Australian Government

The Treasury

Submission to the Parliamentary Joint Committee on Corporations and Financial Services' inquiry into the structure and operation of the superannuation industry

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ACRONYMS

ADF	Approved Deposit Fund
AFSL	Australian Financial Services Licence
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
ASIC Act	*Australian Securities and Investments Commission Act 2001*
ATO	Australian Taxation Office
Corporations Act	*Corporations Act 2001*
Corporations Regulations	*Corporations Regulations 2001*
EESS	Employee Entitlement Support Scheme
FSI	Financial System Inquiry
FSRA	*Financial Services Reform Act 2001*
GEERS	General Employee Entitlements and Redundancy Scheme
PDS	Product Disclosure Statement
PST	Pooled Superannuation Trust
RSE	Registrable Superannuation Entity
SGC	Superannuation Guarantee charge
SIS Act	*Superannuation Industry (Supervision) Act 1993*
SIS Regulations	*Superannuation Industry (Supervision) Regulations 1994*
SMSF	Self-managed superannuation fund
SoA	Statement of Advice
SWG	Superannuation Working Group

INTRODUCTION

This submission provides an overview of the regulatory framework applying to superannuation in Australia, including the operation of the superannuation trustee and Australian Financial Services licensing regimes, and addresses the specific terms of reference for the Parliamentary Joint Committee's inquiry (the inquiry). This submission does not address the retirement income aspects of Australian Government superannuation policy as this is outside the stated terms of reference for the inquiry. The Committee should also refer to submissions by the relevant regulators, the Australian Prudential Regulation Authority (APRA), the Australian Securities and Investments Commission (ASIC) and the Australian Taxation Office (ATO), in relation to the administration of superannuation regulation.

OVERVIEW

The current prudential and disclosure framework applying to superannuation was established by the Government in 1998 as part of its response to the recommendations of the Financial System Inquiry (FSI). This framework, which applies to authorised deposit-taking institutions, general insurers and life insurers, as well as superannuation entities, has the dual aims of ensuring that:

- entities are managed prudently so that they are able to meet their financial promises to consumers; and
- consumers are given adequate information and are kept informed of the nature and performance of their investments.

The regulatory framework for superannuation, as for all financial sector entities, is not designed to guarantee that an entity will not fail or that superannuation fund members will not suffer investment losses. Rather it is concerned with ensuring that the quality of the entity's systems for identifying, measuring and managing risks to its business acts to minimise the risk of failure and that members and investors are kept abreast of the financial position of the entity and the financial products it offers.

The *Superannuation Industry (Supervision) Act 1993* (SIS Act) and its supporting regulations (SIS Regulations) are the principal legislation governing the operation of concessionally taxed superannuation entities, including in relation to prudential and retirement income requirements. Disclosure requirements pertaining to superannuation are enshrined in the *Corporations Act 2001* (the Corporations Act) and its supporting regulations (the Corporations Regulations).

In terms of specific regulatory responsibilities in the superannuation industry:

- APRA administers the prudential and retirement income provisions of the SIS Act and Regulations for superannuation funds (other than self-managed superannuation funds (SMSFs)), Approved Deposit Funds (ADFs) and Pooled Superannuation Trusts (PSTs);
- ASIC is responsible for market conduct, disclosure and complaints arrangements for superannuation, as well as general administration of the Corporations Act and subsidiary regulations; and

- the ATO is responsible for the regulation of SMSFs, including compliance with the relevant requirements contained in the SIS Act.

Additionally, Treasury has responsibility for advising the Government and formulating policy on the broad features of the retirement income system, prudential regulation and consumer protection for individual members of superannuation entities. Treasury works closely with APRA, ASIC, the ATO and industry stakeholders in relation to these responsibilities.

Australia's superannuation industry

It is estimated that total superannuation assets in Australia were around $905 billion in March 2006. This is up from $761.9 billion at 30 June 2005, and three and a half times the value of superannuation assets in June 1995 ($250 billion).

As at 30 June 2005, over 99 per cent of funds in Australia were accumulation funds. As a proportion of total assets in June 2005, only 3.6 per cent (or $19.3 billion) of total superannuation assets were held by defined benefit funds. This is down from 22 per cent of superannuation assets in June 1995.

In terms of the distribution of superannuation assets across the different segments of the industry, retail funds account for just over 30 per cent of assets (or around $240 billion), SMSFs account for a further 22 per cent of assets (or around $170 billion) and public sector and industry funds each have around 15 per cent of assets. Table 1 provides an overview of the structure of Australia's superannuation industry as at June 2005.

Table 1: Australia's Superannuation Industry (June 2005)

	Funds		Assets	
	Numbers	Market share *(per cent)*	Value ($A billion)	Market share *(per cent)*
Corporate	963	*0.31%*	52.5	*6.89%*
Industry	92	*0.03%*	119.8	*15.72%*
Public Sector	43	*0.01%*	128.6	*16.88%*
Retail	226	*0.07%*	242.6	*31.84%*
Small APRA Funds	7104	*2.29%*	3.1	*0.41%*
Single Member ADFs	193	*0.06%*	0.1	*0.01%*
SMSFs	302,249	*97.23%*	172	*22.58%*
Balance of life office statutory funds	n/a	*n/a*	43.2	*5.67%*
Total	**310,870**	***100%***	**761.9**	***100%***

Source: APRA Annual Superannuation Bulletin June 2005 (issued April 2006).

The number of corporate, industry, public sector and retail superannuation funds has been in decline in recent years, as the trend towards consolidation in the APRA-regulated sector of the superannuation industry continues. This contrasts with continued growth in the number of SMSFs. Over the past two years, SMSFs have grown by around 10 per cent per year, albeit with some slowing in the rate of growth recently, while the other types of superannuation funds have declined in number. For example, the number of corporate

funds has declined by over 20 per cent over each of the last four years. Recent trends in the composition of the superannuation industry by fund type are provided at Table 2.

Table 2: Recent trends in the Australian superannuation industry by entity (2001-2005)

Fund Type	Jun-05	Jun-04	Jun-03	Jun-02	Jun-01
Corporate	963	1,394	1,862	2,484	3,224
percentage change	-31%	-25%	-25%	-23%	
Industry	92	115	124	134	150
percentage change	-20%	-7%	-7%	-11%	
Public sector	43	41	58	76	81
percentage change	5%	-29%	-24%	-6%	
Retail	226	235	235	254	275
percentage change	-4%	0%	-7%	-8%	
Sub total	**1,324**	**1,785**	**2,279**	**2,948**	**3,730**
Small APRA funds	7,104	7,843	8,353	8,451	8,052
percentage change	-9%	-6%	-1%	5%	
Single-member ADF	193	226	263	316	345
percentage change	-15%	-14%	-17%	-8%	
Self-managed superannuation funds	302,249	281,063	253,559	226,859	210,667
percentage change	8%	11%	12%	8%	
Sub total	**310,870**	**290,917**	**264,454**	**238,574**	**222,794**
Pooled superannuation trusts	130	143	160	179	177
percentage change	-9%	-11%	-11%	1%	
Total	**311,000**	**291,060**	**264,614**	**238,753**	**222,971**
percentage change	7%	10%	11%	7%	

Eligible rollover funds are classified as retail funds for the purposes of this publication. Source: APRA Annual Superannuation Bulletin June 2005 (issued April 2006)

The prudential framework for superannuation

The SIS Act and Regulations impose stringent duties and obligations on trustees to manage the assets of superannuation entities prudently and in the best interests of all of the members of the entity. Subject to fulfilling these duties and meeting these obligations, the SIS Act and Regulations provide trustees with considerable flexibility in structuring the operations of the entity. In particular, trustees have extensive scope to invest member assets so as to maximise investment returns to members. This flexibility, subject to appropriate prudential safeguards, provides the best opportunity, alongside the age pension, for ensuring Australians have an adequate income in retirement.

The main elements that comprise the prudential regime for superannuation include the trust structure, minimum entry requirements, investment management requirements, restrictions on the purposes for which a superannuation fund may be maintained, and regulator scrutiny and enforcement.

