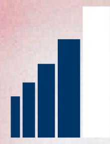

SuperRatings™

September 2006

SuperRatings Pty Ltd

Submission to the Parliamentary Joint Committee on Corporations and Financial Services' Inquiry into the Structure and Operation of the Superannuation Industry

Inquiry into the structure and operation of the superannuation industry

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Overview

SuperRatings created the concept of measuring and rating Australian superannuation funds upon its launch in 2002. Since that time the company has quickly grown to become the leading research firm focusing on the multi-employer superannuation market.

The company is currently retained (amongst others) by the following types of entities to provide research and analysis:

- Federal Government Departments
- Government Superannuation Funds
- Commercial MasterTrusts
- Institutional Fund Managers
- Industry Superannuation Funds
- Corporate Superannuation Funds
- Allocated Pension/TAP Offerings

Our research of the superannuation industry over the last four years, together with the internal depth of our personnel knowledge, has led us to believe that the superannuation industry, as it currently stands, is the safest and most efficient it has been in the history of this industry in Australia. Notwithstanding this comment, there remain several areas where improvements can continue to be made to protect consumers. These are discussed elsewhere in this submission.

However, SuperRatings holds significant doubts over the potential effectiveness of this Joint Committee Inquiry due to the Terms of Reference adopted by the Committee. We believe there are a number of omissions from the Terms of Reference whose inclusion could result in better consumer understanding and/or protection. Similarly, there are a number of issues set down for review that do not appear to have any relevance to the safety, efficiency or effectiveness of the Australian superannuation system.

We have set out our response to the Joint Committee Inquiry on the following pages, based on the particular reference points as detailed in the Terms of Reference document.

Whether uniform capital requirements should apply to Trustees

The recent introduction of RSE Licencing for superannuation trustees was undertaken by APRA in a structured and comprehensive manner. As a part of this licencing procedure, all trustees of Public Offer Funds were required to demonstrate an adequacy of financial resources to ensure they could fulfil their fiduciary responsibilities. This was in line with the prevailing SIS Act. APRA, as part this requirement did consider and accept a variety of mechanisms to demonstrate this capital adequacy.

The SIS Act, when combined with the rigorous RSE Licencing process, has led to a significant reduction in the number of superannuation trustee entities in Australia. This, by definition, has reduced the potential for fraudulent and/or negligent activity to occur.

Given that each Public Offer superannuation trustee has demonstrated the required capital adequacy and the fact that all superannuation trustees are expected to hold Trustee Liability, Directors & Officers and Professional Indemnity insurance (as well as their material suppliers), then as much as practicable has been done to protect members' assets against fraudulent and/or negligent activity.

We would recommend however that minimum requirements for the level and breadth of insurances required to be held by any Trustee entity be introduced.

The reality is that no amount of acceptable capital backing would be sufficient to protect members' assets in the event that a Board of Trustees, or service supplier without adequate safety procedures, sought to wilfully defraud members of fund assets or sustained a significant loss through inadequate processes.

Hence, any prolonged discussion on whether capital requirements should be uniform and/or raised from "X" to "Y" are superfluous, given that sufficient procedures are in place and the reality is that wilful fraud will never be able to be eradicated from any industry, as has already been demonstrated within both this and many other industries.

Whether all trustees should be required to be public companies

We are unsure as to what effect this may have on the effectiveness or otherwise of trustee entities, apart from some minor disclosure and reporting requirements.

In all superannuation fund sectors, with the exception of professional fund trustee companies, trustee companies are normally set up to act for singular trusts, albeit with different

divisions/products underlying the trust. In these cases we do not see any benefit in forcing those "Pty Ltd" structures to a Limited model. Whilst the cost of change and the increase in ongoing reporting are minimal, any benefits are not immediately apparent to us.

