REST
superannuation
Level 10, 50 Carrington Street
Sydney NSW 2000

15 September 2006

The Secretary
Parliamentary Joint Committee on Corporations and Financial Services
Suite SG.64
Parliament House
CANBERRA ACT 2600
By e-mail: corporations.joint@aph.gov.au

Dear Sir

INQUIRY INTO THE STRUCTURE AND OPERATION OF THE SUPERANNUATION INDUSTRY – PARLIAMENTARY JOINT COMMITTEE ON CORPORATIONS AND FINANCIAL SERVICES

Thank you for your letter of 7 July 2006.

In that letter you invited REST to make a written submission to the Parliamentary Joint Committee on Corporations and Financial Services' inquiry into the structure and operation of the superannuation industry.

We hereby attach our submission which addresses all of the terms of reference.

We note that the REST submission will become a Committee document and will be made public only after a decision by the Committee. We note that REST cannot release its submission without the approval of the Committee.

We note that we can request that the Committee treat our submission as confidential in which case it will not be placed on the Committee's website and it will not be referred to in public hearings or in the final report.

We would like to advise you that we wish the Committee to treat our submission as non-confidential

If you have any questions about our submission, please contact REST CEO Damian Hill on (02) 9299 4625 or Brenda Mills on (02) 9086 6325.

Yours faithfully

Peter Robertson
REST
Acting CEO

1. Whether uniform capital requirements should apply to Trustees?

We believe it is unnecessary to impose uniform capital requirements on all Trustees.

Capital requirements for Trustees are set out in Part 2A of the SIS Act and Regulations. We believe that these requirements as set out in the Act are acceptable, given that with each Registrable Superannuation Entity (RSE) licence application, and through regular APRA and internal/external audit (as well as the Trustee's own self-monitoring in its compliance practices) that these requirements are adequate to ensure sufficient resources to ensure ongoing solvency and adequate liquidity to support the operation of the fund. This adequacy is also backed by arrangements with administrators or custodians as well as appropriate insurance.

We noted that the imposition of uniform capital requirements was proposed by the Superannuation Working Group (SWG) in its final recommendations in 2001. However, the Minister clearly stated in the government response to Recommendation 16 of the SWG Final Report, "The Government supports the retention of the status quo for capital requirements at this time." We also note that ASFA has reported that the international policy debate on this topic recognises that capital requirements are a crude mechanism for regulating conduct in financial services, and instead there are alternatives whereby capital requirement standards should be based on risk exposure approach applying to all participants, rather than imposing a capital barrier to entry. We agree with ASFA's discussion here.

Further, unlike other institutions regulated by APRA, accumulation superannuation funds do not undertake risk as regards the benefits they offer. These funds simply pay the contributions received after adding any positive investments earnings and deducting expenses and any negative earnings. So long as the fund adjusts the value of member accounts on a regular basis it will not promise to pay more benefits than it has assets and so cannot become insolvent.

We also believe that extending capital requirements to all superannuation funds fundamentally undermines superannuation provided on a profits to member basis.

Profit to member funds that are not capitalised have adopted a variety of measures to facilitate correction and compensation of any pricing errors that might occur when a superannuation fund makes use of unit pricing.

Where mistakes occur as a result of provider error, the trustee then seeks payment from that provider for the cost of any compensation needing to be paid by the trustee.

Where that error occurs as a result of a trustee error, trustee liability insurance or any reserves of the fund provide a source of compensation.

Further, uncontrolled operational and governance risks are less likely to occur within the trustee licensing regime. Trustee licensing requires trustees to address a multitude of risks and trustees are required to have a robust risk management and compliance framework which addresses them. For instance, trustees are required to have risk management strategies and risk management plans as well as policies on governance, outsourcing and adequacy of resources. These policies and risk and compliance

frameworks are subject to auditing as well as regulars reviews by the regulator. All breaches currently need to be reported to APRA..

We would advocate that the use of capital requirements as a mechanism to mitigate risk is unwarranted, given the current supervisory regime of trustees and current compensatory sources in place.

2. Whether all Trustee should be required to be public companies?

The public company requirements that apply over and above proprietary company requirements may be divided into the following categories:

(a) additional shareholder reporting requirements and meeting requirements.