The trust structure

Regulated superannuation entities generally operate under a trust structure. That is, they are operated for the benefit of members and beneficiaries by a trustee, or trustees, in whom control of the assets of that entity is vested. The assets of the superannuation entity must be kept separate and distinct from the assets of the trustee of the entity, the members, or any related employer-sponsor of the fund.

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

Minimum entry requirements

Since 1 July 2004, a universal trustee licensing and entity registration framework has been in operation for trustees of superannuation entities that are regulated by APRA. The trustee licensing regime is designed to ensure trustees, and the entities they manage, satisfy certain minimum requirements before operating in the market. This in turn enhances the level of safety, and hence public confidence, in the superannuation system. The trustee licensing regime provided for a two-year transition period for existing trustees and their funds, which ended on 30 June 2006. By the end of the transition period, 307 trustees had obtained a licence from APRA.

In order to obtain a licence (referred to in the legislation as a Registrable Superannuation Entity (RSE) licence), trustees must, among other things, meet minimum standards of fitness and propriety and have adequate financial, human and technical resources, an adequate risk management framework and systems to manage the outsourcing of any material business activities. These requirements must be met on a continuing basis.

An additional condition that is imposed on trustees of public offer entities is a minimum capital requirement. Trustees of public offer entities are required to have a minimum of $5 million of net tangible assets or that amount available under an approved guarantee or a combination of the two, or comply with conditions imposed by APRA and agreed to by the trustee regarding the custody of the assets of each of the funds operated by the trustee (capital conditions apply to the custodian in this case).

RSE licensees must also register the entities they manage with APRA. Registration, along with the associated requirement to maintain a risk management plan for the entity, ensures that APRA is able to gain important information about the entities it regulates, the risks they face, and the processes in place to deal with those risks.

Investment rules

As noted above, trustees have considerable scope to invest member assets so as to maximise investment returns to members. However, the SIS Act establishes a range of investment requirements and obligations that are designed to limit the risks associated with superannuation investments, reflecting the important role superannuation plays as a long-term retirement savings vehicle for Australians that is supported by tax concessions.

Under the covenants imposed under section 52 of the SIS Act, the trustee has a general obligation to formulate and give effect to an investment strategy, having regard to the whole of the circumstances of the entity including risk and likely return, diversification and liquidity. In addition, the SIS Act and Regulations permit a trustee to provide

members of the entity choice between two or more investment strategies, subject to the trustee ensuring that each and every strategy satisfies the requirements of the SIS Act.

The investment rules also impose some explicit restrictions in relation to in-house assets and borrowing.

A superannuation entity is not permitted to invest more than 5 per cent of its total assets in in-house assets. That is, superannuation entities are not permitted to make investments in, or loans to, an employer-sponsor, member or their associates (including controlled companies and trusts). One exception to these rules allows a superannuation fund with fewer than five members to invest up to 100 per cent of its assets in business real property leased to a member or employer-sponsor.

The SIS Act also prohibits a trustee of a regulated superannuation fund from borrowing against the assets of the fund, except in certain limited circumstances such as to meet short-term liquidity requirements.

Sole purpose test

The trustee of a regulated superannuation entity must comply with the sole purpose test set out in section 62 of the SIS Act. This test is designed to ensure that the purposes for which a superannuation fund is maintained are limited to the provision of retirement benefits to members and other benefits that are related to the provision of retirement benefits. Essentially, the sole purpose test requires that concessionally taxed superannuation funds be maintained solely for:

- at least one of the legislated core purposes, which are the provision of benefits on or after a member's retirement, attainment of the age 65 or death; or
- at least one of those core purposes and for one or more of the prescribed or approved ancillary purposes, which are the provision of employment termination benefits, salary continuance once a member ceases to work because of ill health, reversionary benefits and other approved benefits on or after an appropriate condition has been met.

Supervision by APRA

The SIS Act and Regulations, along with the *Financial Sector (Collection of Data) Act 2001*, contain extensive arrangements providing for the disclosure of information to the regulator, monitoring and enforcement. In assessing the compliance of trustees, APRA conducts on-site reviews and other monitoring, data collection and analysis and risk assessment at least annually to ensure continuing compliance with the regulatory requirements.

In relation to reporting requirements, trustees are required to submit fund data at least annually to APRA (or the ATO, in the case of SMSFs) and are expected to comply with other reporting obligations, including requirements to report significant adverse events and breaches of legislative requirements and of RSE licence conditions. Whistleblowing obligations are also imposed on auditors and actuaries. Collectively, these requirements are designed to ensure that issues with the potential to impact on the safety of an entity are identified and addressed in a timely manner.

With the introduction of the Government's trustee licensing reforms, supervision of trustees and their entities has shifted towards a more proactive, preventative approach to

prudential supervision, centred on closer monitoring of risk management, resource adequacy and effective governance arrangements.

APRA has at its disposal a wide range of enforcement powers, including issuing directions to replace persons or service providers, restrict business activities, or even to direct the winding-up of an entity. In extreme cases, APRA has the power, subject to ministerial consent, to cancel an RSE licence, or to suspend, remove or replace a trustee. In less severe situations, APRA may accept an enforceable undertaking from the trustee or issue directions to the trustee to address an area of concern and monitor a rectification programme.

The consumer protection and disclosure framework for superannuation

The Australian Government has undertaken significant reform of the consumer protection and disclosure framework overseen by ASIC since the regulator was established in 1998. In particular, the Government introduced the *Financial Services Reform Act 2001* (FSRA), which amended the Corporations Act to provide for a single licensing regime for financial sales, advice and dealings in respect of financial products. Under the FSRA, any person wishing to carry on a financial services business in Australia must hold an Australian Financial Services licence (AFSL), or be the representative of an AFSL licensee.

An AFSL imposes a number of obligations on the licensee with respect to standards of behaviour and training. These obligations include a duty to comply with financial services laws, an obligation to have in place adequate arrangements for managing conflicts of interest and, if the relevant financial services are to be provided to consumers in a retail capacity, an obligation to allow access to an approved dispute resolution system.

Importantly, the law requires financial services licensees to do all things necessary to ensure that the financial services covered by the licence are provided efficiently, honestly and fairly.

The Corporations Act also contains a comprehensive financial product disclosure regime that provides for consistent and comparable disclosure across most financial products, including superannuation. Under the regime, which took full effect in March 2004, financial services providers and their agents have an obligation to disclose 'clearly, concisely and effectively' to consumers, both up front and on an ongoing basis, any information that the particular individual may need to make an informed investment decision or better understand the products and services they are acquiring or holding.

Within the Corporations Act, there are several disclosure obligations that apply specifically to superannuation and superannuation-like products, such as managed investments. In this regard, the Government has recently implemented a requirement on superannuation funds to provide enhanced disclosure of any fees and costs associated with their product in their PDSs and periodic statements. This requirement is designed to allow consumers to compare fees and costs between different superannuation products more easily.

On 1 December 2005, the Government also introduced a series of refinements to financial services laws to improve the clarity and amount of information that consumers receive when obtaining advice about financial products. These include amendments to allow for the provision of a 'short-form' PDS that, in the case of superannuation and superannuation-like products, must include enhanced fee disclosure information. Also included are amendments dealing with the circumstances in which a Statement of Advice (SoA) must be provided in the case of an ongoing adviser-client relationship and reduced verbal disclosure requirements for advisers.

ASIC's enforcement powers

Like APRA, ASIC has broad-ranging powers in relation to its roles and objectives as set out in the *Australian Securities and Investments Act 2001* (ASIC Act) and the Corporations Act. In particular, ASIC is empowered to take whatever action it considers necessary where it has reason to suspect there may have been a contravention of any law in the corporations legislation.

In relation to the financial services laws in particular, ASIC may exercise a range of punitive sanctions against an entity found in breach of these laws, including:

- withdrawal or suspension of the entity's licence;
- imposition of conditions on the entity's licence;
- acceptance of an enforceable undertaking that is binding on the entity; or
- banning of the particular individual from the financial services market.

