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

INTRODUCTION

This submission is made on behalf of the Meat Industry Employees Superannuation Fund and will specifically address Terms of Reference 1, 2 and 9.

DISCUSSION

Terms of Reference 1: Whether uniform Capital requirements should apply to trustees.

The Meat Industry Employees Superannuation Fund (MIESF) and a number of other non-public offer industry funds are currently exempt from the requirement for the trustee to hold minimum capital requirements. It is felt that this situation should continue, as the trustee company is a single purpose trustee company, which has no financial transactions apart from the necessity to purchase trustee indemnity insurance. Under the terms of the Trust Deed, the Trustee Company is typically indemnified for any actions by the Fund and the only source of capital for the Trustee is the Fund.

Superannuation funds are highly regulated trusts that hold only the legal title to assets for the benefit of beneficiaries. Like funds managers, a superannuation fund's very essence is that it invests on behalf of others, not on its own account. The 'sole purpose' test limits the activities of trustees to services related to the provision of retirement income. They do not trade on their 'own' and are subject to a number of prohibitions, which further reduce risk of insolvency including prohibitions on:

- borrowing (except in extremely limited circumstances)
- lending to members or acquiring assets from members
- placing a charge over, or in relation to, an asset of the fund unless specifically permitted under the SIS Act
- the level of *in-house* assets a fund can hold;
- the use of derivatives.

As a result of the level of supervision and the different nature of superannuation funds they should not be fitted into a prudential framework designed for banks, other deposit taking institutions and insurers. This is particularly relevant for the so-called not-for-profit funds that are essentially mutual societies.

Banks are rightly subject to stringent supervision of the full parameters of risks involved in the business of transforming deposits into loans that may not be recovered. In banking and insurance the principal purpose of capital adequacy is to guard against systemic risks and contagion, primarily borne from credit risk (i.e. bad lending). There is no evidence that fund failure poses any systemic risk to the Australian financial system.

The following analysis of the main risk areas further demonstrates the inappropriateness of applying to superannuation funds the risk management strategies applicable to banks and insurers.

Credit Risk

Financial insolvency is one of the lowest risks faced by superannuation funds. Credit risk exists only amongst defined benefit funds, where employer failure can leave a shortfall in the funding of member benefits. An extensive array of solvency rules within SIS addresses those risks.

The assets of an accumulation fund match its liabilities (by definition), eliminating credit risk. Therefore, there is very little potential for liability being created except in the legitimate management of the superannuation fund where investment decisions are made which, from time to time, can potentially result in a loss. However, this is a loss to the fund and the fund members as a result of its investment strategy. Should any loss occur as a result of the negligence of the Trustee Company or its Directors, Trustee Indemnity Insurance covers this.

All superannuation funds are required to define their investment strategy and disclose this to members through the Annual Report, the Product Disclosure Statement, (PDS), and an Investment Policy Statement. These documents are either required to be sent to members or are available on request to all members and potential members.

In recent years a significant number of funds have reported losses to their members as a result of falls in share market values, this did not cause any fund to fail or to see a significant movement of members.

MIESF in its 25-year history has on no occasion suffered a negative crediting rate, this may be attributed to the Fund managing its assets in line with its investment objectives, which are reviewed and disclosed to members on an annual basis.

Contagion Risk

The phenomenon of contagion risk (e.g. bank runs) is much smaller for superannuation funds as preservation rules prevent members from withdrawing their superannuation benefits for the purpose of investment outside of the superannuation industry. Each member bears the investment risk where a run compromises a fund's liquidity.

There are low levels of customer churn in superannuation in Australia even after the introduction of fund choice. In the unlikely even of a fund failure it is unlikely that this would spread to all funds. It should be pointed out that there has been no failure by industry style funds. APRA has also established a fidelity fund in the event of such a failure, although in the first instance it is likely that such a failure would cause a claim under the trustee indemnity insurance.

