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The Committee Secretary
Parliamentary Joint Committee on
Corporations and Financial Services
Department of the Senate
PO Box 6100
Parliament House
CANBERRA ACT 2600

Dear Sir

Subject: Inquiry into the Structure and Operation of the Superannuation Industry

We are pleased to provide our comments on several of the terms of reference of the above Inquiry.

Watson Wyatt is a leading actuarial and superannuation consulting firm in Australia. In Australia we have over 20 actuaries and consultants providing actuarial and superannuation consulting advice to over 100 clients on all aspects of the financial management and operation of superannuation funds, in particular in relation to actuarial and defined benefit matters, and corporate superannuation structures. Globally, Watson Wyatt is a leading human resource consulting firm, specialising in the provision of actuarial and employee benefits advice to pension funds and their sponsors.

In this submission we will concentrate on the following issues (numbers refer to the itemised terms of reference of the Inquiry):

1 & 2 Capital requirements and trustee structures
8 The demise of defined benefit funds
10 The appropriateness of prudential regulation funding arrangements

1 & 2 Capital Requirements and Trustee Structures

In our view, the current structures available to superannuation fund trustees have by and large served members well.

Employer sponsors have a responsibility to choose the structure best suited to their and their employees' needs, whether it be a standalone trustee company that exists only to act as the trustee of a corporate fund, outsourcing of the trustee function for a corporate fund to an APRA approved trustee, or a fully outsourced arrangement such as a master trust or industry fund.

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Under all of these structures, trustees are required by law to act in the best interests solely of trust beneficiaries. All trustees are subject to the existing prudential supervision of APRA (including the new APRA licensing regime) and the disclosure and other requirements of the Corporations Law administered by ASIC. In addition, approved trustees are subject to the net tangible assets or approved guarantee requirements of the SIS legislation. The vast majority of trustees also have indemnity insurance in place to further protect their members' interests.

The common trustee structure for a corporate fund, whereby the directors on the trustee board are comprised of equal representation of members and employers, and the trustee exists solely for the benefit of members and not for any profit motive, is a very sound governance structure, free of conflicts of interest, that should be fully supported by the government and APRA. Our experience with the APRA licensing process was, though, that some trustee directors were discouraged from continuing in their roles, which led to decisions to wind up, or shortly wind up, the trustee and fund – which was a disappointing outcome given the commitment shown in the past by the trustee directors of those funds. We would encourage the government and APRA, in turn, to encourage individuals who willingly take on the role of an employer or member nominated trustee director.

We do not believe it would add to the protection of members' benefits for trustees of non-commercial funds to be required to meet minimum capital requirements. The majority of such funds outsource most or all functions, such as administration, accounting, insurance, and investment management, to professional service providers. It is therefore the service providers who need to have access to capital, not the trustee (we also note that such outsourcing arrangements must themselves meet the outsourcing standards administered by APRA). Any capital requirements would need to be sourced from members' funds, and hence building up capital requirements would detract from members' benefits, and create equity concerns in relation to the generation of members whose benefits would have been used to finance the capital requirements.

For similar reasons, we do not support any requirement for all trustees to be public companies. Investors will only invest in public companies for profit reasons. As with all commercial entities, ultimately they exist to generate a profit for their owners and shareholders. They must therefore deal with several significant conflicts of interest, the main one being the responsibility of the trustee to act in the best interests of members while still satisfying the financial needs of management and shareholders. This conflict already exists in the case of commercial providers of superannuation funds. We do not believe that expanding this conflict to all trustees would be in the best interests of members.

Nor do we believe that the added administrative requirements associated with public companies will provide any greater protection for members, and the outcome of the trustee being a public company would be increased costs that would reduce members' benefits. Indeed, the requirement to become a public company may discourage trustees of non-for-profit funds, and lead them to wind up. As mentioned earlier, these structures have very sound governance, so it would be detrimental to the industry, and members, to discourage such structures.

8 The Demise of Defined Benefit Funds

There have been a number of factors contributing to the trend from defined benefit (DB) funds to accumulation funds, including:

- the changing approach to employee remuneration packaging, from "salary plus benefits" to "total remuneration" packaging,
- the unwillingness by some employers to bear the investment risk of the defined benefits,
- accumulation style benefits provide employers with more certainty in terms of their corporate accounting and the effect of superannuation on their P&L, and
- accumulation style benefits cater more easily for employees with broken work or membership patterns.

Whilst any, or a combination, of these factors can be a valid basis for an employer to prefer an accumulation arrangement for superannuating its employees, it is unfortunate that another factor that has contributed to this trend has been the legislative and regulatory environment – and this should not have been a factor.

While we appreciate that defined benefit arrangements can on occasion be more challenging to accommodate within legislative frameworks, often it appears that legislation is drafted from an accumulation benefit perspective – with the implications for defined benefit arrangements being an afterthought. Examples of this situation include the surcharge tax legislation and the enhanced fee disclosure provisions of Corporations Law. Also, though not as pressing an issue now in light of the proposed changes to the taxation basis of superannuation, the government had excluded defined benefit entitlements from contribution splitting.

A further restriction on defined benefit arrangements is the government's decision to require that new defined benefit funds cannot be established if they have less than 50 members, and the requirement that once an existing defined benefit fund's membership declines below 50, it can no longer admit a new defined benefits member. These requirements pay no regard to important considerations such as the capacity of the employer to finance a defined benefit arrangement and the investment arrangements of the fund, and are an unnecessary restriction.

Defined benefit funds offer a number of positive features that are very attractive to members, and are very much in harmony with the government's aim of improving retirement savings of Australians. In defined benefit funds, the sponsoring employers bear the investment (and, in the case of pension funds, longevity) risk and usually finance the costs of providing the benefits, and hence provide very valuable benefits for members. Indeed given the nature of defined benefit funds, and in view of the greater responsibilities taken on by the employer, the government should be encouraging defined benefit arrangements (particularly the arrangements providing pensions, which typically provide a secure long term form of benefit for members) and ensuring that defined benefit funds operate on at least a level playing field with accumulation funds from a legislative perspective.

10 The appropriateness of prudential regulation funding arrangements

We acknowledge the government's position that superannuation members should bear part of the cost of the regulatory system that protects their benefits. We also note that recent changes to the structure of the supervisory levy have been intended to address equity concerns between small and large funds.

In the case of the supervisory levy, it is very important that members of smaller funds not cross subsidise members of larger funds. Though the separation of the levy into capped and uncapped elements is an attempt to address this issue, small funds still bear a large impost for supervision.

In relation to financial assistance levies there is no logical reason for a cap, and all members should contribute on the same basis, regardless of the size of the fund to which they belong, to the provision of financial assistance to members of other funds.

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Please do not hesitate to contact us if you would like to discuss any aspect of this submission.

Yours sincerely

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Director

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