There is also a general prohibition on misleading or deceptive conduct and unconscionable conduct in relation to the provision of financial services and dealings in financial products in the ASIC Act, which is enforceable by ASIC.

Specific Issues Raised By The Inquiry's Terms Of Reference (ToR)

ToR 1 Whether uniform capital requirements should apply to trustees

As noted in the Overview, under the SIS Act only trustees that hold a licence that allows them to operate a public offer fund are required to hold a mandated level of minimum capital or alternatively to meet custody requirements. The issue of whether minimum capital requirements should be extended to non-public offer trustees was examined by the Superannuation Working Group (SWG), which was established by the Government in 2001 to inquire into options for improving the safety of superannuation. In its 1992 report, the SWG recommended that APRA determine the amount of resources, including capital, required to be held by each trustee to address the operational risks relevant to the trustee. In its response, the Government indicated that it supported, in principle, a risk-sensitive framework for the holding of capital to address operational risk, but considered that the combination of requirements that each trustee be licensed by APRA and prepare a risk management plan substantially addressed the concerns relating to operational risk.

On this basis, the Government indicated that it supported the retention of the status quo for capital requirements, but would revisit the issue once the impact of the trustee licensing and risk management reforms could be assessed.

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

The Government considers that the best way of ensuring that superannuation entities are managed in members' best interests is via a trustee, or trustees, in whom control of the assets of that entity is vested. Prudential regulation of superannuation promotes the safety of members' benefits by focusing on ensuring that all trustees have sound governance practices in place and meet minimum standards in relation to their own operations and the operations of the entities they manage. The prudential framework places the onus on trustees, regardless of their structure, to demonstrate to APRA that they meet these standards.

Consistent with recommendation 2 of the SWG report, the Government has implemented a trustee licensing regime which maintains the practice of allowing trustees to be constitutional corporations, bodies corporate which are not constitutional corporations or groups of individual trustees. In this way, the regulatory framework supports a diversity of arrangements among trustees, including by allowing for individuals to act as a trustee as part of a trustee group. This reflects the historical development of the superannuation system and helps to ensure that trustee bodies are reflective of their fund membership and the broader community at large. However, the SIS Act does impose some restrictions on the superannuation entities which certain trustees are permitted to manage, so that only constitutional corporations are permitted to be the trustee of a public offer entity.

Trustees that are bodies corporate may take various structural forms. Different regulatory requirements apply, depending on the structure adopted. The Corporations Act provides two structures for companies: public companies and proprietary companies.

Public companies are permitted to raise capital by offering their shares for sale to the public. In addition, public companies may list their shares on a registered stock exchange. Listed public companies are subject to more stringent disclosure obligations than other public companies.

Under the law, public companies may have one shareholder but there must always be three directors. While the Corporations Act does not require proprietary companies to hold an Annual General Meeting (AGM), the law requires all public companies to hold an AGM within 18 months of registration and then once every calendar year after that date.

As a general rule, directors of both public and proprietary companies must exercise their duties with due care and diligence in the best interests of shareholders. The law prevents public company directors with a material personal interest in a matter from being present, and voting, at a meeting to consider that matter. By contrast, a director of a proprietary company with a material personal interest in a matter may attend the meeting and vote on that matter provided they disclose their interest.

Further, the law provides that public company directors may only give financial benefits to a related party if that benefit is at arm's length or the company has first obtained the approval of the company's shareholders. There is no equivalent requirement for proprietary companies. 'Related parties' in this context includes any entity that controls, or is controlled by, the public company or individuals related to the public company's directors, such as their parents, spouses or children.

In terms of reporting, public companies must prepare and lodge an annual directors' report and an audited annual financial report with ASIC. The directors' report must include a review of the company's operations for the period, a discussion of the company's principal activities and any changes in the nature of those activities during the period. The financial report is made up of financial statements and associated notes prepared in accordance with applicable accounting standards. Similar financial reporting obligations apply to large proprietary companies.

Given the recently strengthened prudential and governance framework applying to superannuation and the existing requirement for public offer trustees to be constitutional corporations, it is not clear what benefits, if any, would flow from mandating a particular corporate structure for all trustees. Indeed, trustees currently operating under an alternative structure would likely face significant costs in reconstituting themselves to comply with uniform arrangements. These costs would ultimately be passed on to members in the form of higher management fees.

ToR 3 The relevance of Australian Prudential Regulation Authority standards

Under the current prudential framework, APRA does not have the power to make prudential standards in relation to the superannuation industry. In 2002, the SWG recommended, in its report *Options for Improving the Safety of Superannuation*, that APRA be given this power. The Government did not accept this recommendation because it considered that APRA could achieve all its objectives within the existing regulatory framework once the trustee licensing regime was implemented.

While APRA does not have a prudential standards-making power in relation to the superannuation industry, the SIS Regulations include several operating standards covering both retirement income and prudential matters. These subordinate legislative instruments establish minimum standards in relation to key aspects of a trustee's operations, including fitness and propriety of trustees, outsourcing and adequacy of resources. There are also regulations supporting the risk management requirements set out in the SIS Act.

In addition, APRA issues extensive general guidance to the entities it regulates on how it interprets and administers relevant legislation. This includes superannuation circulars, frequently asked questions (FAQs), superannuation guidance notes and other information for RSE licensees. APRA's guidance material is non-binding and designed to clarify

APRA's interpretation of the law and assist industry in meeting the regulatory requirements.

APRA periodically updates its guidance material to ensure that it remains relevant in the face of legislative change and industry developments. For example, in March 2006, APRA released a revised superannuation circular on managing investments and investment choice, which responds to issues arising from recent industry trends.

In January 2006, the Government's Taskforce on Reducing Regulatory Burdens on Business (the Regulation Taskforce) recommended that APRA review its guidance material to ensure it provides effective guidance on good practice in meeting regulatory requirements and does not impose additional or inflexible regulatory requirements. The Government referred this recommendation to APRA for consideration as part of its final response to the Regulation Taskforce Report. The Government's final response to the Regulation Taskforce Report was released on 15 August 2006.

ToR 4 The role of advice in superannuation

The role of financial advice is to assist consumers to make informed investment decisions and understand the products and services they are acquiring or holding. The Government encourages the provision of appropriate financial advice to assist consumers. However, because the quality of financial advice is a key factor in ensuring consumers are in a position to make informed decisions, the law requires any person providing such advice to satisfy certain requirements. [1]

In particular, advisers must ensure that any advice they provide is appropriate to the consumer's circumstances and needs. By law, advisers are accountable for the advice they provide and must have a reasonable basis for that advice. To this end, the law requires the adviser to have sufficient competency training to provide advice.

There is also a requirement for advisers to do all things necessary to ensure that the advice they provide is delivered efficiently, honestly and fairly. Importantly, any person providing advice with respect to superannuation must have in place arrangements to manage conflicts of interest that may arise wholly, or partially, in relation to activities that person undertakes. Complementing this is the requirement that advisers transparently disclose any conflicts of interest such as remuneration, commissions or other benefits that they will receive from providing particular advice.

There are three written disclosure documents that may need to be provided to retail clients when they receive financial advice. These include the Financial Services Guide (FSG), which should be given to any consumer before they receive a financial service. The FSG contains information to enable the client to identify who is offering the service, any associations the adviser has, the nature of the service, remuneration details (including commissions) and avenues to make complaints.

There is also a requirement for advisers to provide an SoA where they give retail clients advice that takes into account one or more of the particular client's needs, objectives or financial situation. This document must include the advice provided, the basis on which the advice was given and more detailed information about any remuneration (including commissions) or associations that might reasonably be expected to be, or have been, capable of influencing the adviser in providing the advice. The purpose of an SoA is to

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1 With regard to SMSFs, there is a limited exemption for recognised accountants. See Treasury's comments in relation to ToR 7.

give the retail client information with which to judge the value and impartiality of the advice, prior to deciding whether to act on it.