(b) additional conflicts of interest requirements.

(c) restriction on directors voting where there are conflicts of interest.

There is a case for the conflicts for voting type interests to apply; however, it is inappropriate for the shareholder type interests to apply.

It is the relationship with member interests rather than that with shareholders that needs to be regulated. Shareholders interests are a relatively minor factor in a superannuation fund.

If the public company conflict and voting provisions are adopted without any consideration, the effect of the voting restrictions in section195 of the Corporations Act, and the requirement in SIS regulation 4.08(3), that two thirds of all directors must vote in favour of a resolution means there could be a real prospect of boards being paralysed.

An example might be useful. Assume a board of eight directors consisting of four employer and four employee directors. Under regulation 4.08 a resolution is not valid unless at least 6 directors vote in favour. Assume three have a material personal interest. Under s195 these three cannot vote. This means the board cannot vote on the resolution as there are insufficient directors who can vote on it to pass it.

It is essential that any adoption of provisions take into account the SIS provisions. Accordingly, it would be better if those provisions of the public companies legislation that were considered appropriate were to be adopted as part of the SIS legislation rather than simply requiring a public company to be the trustee as this would have the effect of failing to take into account other inconsistent statutory provisions.

We note that responsible entities offering managing investments are required to be public companies. We understand that this is intended to ensure that the operations of the responsible entity are “more accountable” to their shareholders. We would query why this needs to be extended to superannuation trustees without qualification as managed investments do not have separate legislation.

REST believes that current fund governance arrangements work well, where we use an incorporated trustee with equal representation on the Board. We believe that having the composition of our Board with both employer and member representatives has contributed to the strength of our management.

3. *The relevance of Australian Prudential Regulation Authority standards.*

We believe that taking a "one size fits all" approach whereby the APRA standards for approved deposit taking institutions, life companies, general insurers and others, should apply to superannuation funds is inappropriate. This is because the governance standards for these entities are necessarily at the firmer end of the governance spectrum and would only add to the existing **adequate** governance requirements which superannuation funds are required to meet. These requirements include the registrable superannuation entity licence policies, such as meeting the fit and proper test, adequate resourcing, proper outsourcing processes and risk management policies and strategies, as well as SIS operating standards and common law fiduciary related Trustee duties.

We would argue that the current governance requirements for superannuation funds are adequate.

Superannuation trustees are regulated by operating standards supervised by APRA and also are "guided" by guidance notes, FAQs and circulars. While guidance notes circulars, and FAQs do not have any legal effect, in fact, they indicate APRA's preferred approach and operate as "de facto" legislation. We would query that these "sources of regulator intent" have, while appearing to clarify certain areas of law, also confuse it. Given that superannuation trustees must seek their own legal advice, that advice must have consideration to APRA issued documents, regardless of their legal effect. We would argue that this has increased compliance costs as given the plethora of FAQs and other guidance issued by APRA, the position of a superannuation trustee at any point on compliance must have regard to these different sources. We agree that compliance details should not be placed in the legislation but in other documents, which are underpinned by the law. However the number of those other documents should be reviewed and re-scoped to form larger documents dealing with various topics.

It is not appropriate that regulatory authority guidelines be given the force of law without a proper parliamentary review process. Otherwise, it is delegation of legislation without the proper review process.

4. The role of advice in superannuation

We would agree with the comments of the Corporate and Financial Services Regulation Review Consultation paper (April 2006) which queried whether changes to the scope of general advice be given additional consideration particularly to avoid licensing and disclosure requirements for general educational activities.

We find that the current financial services regime offers a financial advice framework that is quite restrictive and subject to significant legal liabilities.

The result of this is that far fewer trustees wish to give financial advice even if it takes the form of general education, as it could be construed that such information might be termed “advice”. The definition of general advice is quite broad, ie, it basically constitutes any financial product advice that is not personal advice. The definition of financial product advice includes recommendations, statements of opinions or reports of either of these things which are intended to influence people in making a decision about a financial product. The breadth of this definition means that most activities of the Trustee would be caught by it, which triggers the necessity for disclaimers, training and the requisite provision of FSGs.