A different scenario however appears where the trustee company is in the business of acting as a professional trustee of various, and unrelated, superannuation funds. In this case we do believe that there are significant benefits to be gained from greater disclosure of a Trustee's financial position, skills and operational procedures. This may then be extended to consider the capital adequacy or otherwise of these types of trustee organisations. We believe that of all the fund trustee companies, those who are in the business of operating a professional trustee company, may in fact provide the highest level of risk. Whilst this may appear to be contrary to expectations, our experience has shown that often these companies are the furthest removed from the operating activities of the funds themselves.

It is an accepted practice that where the trustee company acts for a singular trust, then that trustee company does not have a saleable value. There have been a limited number of exceptions to this comment, where the trustee company has been purchased, presumably to gain the goodwill of the fund's membership. Directors of trustee companies have a fiduciary responsibility to act in the best interests of members at all times and the sale, for self gain, of a trustee company by the trustee directors, may be construed as a breach of this responsibility.

The relevance of Australian Prudential Regulation Authority standards

SuperRatings does not have any comment in this area other than to express that we believe APRA has done a sound job in the regulation of Australia's superannuation industry given the resources provided to them.

The role of advice in superannuation

The importance of financial advice in Australia cannot be understated. Unfortunately the delivery of advice in its current form within the superannuation industry is both inadequate and in some cases fundamentally flawed.

It is estimated that only between 10%-12% of Australians currently use a financial planner. If this statistic is valid then a lower number utilise a planner for their superannuation.

The Australian superannuation system is a mandated structure, meaning that nearly every working Australian is entitled to superannuation contributions on their behalf. This mandated structure means that the great majority of the current 10 million Australians' future retirement benefits hinge on their superannuation benefit.

The superannuation industry has done an excellent job in creating default investment and insurance structures for those Australians who do not actively choose to become involved in their superannuation (SuperRatings' research shows that some 82% of Australians accept the default position within their funds). This apathy we believe is due to a lack of understanding of the superannuation system (due to continued changes by respective governments) as well as the historical demographics of many funds which reflected younger (and hence less interested) members.

However, as account balances grow and the population ages, it is expected that the financial literacy of Australians with respect to superannuation will improve, thus creating an increased need for advice. The issue is how this advice is to be delivered.

That being said, the current delivery of advice does not work in most instances. Advice in many funds is built into the costing structures and in many cases members are unaware that their fees include an advice component. The only way that any advice can be satisfactorily delivered is via an "opt-in" approach, as opposed to the present, at times, "opt-out" model. The key here is to provide members with the ability to fund these costs via their superannuation accounts.

In the short term we are not against the use of commissions as a method of remuneration to qualified and professional advisors. However, we are strongly opposed to the commission payment being an implicit part of an already implicit administration fee. We believe that all member statements need to clearly have as line items, both administration fees and advisor fees, in an identical manner as Wrap Accounts statements currently provide. By having explicit fees, consumers will be able to make a conscious decision as to whether the advisor's fee is of value in their own financial planning process. Those members who genuinely meet with and benefit from an advisor's expertise will no doubt be more than willing to have the cost met via a fund deduction.

In the medium term we are opposed to commission payments (as opposed to fees) being made from mandated superannuation contributions. However, we accept that an overnight change to a fee for service model is impracticable. We therefore feel that commissions paid from superannuation assets should be phased out on an agreed timetable spread over two to three years. Fees in respect of superannuation advice should however be deductible from any superannuation fund of which they are a member, thus providing a simple but effective funding source for payment.

As an immediate issue however is the need for all administration and advice costs to be explicitly shown as a line item on member statements. The current "dollar disclosure" legislation is unsatisfactory and unlikely to make members aware of the level of fees incurred or how they are being distributed.

Sound financial advice can only be in the best interests of our national retirement savings requirements. What we need however is to educate Australians to actively request and seek such advice and to be provided with a simple mechanism to pay for same. To provide assumed advice

components within fee structures, when the service may not be delivered, is counterproductive to the industry and serves only to inflate underlying fund costs.