When a person becomes a member of a superannuation fund, the trustee is required to give the member a PDS. This is a point-of-sale disclosure document that applies to all financial products with the exception of securities. PDSs are intended to provide consumers with sufficient information to make informed decisions in relation to the acquisition of the financial product, including the ability to compare a range of products.

As noted in the Overview, the Government introduced a series of refinements to financial services regulation in December 2005 with the aim of encouraging the production of disclosure documents that have less duplicated information and relate more directly to consumer needs, whilst at the same time reducing the compliance costs for industry.

Of particular note were amendments permitting financial service providers to provide retail clients with a 'short-form' PDS. This may be provided to consumers in place of the full PDS, however a product provider must still prepare a full PDS and provide consumers with a clear notice in the short-form document that the consumer may request this information if they think it necessary.

The refinements amended the law to exempt from financial services disclosure obligations any advice that is not linked to a specific product and where no remuneration or other benefit is received.

The refinements also specify that an adviser need not provide an SoA where they are giving related advice to a client with whom they have an ongoing relationship, if that client has already received a relevant SoA. This amendment was in response to concerns that the provision of particular information in an SoA may be duplicative or unnecessary.

Further, the refinements reduced the verbal disclosure requirements for financial products subject to a cooling-off period, such as superannuation, so that consumers are only required to be informed under oral disclosure requirements that a cooling-off period applies, and that written disclosure will be provided at a later time.

ToRs 5 and6 The meaning of member investment choice and the responsibility of the trustee in a member investment choice situation

The SIS Act recognises that individual circumstances, and hence investment needs, will vary, and accommodates this by permitting trustees to offer superannuation fund members a choice between two or more investment strategies. Where investment choice is offered to members, this must be done in a way that is consistent with the investment management requirements of the SIS Act. As outlined in the Overview to this submission, these requirements assign sole responsibility for formulating investment strategies to the trustee of the entity, who must do so in a manner that has regard for the whole of the circumstances of the entity including risk and return, diversification and liquidity.

Where investment choice is offered to members, the SIS Regulations and the Corporations Act and Regulations impose specific disclosure obligations on trustees, including:

- a general obligation under the Corporations Act to provide in a PDS information about any significant benefits, risks, features and costs associated with each investment option;
- an obligation under the SIS Regulations to provide, in a PDS or a separate document, information on the objectives of each investment strategy and all the information the

trustee reasonably believes a person would need to understand the effect of, and any risk involved in, each strategy;

- an obligation under section 1012IA of the Corporations Act to provide a PDS concerning any financial products that may be acquired through an investment strategy[2] ; and
- an obligation under the Corporations Regulations to disclose in periodic statements details of any other investment strategies that may be available to a particular member or how such information can be requested.

An issue that has recently received some attention is the role of the trustee in formulating investment strategies where members are in receipt of advice from a financial adviser.

While the SIS Act does not expressly prevent a trustee from considering financial planner advice, as a trustee must consider all the circumstances of an entity when formulating and implementing an investment strategy, the extent to which a trustee can consider financial planner advice will always be incidental. Where a trustee is properly complying with its investment management obligations, the impact of factors such as the diversification and liquidity of the entity should already have been considered by the trustee in developing the strategy and should not need to be revisited as a result of individual members choosing between strategies.

Treasury notes that on 13 March 2006, APRA released a revised superannuation circular providing updated guidance to trustees on the SIS Act requirements concerning managing investments and investment choice.

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

SMSFs perform the same role as other superannuation funds, by investing contributions and making benefits available to members on retirement. Generally, a superannuation fund is an SMSF if it has fewer than five members, where each member of the fund is also a fund trustee. This ensures all members of SMSFs are able to protect their own interests.

Growth

There has been considerable growth in the SMSF sector in recent years. However, this growth needs to be viewed in the context of broader changes across the superannuation industry. From 1996-97 to 2004-05, the market share of superannuation assets of retail, small funds and industry funds increased, while the market share of all other types of superannuation funds decreased. In this context it is difficult to separate the drivers of SMSF growth specifically, from the drivers which have influenced the growth of superannuation savings more broadly. Similar issues will arise if attempts are made to separate growth in SMSF savings from broader growth in superannuation savings following the release of the Government's *Plan to Simplify and Streamline Superannuation*. Given that the Government's plan is designed to encourage saving in the Australian superannuation environment, it could be expected that SMSF assets will grow as a result of this policy.

The past 15 years has seen positive economic conditions in Australia, with continuous economic expansion and record low unemployment over that time. Combined with the maturing of the Superannuation Guarantee system, these conditions have helped drive the

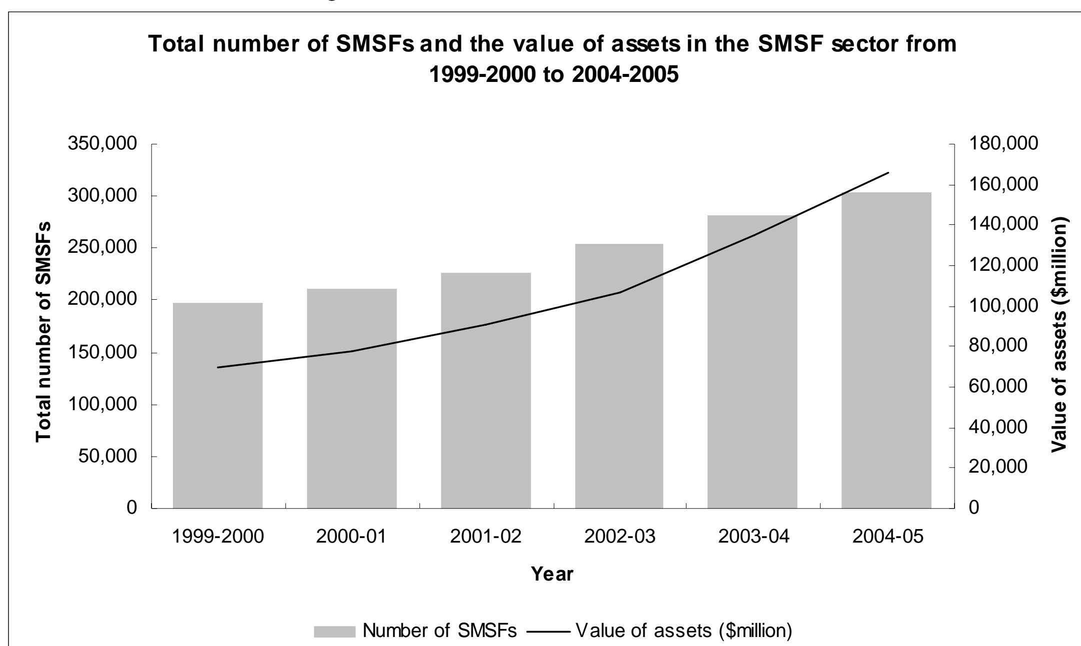
2 ASIC has extended interim relief from complying with this requirement until 30 June 2007.

growth in overall superannuation assets and account balances. Given that above-average superannuation holdings are generally recommended as necessary for the successful establishment of an SMSF, larger superannuation account balances mean many Australians are now better placed to establish an SMSF.

The number of SMSFs grew from around 198,000 as at June 2000 to over 303,000 by the end of the 2004-05 financial year. [3]

Data from the ATO indicates the value of assets in SMSFs grew from $70 billion in June 2000 (14 per cent of total superannuation assets) to $165 billion in June 2005 (22 per cent of total superannuation assets).[4] As a result, SMSFs moved from the fifth-largest to the second-largest superannuation sector in terms of market share of the value of assets. Chart 1 shows the growth in the number of SMSFs and the growth in the value of assets in the SMSF sector from 1999-2000 to 2004-05.

Chart 1: Total Number of SMSFs and the value of assets in the SMSF sector in each financial year from 1999-2000 to 2004-05.



The number of accounts in SMSFs grew from around 377,000 in June 2000 (1.75 per cent of total superannuation accounts) to 579,000 in June 2005 (2.1 per cent of total superannuation accounts). By asset size, SMSFs are now a significant part of the superannuation industry, although in terms of total number of members involved, they are still small when compared to the industry as a whole.

