance from trustees	**Response options**		
Topic	**Information**	**Likely "advice"**	**Member guidance/education: implications unclear**
	If funds have a Retained or Preserved membership category: information on mechanism for retaining or deferring balances in the fund on cessation of employment		Discussion with members as to whether or not to rollover monies into the fund; outline of circumstances where there will be benefits in doing so
RBLs, pensions, tax considerations	Information about reasonable benefit limits; assistance with transitional RBL applications; recommendation that a person should check RBL status with ATO		
	Discussion on allocated pensions, how they work; tax benefits of an allocated pension	Recommendation that the member should take an allocated pension	Discussion of general advantages of particular types of pension / benefit structure to people in specific types of circumstances
	Information on tax thresholds; if close to end of financial year advice that the tax free threshold will increase on 1 July, similarly if close to age 55 that if the beneficiary waits until then there will be a tax free lump sum amount	Recommendation that the member wait until a particular date before taking benefits	Advice that many members benefit from waiting until a particular date before taking benefits
Family law	Information on family law issues		