We believe that the current legal and accounting industries' fee for service model works extremely well. Such a model is easily able to be replicated within the superannuation system provided that the mechanisms for payment are implemented by the funds themselves.

The meaning of member investment choice/ The responsibility of the trustee in a member investment choice situation

The initial concept of member investment choice was to provide members with the ability to lower or increase their risk/reward profile. This was particularly relevant, prior to the introduction of flexible pension style retirement products, when benefits were required to be cashed at age 65.

As the superannuation fund trustee is ultimately liable for any member's choice of investment option, it is imperative that all trustees appropriately research and monitor their investment choice structures and the procedures for allowing members to choose any specific or multiple options.

Where sound financial advice has been provided to a member, or that member could be reasonably expected to understand the characteristics of a specific investment option through appropriate disclosure, then it is likely that the trustee has satisfied their duty of care. However, where options are provided to members with little or no assistance and/or disclosure then some liability may well exist. It will be interesting to see the level of legal actions occurring in the future due to sudden market changes that have a marked impact on retirement benefits.

In recent times the concept of member investment choice has blurred, to the point where geared equity funds and direct equities are commonplace on investment menus. These are acceptable options in an informed marketplace but somewhat dangerous in a financially illiterate marketplace. This is a sound example of the role advice can play in our retirement savings policy.

Notwithstanding the above, the great majority of fund members (as already mentioned at 82%) do not actively choose investment and/or insurance options. Hence, the role a trustee plays in investment choice is critical. Our research indicates that the default investment options of Australia's major superannuation funds range from a growth asset exposure of around 12% through to 90%, with an average exposure to growth assets across the industry of approximately 70%. It is debateable which funds are correct in their asset allocations. However it is clear that during the 1990's trustees continued to increase their weightings to growth style assets and that over the long term, as would be expected, this strategy has yielded significantly higher benefits than less growth orientated funds. Does this then mean that members of the more defensive default option have cause for complaint?

Perhaps the main concern surrounding member investment choice and trustee management of same, is the evidence of conflicts of interest within the manager selection process. Again the role of the trustee is to act in members best interests at all times. This must surely encompass the need for diversification of investment managers and the clear addressing of conflicts of interest created through dealings with related parties. We see continual evidence of these conflicts arising within the investment management process.

Overall, member investment choice and the responsibility of the trustee in this process has been handled particularly well by most trustees and Australians of most major funds have benefited greatly from an improved diversification of managers and the medium term investment approach adopted by most funds.

The reasons for the growth in self managed superannuation funds

The growth of self managed superannuation funds ("SMSF") is a natural progression of the less rigid superannuation environment.

The argument as to whether SMSFs are in Australians' best interests is a valid one. There is ample evidence to suggest that those who own SMEs and/or require access to non-traditional asset classes such as artwork or direct property (through a related entity) are suited by the flexibility of the SMSF structure. Conversely, there is some evidence of SMSFs being oversold to those with relatively low account balances of less than $100,000.

In addition, many Australians believe that they are able to manage assets better than traditional fund managers, which assisted in the term DIY Funds being phrased. This is no different to the managed fund area where investors are split between using traditional fund managers and investing directly in the equity markets themselves, often via web-based brokers. Not surprisingly, anecdotal evidence indicates that most SMSF money is invested either directly in the Australian equity market or held in cash.

SuperRatings believe that SMSFs provide a valuable alternative to mainstream superannuation funds within the superannuation sector. If a consumer believes that they can, with or without the assistance of an accountant/advisor, outperform mainstream superannuation funds then this is no different to a non-superannuation investor directly investing in equities.

The main issue for consumers is that they need to be aware of appropriate performance indices of the various asset classes so as they can compare the success or otherwise of their SMSF. It is unlikely that those who were pushed into a SMSF would be made aware of their ongoing performance relative to the mainstream market. For this reason SuperRatings publish on our website the market indices for all major superannuation asset classes/investment option types on both a monthly and financial year basis, together with five year averages.