Major reasons for growth

In an environment of positive economic conditions and a maturing superannuation system, the three main reasons likely to have contributed to the stronger growth in the value of assets held in SMSF accounts are:

- investors' desire for control and flexibility;

3 ATO Taxation Statistics 2003-04 (issued May 2006)
4 ATO Taxation Statistics 2003-04 (issued May 2006)

- investors' dissatisfaction with larger fund performance; and
- advice from accountants and financial planners.

Investors' desire for control and flexibility

The most popular reason cited for establishing an SMSF is the greater degree of control and flexibility it offers.[5] SMSFs potentially offer greater control and flexibility, compared to other superannuation vehicles, in areas such as investment strategies and management.

For example, superannuation fund trustees must select their investments and their investment strategies with the whole fund in mind. In contrast, SMSFs are able to plan their investment decisions and strategies to align with the specific interests and preferences of their limited number of members.

Recent Government policies allowing choice of superannuation fund, and improving the ability of fund members to transfer and consolidate their superannuation holdings, may also have played a role in delivering the opportunities for investors to take control of their retirement savings.

Dissatisfaction with large fund performance

The rate of SMSF establishments tends to increase when returns from other superannuation vehicles fall. Treasury analysis shows that, from 2000-01 to 2004-05, median superannuation fund investment returns were inversely related to the growth rate in the number of SMSFs. However given the relatively limited timeframe this data covers, it is not clear whether growth in this sector will continue to follow such a pattern.

Survey evidence also suggests that perceptions of lower costs of using SMSFs, compared to other superannuation vehicles, may be a reason for their establishment.[6]

Advice from accountants and financial planners

Many individuals depend on their accountants for advice and assistance with their entire business, taxation and financial affairs. Some individuals also seek the advice of financial planners. Research suggests that two main reasons cited by SMSF trustees for establishing their SMSF was advice from their accountant or financial planner.[7]

Treasury notes that some specific activities, which by their nature do not constitute, or should not be treated as, financial services, are not subject to financial services licensing. This includes advice in relation to the structure and operation of SMSFs.

Recognised accountants that hold appropriate qualifications are able to provide advice to their clients on a decision to acquire or dispose of an interest in an SMSF without the need to be licensed under financial services regulation. This exemption recognises that the

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5 Fifty-five per cent of people said that having more control over their superannuation investments was a factor in establishing their SMSF; Investment Trends research presented at the 3rd Annual SMSF Conference (October 2005). Control and flexibility were commonly mentioned reasons for considering establishing an SMSF in the Association of Superannuation Funds of Australia's Report into Choice and in a survey by CPA Australia: CPA Australia, 'Self Managed super funds' (October 2004).

6 Investment Trends research found that 24 per cent of trustees set up an SMSF to save money on fees; AMP Capital Investors media release, 23 March 2005.

7 The research found 33 per cent of people said that advice from their accountant was a reason for establishing their SMSF, 29 per cent of SMSF trustees cited advice from their financial planners was a main reason for setting up their SMSF: Investment Trends research presented by Mark Johnston, the director of Investment Trends, at the 3rd Annual SMSF Conference (2005).

establishment of an SMSF often forms part of an overall business strategy, which would include other advice not covered by financial services regulation, such as on business structuring and taxation. The exemption does not cover the provision of advice about the particular investments that an SMSF should hold.

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

A defined benefit superannuation fund is a fund which provides benefits to members according to a predetermined formula, which may take into account factors such as the member's length of service, salary averaged over a period or at a particular point in time, or a specified amount. As a defined benefit entitlement is not linked, or only partially linked, to market returns, it is the employer-sponsor who bears the financial risk of ensuring the fund is able to meet its benefit promises to members. In contrast, an accumulation fund pays benefits to members equal to the amount accumulated in the fund in respect of the member, being made up of contributions and investment earnings, less fund expenses. Consequently, members directly bear the investment risks in accumulation funds, including the risk of investment losses.

These differences in the structure and funding arrangements of defined benefit funds and accumulation funds are reflected in the inclusion in the SIS Act of specific prudential requirements for defined benefit funds.

Under the SIS Act, responsibility for maintaining the solvency of a defined benefit fund rests with the employer-sponsor of the fund, who must make contributions according to an actuarially determined formula covering all the members of the fund. Employer-sponsors are also required to make up any funding shortfall that arises, for example, as a result of the fund suffering investment losses. For an accumulation fund, the employer-sponsor's obligations are limited to contributions as mandated under the Government's Superannuation Guarantee legislation (9 per cent of ordinary time earnings) or by an industrial award or workplace agreement.

In order to ensure defined benefit funds are adequately funded, the SIS Act also requires all defined benefit funds to:

- undertake an actuarial investigation of the fund on a triennial basis; and
- on the basis of the actuarial investigation, obtain a funding and solvency certificate establishing, among other things, the minimum contributions reasonably expected to be required in respect of any member or class of members to secure the solvency of the fund over the next triennial period.

APRA may also direct the trustee of a defined benefit fund to obtain a new or replacement funding and solvency certificate, or undertake an actuarial investigation, if it considers on reasonable grounds that to do so would be in the prudential interests of the fund and in the best interests of fund members.

In addition, as part of the more proactive and preventive approach to prudential regulation introduced in 2004 through the Government's superannuation safety reforms, the reporting requirements concerning defined benefit funds have been strengthened to require actuaries and auditors of defined benefit funds to report to the trustee and APRA where they form an opinion that the trustee has failed to implement an actuarial recommendation in relation to the fund.

Over the last few years the number of defined benefit funds has been in decline. Recent trends in the composition of the superannuation industry by funding type are shown in Table 3.

Treasury has not conducted any specific analysis of the reasons for the decline in the number of defined benefit funds. However, anecdotal evidence suggests that this decline can be viewed as part of a broader market trend towards consolidation in the superannuation industry, which has seen corporate funds, in particular, transfer members and assets into public offer superannuation funds such as retail master trusts.

Table 3 Composition of the superannuation industry by fund type (funds greater than four members)[8]

	Jun-04			Jun-05		
	Entities	Members ('000)	Assets ($m)	Entities	Members ('000)	Assets ($m)
Accumulation	1,257	17,490	283,589	876	17,941	270,977
Defined benefit	140	734	19,449	88	604	19,326
Hybrid fund	388	7,967	160,943	360	8,747	253,190
Total	1,785	26,191	463,981	1,324	27,292	543,493

Source: APRA Annual Superannuation Bulletin, June 2004 (revised 20 April 2006) and June 2005 (issued 20 April 2006).

Possible drivers of this trend may include:

- employer-sponsors seeking to realise cost savings, exit non-core business operations, or provide their employees with access to a broader range of benefits, such as insurance benefits;
- trustees and employer-sponsors being unwilling to meet regulatory requirements, such as actuarial requirements and requirements imposed by the new superannuation trustee licensing regime; or
- employer-sponsors seeking to limit their exposure to financial risk, for example through the obligation to make up any funding shortfall in the event a defined benefit fund is unable to meet its liabilities.

ToR 9 Cost of compliance

Compliance costs for APRA-regulated superannuation funds

It is important that regulation represents an appropriate and measured response to the problem being addressed. Compliance costs associated with regulation are a major concern for all businesses and especially small businesses. The Government is committed to reducing the burden of red tape to improve the economic environment further so that

8 Comparable data is only available for 2004 and 2005 due to different methodological approaches being used by APRA over time. The term 'hybrid fund' is not defined in the SIS Act, but is a term used by APRA to categorise those funds that have both accumulation and defined benefit members. Under the SIS Act a fund with at least one defined benefit member is deemed to be a defined benefit fund.

all businesses can prosper and grow, while at the same time maintaining a strong and effective prudential regulation and consumer protection framework that ensures financial sector entities such as superannuation funds are able to meet their promises to consumers.