Operational Risk

Operational risk has been described by the Federal Government as "*the risk of loss as a result of inadequate or failed internal processes, people and systems or from external events*". This may include:

- risk of error or failure in the administrative procedures of the business
- risk related to error or failure of technology
- risk of fraud
- compliance risk, including penalties associated with failure to meet legislative requirements
- legal risk associated with the many contractual arrangements entered into by a superannuation fund.

Administration and technology risks

Capital reserves are an inappropriate tool with which to manage administration and technology risks.

There is no suggestion that superannuation funds are managing technology risks poorly and endangering investors' funds as a result. The key to guard against operational risk is proper management and controls and where this function is outsourced, through proper control of the service provider.

Funds are now required to establish business continuation and disaster recovery plans to ensure that in the event of any systems failure the funds can be operational in a short period of time and that data can be restored. This risk is therefore managed through good management systems and insurance.

Conclusion

As the Trustee only carries out the one class of business, there is no possibility of there being losses or liabilities created by one class of business that have to be subsidised by the superannuation fund. The Trustee is subject to very strict regulation by APRA and is also subject to regular audit review, both in terms of the proper management of the Fund and of compliance to the Government's regulation.

It is therefore felt that there is no necessity for the Trustee to maintain any particular level of capital and, indeed, to impose such a requirement would either necessitate the Trustee reducing member account balances so as to obtain the capital or incurring additional expenses in negotiating bank guarantees or insurance bonds which would ultimately have to be paid for by the Fund members. This would result in an additional cost to no particular benefit for the security of the members' funds.

As a compensation measure or as an instrument to minimise operational risk, we submit that capital adequacy is largely ineffective.

<u>Terms of Reference 2: Whether all trustees should be required to be public companies.</u>

MIESF submits that this would be an unwarranted requirement as the management of the superannuation fund is significantly regulated by APRA and subject to quite onerous regulatory, governance and compliance requirements and these are reviewed by APRA and the Fund's own auditors on a regular basis. It would seem that there would be no advantage to the Fund members in requiring the Trustee Company to become a public company, but it would impose an additional regulatory burden and cost upon the Trustees which ultimately would have a negative impact on member earnings.

Understandably, the governance requirements under the Corporations Act for a proprietary company are not as strict as those for a public Company. However, in the case of corporate trustees of superannuation funds this needs to be considered in the context of all the other regulatory requirements that apply under SIS and the Corporations Act.

Corporate trustees are subject to significant prudential regulation by APRA under SIS and its regulations, and must comply with requirements attaching to both APRA and, in many cases, to AFS Licences. A move to public rather than proprietary status therefore adds little substance to the existing regulatory position and may create duplication and conflicts between the two requirements. In particular, disclosure under the Corporations Act is dealt with extensively.

If the regulator is concerned about disclosure this can only be relevant to the funds themselves rather than to the trustee entities. In the case of industry funds, which hold no assets in their own right, disclosure at the fund level is important from a consumer protection viewpoint, whereas disclosure at the trustee level is of little relevance to the fund members.

Terms of Reference 9: Cost of compliance.

MIESF, along with other funds, is concerned that over recent years there has been a significant cost of compliance both in terms of fees paid to the regulator (APRA) and also in the internal costs associated with the various licensing regime that now apply to superannuation funds. The Committee should be aware that the various documents required for the APRA License were prepared at a significant cost of time plus advisory fees and that the actual benefit derived in the overall management of the Fund is considered to be quite minimal. This is because MIESF, like most other industry superannuation funds, were already meeting quite stringent and proper management controls and the additional documentation did not result in any significant difference to the way in which the Fund is managed.

It would be a concern to the Fund if further regulatory change results in additional costs and it would be of great benefit to the industry if the regulatory environment could be stabilised for a number of years so that the compliance procedures may also be stable and enable funds to refine them to suit their own particular requirements.

Yours sincerely

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