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

We are unsure what relevance this has to the inquiry. However, the trend towards accumulation /defined contribution funds has been driven purely by employers. When contributions were not mandated superannuation was a significant attraction to potential employees when negotiating terms. With the introduction of the SGC, superannuation has quickly become a negligible factor within most employers in terms of a differentiator in attracting staff.

Hence, employers, who had traditionally used a defined benefit fund, and carried the complete risk in funding their employee's retirement benefit, saw the attractiveness of having fixed employment costs by using defined contribution funds in line with the SGC requirements.

Defined benefit funds pose a significant financial risk to a sponsoring employer's business and we expect to see a continual decline in the use of this style of fund. Members of accumulation funds carry their own investment risk and the introduction of member investment choice to most funds has provided members with the ability to manage their own risk. Defined contribution funds also better suit the more transient nature of the modern Australian workforce.

Whilst in a perfect world, defined benefit funds would provide Australians with a clearer retirement picture, they are largely inappropriate for the great majority of Australian businesses.

Cost of compliance

Continued changes to the superannuation legislation since 1983 have left significantly fewer funds within the industry. The introduction of the SIS Act 1993 (as amended) and increased regulation through AFS Licencing and RSE Licencing has moved the industry to a point where it is in the main well run from a compliance point of view. The costs associated with these changes, and ongoing management, are reasonable given the level of savings retained within the industry.

Continued compliance requirements through the various regulatory bodies, whilst no doubt frustrating to many participants, are essential to an industry in which the country's retirement savings are entrusted. As previously mentioned no amount of regulation can protect the system against intentional fraudulent activity by fund executives, promoters and/or staff. Fortunately the occurrence of this type of activity has been low within the industry and by our understanding continues to fall. There exist protection mechanisms within the industry to recoup members' losses in the event of the failure of a fund's relevant insurance policies and this leaves the Australian consumer in a strong position.

The only as yet untested significant risk within the industry rests in the investment area where poor (but not fraudulent) investment decisions may lead to significant investor losses. Whether the trustee holds any liability in this instance is obviously up for debate.

Overall we believe that the current costs of compliance are not excessive and that they are necessary to protect and subsequently strengthen Australians' belief in the superannuation system. It will only take one significant case of investor loss (e.g. a Westpoint) for much of the goodwill in the industry to evaporate.

The appropriateness of the funding arrangements for prudential regulation

We have no comment on the current funding arrangements for the regulation of funds..

Whether promotional advertising should be a cost to a fund and therefore to its members

Promotion is a key part of any marketing strategy for any business. Superannuation funds are in essence a business whether they are not for profit or commercial arrangements. The promotion of superannuation funds and mutual structures has been in evidence for many decades and no matter how structured, were always directly or indirectly a cost to policyholders.

For instance, prior to the demutualisation of Australian Mutual Provident Society; National Mutual Life; Colonial Mutual Life; et al, all of these mutual societies advertised regularly with the costs of this advertising being borne from their own various statutory funds. This was in a post SIS era meaning that the sole purpose test was in place at the time. By deducting the costs of this advertising from statutory funds, policy holders (members) were directly affected through the reduction of available surpluses for distribution as either "bonuses" or crediting rates.

Now in a public company environment, these same promotional costs are effectively sourced through administration/investment fees, which are deducted from policy holders' (members') accounts. Revenue for any business is predominately sourced through its clients. Promotion of that same business, whether it is by advertising or any other form of communication, can only be achieved through the use of those client revenues.

Hence, the reality is that all costs associated with business promotion, are funded through its clients. The question is whether such promotion is in members' best interests. Our view is that when undertaken in a professional and transparent manner, then the long term interests of members will be served. Any Board of Directors that does not address the need for marketing, which is integral to any business planning, is potentially compromising the success of the business and ultimately its current clients.