As noted in the Overview, the Government has implemented major reforms to both prudential regulation of superannuation and to the way in which the conduct of financial services providers are regulated in recent years. As a result some superannuation trustees are now required to hold both an RSE licence, issued by APRA, and an AFSL, issued by ASIC. It has been argued that there has been an increase in compliance costs associated with meeting these licensing requirements.

Under both the RSE and AFSL regimes, applicants are subject to a 'one-off' licence application fee. Consistent with the Government's cost recovery policy, RSE licence application fees are designed to recover APRA's costs of processing applications for the different classes of licence, while corporations fees are set to ensure that, over time, total revenue from corporations fees approximates the total costs and outlays associated with the national corporations regulation scheme.

The RSE licence application fees are:

- $20,000 for public offer and extended public offer licence applications;
- $5,500 for general non-public offer entity licence applications; and
- $3,500 for small non-public offer entity licence applications.

The AFSL application fees, which are also set on a cost recovery basis, are:

- $150 for an individual (lodged electronically);
- $330 for an individual (lodged by paper);
- $270 for a corporation, partnership or trustee (lodged electronically); and
- $540 for a corporation, partnership or trustee (lodged by paper).

Licensees may also face costs stemming from the need to comply on a continuing basis with minimum standards established under the respective licensing regimes. With regard to the superannuation trustee licensing requirements, the impact on compliance costs over and above the licence application fees will inevitably vary depending on the size of the entity, the complexity of its operations and the quality of its existing systems and management structures. However, Treasury notes that many of the activities required by the trustee licensing reforms are consistent with what might be considered sound business practice, for example, in the area of risk management, and compliance costs would consequently be expected to be less for well-managed funds.

Nonetheless, any increase in costs to funds should be balanced against the greater confidence members can have that their retirement savings are being managed in a manner that is consistent with best practice and the significant benefits for consumers through the introduction of consistent basic standards for financial advice and disclosure across the industry, including to allow consumers to compare like products.

Anecdotal evidence provided by the industry suggests that many funds have realised benefits as a result of going through the RSE licensing process. For example, trustees have reported that the licensing process has proven to be beneficial by providing an opportunity for them to undertake a more rigorous self-assessment of internal compliance

processes and risk management practices and identify areas where operational improvements could be made.

Given APRA's and ASIC's respective responsibilities for prudential regulation and consumer protection, inevitably there will be some areas where their responsibilities potentially overlap.

The Government is working with both APRA and ASIC to reduce compliance costs resulting from overlap, including by improving information sharing arrangements and identifying areas where processes can be streamlined. In this regard, the Government has accepted all of the recommendations of the Regulation Taskforce report *Rethinking Regulation* relating to unnecessary regulatory burdens within financial and corporate regulation. In particular, the Government is reviewing requirements on data collection, breach reporting and responsible person regimes relating to both regulators.

The Regulation Taskforce also recommended that the Government give a high priority to comprehensive simplification of the tax rules for superannuation. Following an extensive consultation process, the Government announced, on 5 September 2006, that it will proceed with the proposals outlined in *A Plan to Simplify and Streamline Superannuation*. The plan will remove the current raft of complex tax arrangements and restrictions that apply to superannuation benefits, making the superannuation system easier to understand and comply with for both funds and fund members.

To reduce the costs for industry of complying with financial services regulation, the Government implemented, in December 2005, a series of refinements to financial services laws. These refinements, which are dealt with in more detail in Treasury's comments in relation to ToR 4 concerning the role of advice in superannuation, provide industry with greater certainty as to how it should comply with its legal obligations and ensure that consumers receive information that is relevant to their needs.

The Government is also examining the effect on the superannuation levies for prudential regulation of superannuation funds of the fundamental changes to the superannuation industry over recent years (see Treasury's submission in relation to ToR 10 concerning the appropriateness of the funding arrangements for prudential regulation).

Compliance costs for SMSFs

In many cases, costs of compliance for SMSFs are significantly lower than those faced by APRA-regulated superannuation entities. This reflects the unique circumstances of SMSFs, in that they have fewer than five members and all members generally are trustees. SMSFs are exempt from the broad legislative requirements to hold an RSE licence and a financial services licence which impact on other superannuation entities.

Despite their unique circumstances, it remains necessary for a level of regulatory oversight to be imposed. Superannuation receives substantial tax concessions designed to increase the retirement incomes of members. Given the scale of these concessions, it is important to ensure that superannuation funds are complying with relevant legislative requirements and, as such, are being used for retirement income purposes.

ToR 10 The appropriateness of the funding arrangements for prudential regulation

The current funding arrangements for prudential regulation are derived from the 1997 FSI. The FSI accepted the '…general principle that the costs of financial regulation should be borne by those who benefit from it'.[9] The FSI saw the most practical way of applying this principle as being the levying of industry to meet the cost of regulation incurred by regulatory agencies, with each industry sector levied in proportion to the agency resources expended on it.

As a result, the cost of prudential regulation in the financial services sector is paid for collectively by the regulated institutions themselves. This is consistent with recommendation 104 of the FSI that 'as far as practicable, the regulatory agencies should charge each financial entity for direct services provided, and levy sectors of industry to meet the general costs of their regulation'.[10]

The vast majority of the costs associated with APRA's supervisory role, and certain consumer protection and market integrity functions (related to prudentially regulated entities) of ASIC and the ATO, are funded through levies on prudentially regulated entities. These levies are known as the financial sector levies.

The remainder of APRA's costs are recouped through direct fees and charges. This method of funding is used primarily for discrete activities with direct benefits that cannot be considered as general prudential supervision. For example, approval of applications to be an authorised deposit-taking institution, insurer or superannuation fund trustee are charged directly to the applying entity.

The levy-setting arrangements have been reviewed, in consultation with industry, twice since 1997 to ensure their continued effectiveness. The Government announced the findings of the latest review of financial sector levies in May 2004 and noted that 'these measures ensure that the burden of funding regulation is shared in a fair and efficient way and allows for increased flexibility in the way levies are collected'.

In addition, as part of the annual process of determining the financial sector levy parameters, Treasury and APRA consult with industry.

Conceptually, there is a wide range of possible arrangements for recovering from industry the costs of the prudential supervision and regulation functions. At one extreme are individualised fee-for-service arrangements and, at the other, broad-based funding from the financial sector as a whole that takes no account of the individual costs of regulating particular industry sectors or institutions. The last review of levies found problems with both of these models and industry did not favour them.

The existing levy arrangements lie between these extremes, attempting to strike the best balance of horizontal and vertical equity — that is, equity between entities in the different prudentially regulated sectors (deposit-taking institutions, general insurers, life insurers and superannuation funds) and equity between different entities in the same sector.

The cost of prudential regulation and the consequent levies are separately determined for each industry sector as each sector contains entities undertaking broadly the same activities and is clearly differentiated from other industry sectors. This sectoral approach to levies was supported by broad industry consensus.

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9 Financial System Inquiry Final Report, 1997, pages 68, 532.

10 Financial System Inquiry Final Report, 1997, page 532.

Within industry sectors, the levies are determined based on the total value of the assets of regulated institutions. Total assets are considered to be correlated with the level and cost of prudential supervision by the regulator, an institution's capacity to pay, the impact on the system of its possible failure and the institution's stake in a stable financial system.

Currently, the superannuation industry is experiencing major structural changes. Strong growth in the asset base of superannuation funds has been occurring at the same time as the number of funds and trustees has been rapidly declining. Many funds are consolidating, transferring or winding up as a consequence of opting not to seek an RSE licence.

In recognition of these changes, the Government afforded the superannuation sector transitional arrangements in implementing the new levy determination framework announced in May 2004. In setting the levies for 2006-07, the Government extended the transitional levy arrangements that applied to superannuation entities in 2005-06 (the first year of the new framework) for one more year.

The impact of the decline in superannuation fund numbers and its longer term impact on prudential regulation and the financial sector levies are being examined by Treasury and APRA, with a view to consulting with industry on these issues.