While REST’s licence allows it to give general financial product advice, but not personal advice, we are continually mindful of this restriction, and as a result we must continually monitor this area to ensure we are not breaching our licence. We would consider that there is scope to move the boundaries of the divide between general and personal advice. We would hold the view that the onerous requirements of giving advice, e.g. distribution of FSGs should be quarantined only to the giving of personal advice, where Trustees of superannuation funds are concerned.

Approximately 75% of REST members are under 35 years of age with an average account balance of around $3,500. This is not a traditional market for financial advisers. Yet the importance of seeking basic advice on investment choices and the value of making voluntary contributions early to ensure an adequate level of income in retirement cannot be understated. The limitations of REST’s licence restrict our ability to provide education to our members that would assist in making basic decisions yet such early life decisions have a strong impact on future savings. As the barrier to advice is currently too high, members seek advice instead predominantly from family or friends. As result, they may be ill-advised.

REST has engaged the services of Money Solutions Pty Ltd to offer personal advice to our members while operating under its own personal advice licence. This model allows members access to one off coaching for individuals issues rather than a full financial plan. We believe that it is appropriate to allow for payments for such advice to be deducted from a member’s superannuation account, subject to the sole purpose test rules. Our experience shows that over 92% of our ,members who receive single issue superannuation advice under this arrangement do not wish to go to a full financial plan and consequently would go unserviced or be poorly serviced by the traditional financial planning industry.

5. The meaning of member investment choice

We take this to mean where the member is able to choose from different investment options within a superannuation fund. Further comments on this topic are discussed under the next question.

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

The responsibilities outlines in Section 52 of SIS require a Trustee to formulate and give effect to an investment strategy that has regard to the whole of the circumstances of the fund, including the risk, the likely return, objectives and cash flow expectations

of the fund, diversification to ensure risks are diluted and liquidity in relation to cash flow, as well as to discharge any existing and prospective liabilities.

Other initiatives by APRA e.g. the Superannuation circular 11 D.1 "Managing Investments and Investment Choice" requires a Trustee to take a more intrusive role in a member's investment choice, with insufficient knowledge of the member's needs. For instance a member may have decided on a more aggressive approach in superannuation investment choices, given that their portfolio of investments in non-superannuation areas may be in less aggressive areas. Such a proposal removes the responsibility of choice from the member and overrides the entire choice model.

In addition, the APRA Circular proposals suggest that the Trustee is also venturing into the personal advice area if it requires a member to change their investment strategy.

The result is that the Circular has put Trustees in a very difficult position in trying to comply with regulatory requirements which may be in direct conflict with the member's own choices.

We would recommend further discussion and review of APRA's approach.

7. The reasons for the growth in self-managed superannuation funds

We understand that the growth of self-managed funds could be attributed to perceived benefits by holders of SMSFs whereby they are able to manage their superannuation funds better than other superannuation fund providers.

Research commissioned by the Australian Stock Exchange (November 2003) stated that the "SMSF mindset is characterised by a strong need to have control and responsibility for one's own financial affairs/well-being, and interest in learning about investing tracking investments and doing the administration. They prefer to make and learn from their own mistakes than pay professionals to do it for them. Opinion leaders also recognised the growing awareness of the need to provide for their own retirement and the desire for choice as factors."

Additionally, small business operators which would make up a large number of holders of SMSFs may be enjoy certain tax benefits, for example putting their superannuation in commercial properties from which they operate their businesses, and may be advised by their accountants to set up such a fund.

As a result, SMSF holders may feel they are able to exert their own personal control over investment decisions and timing. There may be a perception (which may not necessarily be true, depending on their financial skills) among holders of SMSFs that they could do a "better job" than other superannuation fund providers.

The March 2006 APRA statistics state that there are almost 320,000 self managed funds holding $210 billion in assets. There must be a real issue as to the capacity of the Australian Taxation Office to effectively regulate such a large number of funds and funds under management. Unless there is a perception of strong regulation which

occurs with APRA regulated funds, standards of compliance may be low, and the intention of the funds being used to fund retirement benefits may not be met.