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

The description of a superannuation fund that does not, by its constitution, seek to profit shareholders, has been for some time open to debate.

It is however clearly a different structure to a commercially operated superannuation fund. These varying structures are no different to not for profit structures, such as Credit Unions, competing against the "for profit" banks (many similar examples exist in different industries). In reality, many of today's commercial superannuation funds were in fact once, "not for profit" entities. Their reasons for moving away from a not for profit structure were no doubt many and varied, however the access to capital for expansion was often cited.

It is up to any Board of Directors how they choose to structure their business. How they choose to then describe their business structures is also optional, provided of course that it fits within legal requirements.

There has been some concern raised by parties (who are often conflicted) that a number of superannuation funds in the not for profit sector use commercial suppliers. Much of this comment is baseless in that any not for profit entity, whether superannuation or otherwise, uses commercial suppliers in managing their business.

Hence, whether a fund chooses to describe or structure itself as a "not for profit"; "all profits go to members"; "co-operative"; "mutual"; "mastertrust"; "platform" or any other such description, is irrelevant provided that such a description conveys an accurate picture to the consumer. Mis-representation is clearly dealt with within the legal process and all superannuation funds would no doubt be aware of this.

Funds are entitled to differentiate their offering against competitors provided that such differentiation is valid. Promoting a "not for profit" or "all profits go to members" structure is no different to differentiating on brand; costs; services and the like.

Our main concern is where there exist obvious conflicts of interest between Trustee Boards and suppliers. These conflicts are evident in both the "not for profit' and "commercial" sectors and our understanding is that in the main they are reviewed by the relevant regulatory bodies. These conflicts have nothing to do with the type or description of a fund, but do have the potential to undermine the system where the conflicts are not adequately managed and/or monitored.

Benchmarking Australia against international practice and experience

Australia has established one of the leading retirement savings models in the world. The execution of this model has in the main been adequately handled by creating and maintaining a competitive superannuation environment.

There are no doubt a number of areas within the superannuation industry that could be benchmarked against World practice.

As one of Australia's leading benchmarking firms in the area of superannuation, SuperRatings could no doubt assist the committee should they wish to progress discussions in this area.

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

We have previously spoken about the inability of any industry to completely insulate itself against fraudulent activities. In an industry that is likely to exceed $1 trillion in 2007, unscrupulous operators will continue to be attracted.

Whilst theft and fraud appear to be adequately structured in terms of compensation mechanisms to affected members, the event of employer insolvency is one that falls outside the domain of the industry.

We are aware of a number of larger funds that have in place follow up procedures for the collection of outstanding SG contributions and these funds are to be commended for minimising the potential for outstanding contributions to compound. However, with choice of fund, the ability for employers to evade such monitoring may increase.

In reality, should an employer seek to evade their superannuation liabilities due to the state of their business or otherwise, there is no real mechanism for employees to be notified by the fund, apart from being self-monitoring. If, as part of the financial literacy campaign, Australians were educated that contributions need to be made quarterly (we believe monthly should be mandatory) then consumers may begin to more regularly monitor their employer and/or fund and hence avoid significant losses in the event of employer insolvency.

Our view on outstanding superannuation contributions is 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.

Any other relevant matters

As mentioned in our "Overview" in this report, we believe that the Australian superannuation industry is in the main well run. There remain some changes that could, and should, be made to better protect Australians' retirement savings.

At the top of our preferred changes would be the immediate introduction of bank style superannuation statements where all income and expenditure is clearly itemised. This would include income; contributions by date; administration fees by date; investment fees by date; insurance costs by date, some tax items by date, advisor fees by date and any other relevant transactions.

Some other areas that require further review are: minimum insurance structures in place for trustees; related party transactions; the make up of Trustee Boards; and the need to better educate Australian consumers.

We look forward to discussions regarding SuperRatings' submission to this inquiry.