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

In the Australian superannuation system, expenses which may legitimately be funded out of the assets of a superannuation entity will be determined by a number of factors, such as the general law of equity, the trust deed of the entity and legislation. For example, under the general law of equity, trustees are entitled to be remunerated out of the trust's assets for costs incurred in managing the trust, but are not entitled to make a profit from their position as trustee. The trust deed of the entity may specify the remuneration, if any, that may be received by a trustee and also set out other expenses which may be funded from the assets of the entity.

Government policy in relation to superannuation is designed to ensure that the superannuation savings of Australians, which are supported by tax concessions, are available for retirement. The Government supports this objective through a number of measures and, in particular, through legislated restrictions on the purposes for which concessionally taxed superannuation funds can be maintained. These restrictions are known as the 'sole purpose test'.

As outlined in the Overview, the sole purpose test permits concessionally taxed superannuation funds to be maintained solely to provide retirement or death benefits (core purposes) and certain ancillary benefits, such as redundancy and disability benefits, for members. The sole purpose test aims to strike a reasonable balance between giving trustees flexibility in deciding what services to offer to members and how best to manage superannuation entities in members' interests while ensuring that members' assets are not used for purposes that are not related to paying benefits on retirement.

APRA has responsibility for ensuring that superannuation entities comply with these requirements and has provided guidance on how it interprets and intends to enforce the sole purpose test in its Superannuation Circular No III.A.4 *The Sole Purpose Test*. APRA's circular suggests that expenditure out of fund assets could be considered to meet the test where it can be demonstrated that it has a 'reasonable, direct and transparent connection' with the provision of core and ancillary benefits to current members. This is to be assessed in light of the overall circumstances of the particular superannuation fund.

In relation to expenditure on fund advertising, Treasury notes that on 14 March 2006 Mr Ross Jones, Deputy Chairman of APRA, wrote to all trustees of APRA-regulated superannuation funds to explain APRA's approach to advertising in the context of the sole purpose test and the trustee's duty to act in the interests of members. In addition to reinforcing the guiding principle that there should always be a reasonable, direct and transparent connection between a particular scheme feature or trustee action and the core and ancillary purposes of the fund, Mr Jones noted that expenditure on marketing and promotional campaigns may be appropriate in limited circumstances, for example, where it is designed to inform and educate existing members. A copy of Mr Jones' letter can be found on APRA's website. [11]

ToR 12 The meaning of the concepts 'not for profit' and 'all profits go to members'

The prudential framework for superannuation is risk-based and, as such, focuses upon the risks to the particular entity irrespective of how that entity may be structured. The risk profile of the entity, rather than its profit status, will determine how an entity is to be regulated by APRA.

Consistent with this approach, the SIS Act does not distinguish between superannuation funds according to their profit status, but it does introduce certain legal classifications for superannuation funds, for example, to distinguish between public offer and non-public offer superannuation funds for the purposes of establishing minimum capital requirements.

The term 'not-for-profit' has a well-established meaning under common law. For an organisation to be a not-for-profit company it must be a company that is not carried on for the purposes of profit or gain to its individual members and its constituent documents must prohibit it from making any distribution, whether in money, property or otherwise, to its members. Instead, any profits are put to furthering the organisation's objectives. The prohibition on distributions applies while the organisation is operating and on its winding-up. Where there is a surplus of assets when the not-for-profit organisation is wound up, these assets must be distributed to an organisation with similar objectives and cannot be returned to members. It is, however, acceptable for a not-for-profit company to make payments to its members as bona fide remuneration for services that they have provided to it, and as reasonable compensation for expenses incurred on behalf of the organisation. Where these organisations use a Corporations Act structure, they are typically constituted as public companies limited by guarantee.

Treasury notes that a number of superannuation entities refer to their profit status in information targeted at informing members. A superannuation entity that claims to be a not-for-profit entity or claims that it distributes all profits to members must ensure that it complies with the relevant consumer protection legislation when providing information that consumers could rely on in making financial decisions. Under Division 2 of the ASIC Act, ASIC has access to a number of consumer protection provisions in relation to misleading or unconscionable conduct by financial sector entities. These powers were transferred from the Australian Competition and Consumer Commission (ACCC) in 2001 as part of the FSRA. The ACCC still retains jurisdiction in this area in respect of non-financial sector entities.

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11 The relevant link can be found at www.apra.gov.au/Superannuation/Other-Information-for-Superannuation.cfm under the heading 'Letter to all Trustees of APRA-regulated superannuation funds'.

ToR 13 Benchmarking Australia against international practice and experience

As it is unclear exactly what benchmarking the Committee has in mind, Treasury's comments in relation to this term of reference must necessarily be broad.

The Australian Government has not undertaken any international benchmarking of the Australian superannuation system. International benchmarking is inherently difficult due to the diversity of policy objectives, regulatory structures and historical development and the absence of internationally agreed standards upon which to base any international comparison.

Treasury notes that Australia's three-pillar retirement income system involving the publicly managed age pension, privately managed mandatory savings and voluntary savings through superannuation is consistent with the multi-pillar design approach that has been endorsed by the World Bank as a more efficient and effective approach to deliver retirement incomes. In particular, this approach offers the best prospect of simultaneously being fiscally sustainable in an environment where the population is aging, of improving national saving, ensuring intergenerational equity and providing higher incomes in retirement.

The difficulties associated with undertaking international benchmarking of specific aspects of the system have recently been illustrated in the report, *International Comparison of Australia's Taxes*, commissioned by the Treasurer earlier this year, which noted that variance in the structure of both retirement income arrangements and the taxation regimes which makes international comparison problematical at best. For instance Australia focuses strongly on the second (privately managed, mandatory savings) and third (voluntary savings) pillars in the traditional three-pillar model of retirement savings. This stands in strong contrast to many western European countries which focus more heavily on first-pillar (mandatory, publicly managed) arrangements. This difference in focus may have many different benchmarking implications. For example, it might result in significantly different governance arrangements. Even within a pillar, arrangements utilised by different countries can vary widely and in ways which hamper benchmarking.

Even if direct comparisons were possible, for example between countries with similar arrangements across the three pillars, there is a further confounding factor in that there are currently no internationally agreed standards upon which to base any conclusion.

It is for this reason that Australia's superannuation prudential regulation framework has not been included in Australia's Financial Sector Assessment Program currently being undertaken by the International Monetary Fund. However, the International Organisation of Pension Supervisors (IOPS) is in the process of developing principles of private pension supervision, which, if approved at the 2006 AGM of the IOPS, could facilitate international comparison in this area should they subsequently be adopted as recognised standards by the governments of IOPS member states. APRA is representing Australia in the IOPS process.

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

Compensation in the event of theft and fraud

The prudential regulatory framework set out in the SIS Act is designed to provide a high level of safety for the superannuation savings of all Australians. However, in recognition of the compulsory and long-term nature of superannuation savings, the Government

provides an additional safeguard through access to financial assistance for superannuation losses resulting from fraudulent conduct or theft. This financial assistance is provided under Part 23 of the SIS Act.

Under Part 23 of the SIS Act, the Minister has discretion to compensate up to 100 per cent of a loss suffered due to fraudulent conduct or theft. This discretion ensures that public interest considerations can be taken into account in assessing the level of financial assistance to be provided.

Within this framework, it has been long-standing Government policy to cap financial assistance provided under Part 23 at 90 per cent of the eligible loss.[12] This policy position remained unchanged after the Government's review into the operation of Part 23 of the SIS Act that was completed in 2004.

The 90 per cent cap is intended to assist in ameliorating the risks of moral hazard by providing incentives for superannuation fund members to ensure that their fund is being managed in a prudent manner. The Government considers that the provision of financial assistance for the full eligible loss would not reflect the fact that members bear the full risks of their superannuation investments and would undermine the financial incentives for superannuation fund members to monitor and take an active interest in the management of their retirement savings.