In the case of funds with small account balances, it must be questioned whether investors have the sophistication to properly manage the funds. It is not appropriate to regard the fund as the members' own money. The funds are accumulated under a tax concessioned regime and accordingly it is essential that government policy as to the meeting of the purpose of that legislation is met. It may be that sophisticated investor criteria ought to apply as a measure of the minimum amount required before a person can take advantage of the tax concessions and at the same time operate their own fund.

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

The introduction of superannuation guarantee has meant that the provision of superannuation benefits by an employer is no longer seen as an additional staff benefit; it is simply a statutory obligation. Furthermore, there is no benefit to the employer underwriting the benefits and incurring a liability greater than necessary. It is not surprising that this field has been largely vacated. It may well be the case that most of the remaining funds are simply operating because they are in surplus.

We understand that the demise of defined benefit funds can be attributed to their administrative and operating costs (which tends to be more expensive than accumulation funds) which is borne entirely by employers. Accumulation funds, in contrast use the model where the members bear the investment risk as well as the costs of the fund.

In addition, the nature of the workforce has changed. Longevity of employment with one employer is no longer the norm and the employment of contract and casual staff has increased over the years. Defined benefits are not suited to such mixed workplaces.

Administration of defined benefit funds tends to be more difficult than accumulation funds, and often involve complex a benefit design which has been grandfathered from previous transfers from both funds, and previous employers. Such complexity in benefit design requires additional specialist administration services as well as the services of an actuary, on a frequency, as prescribed by law. Employers and member alike are more likely to understand accumulation benefits more than defined benefits and understanding provides greater trust and peace of mind.

We also believe that accumulation funds are now the industry standard because of certain Government initiatives, e.g:

- choice of fund,
- minimum limit of 50 members in a defined benefit fund,
- the superannuation surcharge,
- superannuation guarantee

have all been modelled around the simpler accumulation model, making such initiatives applying to a defined benefit fund more onerous to apply administratively.

REST is the trustee currently of four defined benefit funds. We have found that many of the defined benefit funds which transfer to us through successor fund transfers or other transfers, are more administratively complex to manage. This results in greater costs for us which must be factored into our transfer arrangements with the transferring fund. However many of the members enjoy enhanced benefits as a result of their defined benefit arrangements.

9. Cost of compliance

We find that as a superannuation trustee we are facing considerable compliance costs as a result of SIS and Corporations legislation and its associated regulations and policies. We also find a duplication of costs with the necessity to have an ASIC and APRA licence.

We understand that ASFA is currently undertaking research on this topic and will be releasing the results at the ASFA National Conference in Perth in November 2006.

The other, more incidental, cost of compliance is its effect on member understanding. Funds and staff naturally err on the side of caution for fear of overstepping the compliance line. The effect is to the detriment of clear and concise communication and member education. Members have nowhere to go for basic assistance without incurring costs for advice and are more likely to be ill-advised by non-professionals as a result.

10. The appropriateness of the funding arrangements for prudential regulation

Superannuation trustees pay for their own regulation, unlike insurers or approved deposit taking institutions which are governed by regulators funded by Consolidated Revenue. With the introduction of RSE licensing the number of superannuation trustees available to fund the levy has vastly reduced. This means that a smaller number of existing funds are bearing a larger proportion of the costs, hence the increase in their levies (which are based on assets of the fund). The average account balance for a REST member is only $6,000. Accordingly REST is bearing a greater financial burden than before.

We would suggest a more equitable distribution of regulatory costs for large funds.

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

The sole purpose test of SIS must be complied with by all resident, regulated superannuation RSE licensees. This test, set out at section 62(1) of the SIS Act requires (inter alia) that each trustee of a regulated superannuation fund must ensure that the fund is maintained solely for the provision of benefits for each member of the fund.

In having regard to whether spending the fund's monies on promotional advertising is in conflict with this test needs to be addressed by each trustee. Most trustees would hold the view that existing members of the fund benefit from promotional advertising as it helps to assist existing members to stay with the fund and/or enables new members to join the fund. The greater volume of members within the fund then cuts costs for the whole membership in terms of fees and expenses. Members may also benefit from other offers as a result of their membership that may enhance other areas of the member's life (within certain boundaries), e.g. discounts from health membership or home loans from agreed providers to the fund.