The capping of financial assistance for eligible losses is consistent with international best practice and with other major Government assistance programmes in Australia. Financial assistance schemes overseas generally limit the compensation paid through either a percentage or a monetary cap. The United Kingdom Pensions Compensation Board limits payments of assistance to 90 per cent of loss suffered (except where a person is within 10 years of retirement, where 100 per cent is paid). The OECD also reports that a number of countries including Canada, the US and France impose caps on payments, while Japan and the UK provide a percentage-based limit on compensation.

Other Commonwealth assistance programmes have also imposed a limit on compensation paid. In 1991, the then Labor Government enacted the *Life Insurance Policy Holders' Protection Levies Collection Act 1991* to establish a trust fund for the purpose of providing compensation in the life insurance industry after the failure of two prominent life insurance companies due to fraud. This legislation limited restitution to not more than 90 per cent of amounts due and payable under a life policy, or due and payable in respect of the surrender of a life policy. The legislation also provided compensation for 100 per cent of the administration expenses incurred in meeting liabilities.

The cost of providing financial assistance under Part 23 of the SIS Act is recouped through an industry levy imposed on regulated superannuation entities eligible for financial assistance. The cap on financial assistance ensures that the costs of losses resulting from theft or fraudulent conduct are shared equitably between members of funds who have suffered losses, and other superannuation fund members. The provision of 100 per cent compensation to members of affected funds would require a further reduction in the benefits for members of other funds in the industry.

Industry has generally been supportive of the 90 per cent cap on financial assistance provided under Part 23 of the SIS Act, acknowledging that the capping reduces moral hazard risks and promotes an equitable outcome between members suffering losses and

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12 The FSI recommended that such financial assistance be limited to 80 per cent of the original entitlement of beneficiaries (recommendation 55). The financial assistance regime contained in Part 23 of the SIS Act is consistent with the spirit of the FSI recommendation and provides more generous compensation to members who suffer from eligible losses.

members funding the financial assistance by way of a levy. A small number of stakeholders have suggested that financial assistance should cover the full eligible loss. However, this proposal was also linked to the taxpayer, rather than the industry, meeting the cost of financial assistance.

Protection of employee entitlements in the event of employer insolvency

The protection of employee entitlements in the event of employer insolvency is an important and well-established principle of insolvency law. Under the current law, unpaid employee entitlements, including superannuation, rank highly in the statutory order of payment on employer insolvency.

Such entitlements are paid after the fees, costs and charges of a winding-up but before all other unsecured creditor claims, such as the claims of suppliers, subcontractors, customers and creditors whose debts are secured by a floating charge. Employee entitlements also take priority over the debts of Commonwealth and state taxation authorities.

In the event that a company enters insolvency, the Government has implemented schemes to provide employees with direct financial assistance. In January 2000, the Government established the Employee Entitlement Support Scheme (EESS) for the payment of a 'safety net' level of employee entitlements. However, the range of payments that could be made under this scheme was limited so, on 12 September 2001, this range was enhanced under the Government's General Employee Entitlements and Redundancy Scheme (GEERS).

GEERS provides payment for all unpaid wages, annual leave, long service leave, and pay in lieu of notice, as well as redundancy payments up to the community standard. There is no cap on the maximum amount that can be claimed, subject to a maximum wage rate of $94,900 for 2005-06. This maximum wage rate is indexed annually.

On 22 August 2006, the Minister for Employment and Workplace Relations announced an extension to GEERS. The amount of unpaid redundancy pay available under GEERS has been doubled from 8 weeks to a maximum of 16 weeks. This change is applicable to all GEERS claims made as a result of liquidations or bankruptcies that occur on or after 22 August 2006. This extension of GEERs brings it into line with the community standard for redundancy provisions now available in awards and agreements.

As a result of GEERS, employees can now receive the majority of all entitlements owed to them following the collapse of their employer. Since the inception of the employee entitlements schemes in 2000, the Australian Government has helped over 59,000 employees and advanced over $697 million in assistance.

Payment of entitlements out of these schemes does not preclude action being taken against the directors and others for breaches of the Corporations Act relating to the insolvency of the company. Further, although GEERS does not include superannuation, employers have been required to make at least quarterly Superannuation Guarantee (SG) contributions since 1 July 2003. This requirement lowers employee exposure to the loss of superannuation benefits in the event of employer bankruptcy or insolvency as the regularity of employer contributions is increased.

To boost its commitment to protecting employee entitlements, the Government announced on 12 October 2005 a series of proposals to improve the operation of corporate insolvency laws and strengthen the protections for employee entitlements in the event of employer insolvency.

The proposals will give the Superannuation Guarantee charge (SGC) the same priority as employee entitlements generally in all forms of external administration and not only

liquidation as is the case at present. In relation to SGC that is owed in respect of an excluded employee, the Commissioner of Taxation will receive a power to take into account any limitation or cap on the amount of unpaid employee entitlements that may receive priority in a winding-up when allocating superannuation entitlements to employee accounts.

The proposals will also amend the Corporations Act to preserve the priority of employee entitlements in a voluntary administration. Under the current law, it is not mandatory for a deed of company arrangement to preserve the priority available to creditors in the Corporations Act. This will be mandated unless employees agree to waive their priority or the court upholds the deed on the grounds it offers dissenting creditors a better return than they would receive in a liquidation.

GLOSSARY OF KEY SUPERANNUATION TERMS

Accumulation Fund: A fund that pays benefits to members equal to the amount accumulated in the fund in respect of the member, the amount being derived from contributions plus earnings less taxes and expenses.

Approved Deposit Fund (ADF): A continuing fund maintained by a trustee that is a constitutional corporation (corporate trustee) and approved by APRA. ADFs are principally roll-over vehicles. They can only accept eligible termination payments from another superannuation entity in respect of a member, and certain other payments, rather than directly accepting ongoing contributions in the same way as a regulated superannuation fund. They must pay out members' benefits when the members reach age 65 and they cannot pay a pension.

Defined Benefit Fund: A fund to which contributions are paid in an aggregate amount rather than in respect of a particular member. The formula for calculating retirement benefits is specified in terms of length of service and salary averaged or at a particular date, or a specified amount.

Fund: A regulated superannuation fund or an approved deposit fund.

Hybrid Fund: A fund that combines the features of a defined benefit fund and an accumulation fund, though often one type dominates over the other.

Pooled Superannuation Trust (PST): A unit trust maintained by a corporate trustee approved by APRA and used only for investing assets of regulated superannuation funds, approved deposit funds and life offices (in effect, a wholesale superannuation entity). The tax liabilities are discharged at the PST level rather than by the investing fund trustee.

Registrable Superannuation Entity: A regulated superannuation fund (but not including a self-managed superannuation fund regulated by the ATO), an approved deposit fund or a pooled superannuation trust.

Registrable Superannuation Entity Licence (RSE licence): The licence that a superannuation trustee (other than trustees of self-managed superannuation funds and exempt public sector superannuation schemes) must obtain from APRA in order to act as trustee of the entity.

Regulated Superannuation Fund: A superannuation fund that satisfies certain requirements specified in subsections 19(2) to (4) of the SIS Act.

Retirement Savings Account (RSA): An account with an authorised deposit-taking institution or life insurance company to which superannuation contributions may be made by, or on behalf of, an individual. An RSA does not operate under a trust structure but takes the form of a 'capital guaranteed' account or policy. RSAs must also be fully portable, owned and controlled by the member and subject to the retirement income standards applying to other superannuation products.

Reversionary benefit: A benefit that is paid in respect of a deceased superannuation fund member to the member's legal personal representative and/or to dependants of the member, where the member dies after retirement or after reaching age 65.

Superannuation Entity: A regulated superannuation fund, an approved deposit fund or a pooled superannuation trust.

Superannuation Guarantee: The minimum amount that an employer is required to contribute to superannuation on behalf of most employees. The minimum amount is 9 per cent of salary or wages.

Trustee: A person or company (corporate trustee) appointed under the terms of the trust deed to hold the trust property for the beneficiaries and ensure that the entity is operated in accordance with the trust deed. Generally, trustees owe a fiduciary duty to the beneficiaries. Superannuation trustees must also comply with certain legislative duties.