Thus we would agree that where members are seen by the Trustee to be benefiting from such promotional costs, then they should be a cost to the fund.

It is submitted that the current standards are appropriate, advertising needs to meet the sole purpose test to be appropriate. No legislative change is required.

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

We note that an advertising campaign last year produced by Industry Fund Services Pty Ltd, mentioned, among other things in its advertising that industry–based superannuation funds "return all profits to members". This was one claim that was singled out by ASIC in the enforceable undertaking against IFS dated 3 June 2005.

ASIC stated in the Enforceable Undertaking as part of its background material (and not as part of the Enforceable Undertaking itself) that the claim that industry-based superannuation funds "returning all profits to members" implies that Retail Master Trusts do not return all profits to members. This, they implied, was incorrect.

There are a number of points to be made about ASIC's comment.

The term "return all profits" to members is not correct. if profits are interpreted as the surplus remaining after fund expenses are paid which is retained in the fund for the benefit of members and not actually "distributed" to members.

"Profit" should be interpreted to mean a non-distributable surplus which arises after all expenses of the fund are paid.

Not for profit should mean that the trustee does not charge fees and that it is only reimbursed for its expenses of operating the fund (including where appropriate reimbursement for arm's length director fees). Further, there should be no benefits to associates as somebody could set up a fund and not charge trustee fees but charge excessive management fees for granting management rights to associated entities.

Any associated entity activity should also be not for profit. For example, if there is an associated funds management entity, it too should either operate on a non profit basis, or, alternatively, its share capital should be held wholly on the trust of the fund so that any fees charged are in fact ultimately returnable to the fund.

13. Benchmarking Australia against international practice and experience

REST is not averse to such practices and believes that such comparisons are useful. It has undertaken a number of such exercises itself as a way to provide better service and/or lower costs to members.

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

The Financial Assistance Levy is a mechanism used by the Commonwealth to recover grants made under Part 23 of the Superannuation Industry (Supervision) Act 1993. This means that when a fund has been the victim of an "eligible loss" ie, a loss suffered by the fund as a result of fraud or theft, or in the case of defined benefit funds, where the employer sponsor is unable to pay for the loss, the Trustees can apply to the Commonwealth for a grant to recover all or part of the loss. We note that section 232 of SIS states that the "amount of financial assistance to be granted to a trustee of a fund in respect of the fund must not be greater than the amount that the Minister determines to be the eligible loss suffered by the fund."

APRA's view is that by doing this, the superannuation industry is effectively protecting itself against such losses (APRA letter to Trustees dated 8 May 2006). The superannuation industry then bears the losses of other superannuation funds.

However, some superannuation funds are paying more than others. The Financial Assistance Levy is based on the fund's asset values as at 30 June for each year, which are then multiplied by a prescribed rate. It is those funds with large asset bases, such as REST, which are paying higher levy rates and effectively subsidising the smaller players.

We also note that as the Commonwealth has already made grants of financial assistance to superannuation funds that have suffered a financial loss due to fraud or theft in the 2005-06 financial year, there will be a financial assistance levy for 2007.

REST would suggest a more equitable distribution of levies.

15. Any other relevant matters

REST would like the Committee to consider a review of the current method of applying the member protection rebate for superannuation funds. Whilst the overlying policy of protecting members with low account balances is not questioned, the current method is inequitable across the industry as a whole. Funds with a high proportion of members with first time employment and/or a high demographic of casual and part-time membership will pay a disproportionately higher level of protection costs.Funds with no small account balances contribute no member protection costs.

Approximately 45% of REST members have an account balance of less than $1,000. As a result, REST's member protection costs are substantial and the high cost of protection can only be borne by other fund members. However, the average account balance of a REST member is only $6,000 which is indicative of the very young, highly casualised, part-time, predominantly female demographic of the retail industry. The low income earners workers that member protection is trying to assist, ultimately pay a higher levy to fund this protection.

The member protection system is inequitable and it is proposed that a more equitable approach would require a contribution by each participant in the superannuation industry.