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

Email: corporations.joint@aph.gov.au

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

The Association of Superannuation Funds of Australia Ltd (ASFA) is pleased to make this submission to the Parliamentary Joint Committee on Corporations and Financial Services' Inquiry into the Structure and Operation of the Superannuation Industry.

ASFA is a non-profit, non-political national organisation whose mission is to protect, promote and advance the interests of Australia's superannuation funds, their trustees and their members. Our members, which include corporate, public sector, industry and retail superannuation funds, account for more than 5.7 million member accounts and over 80% of superannuation savings.

The last two years have been a period of change for the superannuation industry:

- Following the Safety of Super Inquiry, the industry went through the long and costly business of licensing and is now working on the task of keeping a licence.
- The introduction of choice of fund legislation in July 2005 and the extension of choice to certain state award employees on 1 July 2006.
- After some lengthy examination of the FSR regime requirements, implementation of additional fee disclosure requirements.
- The government decisions to improve and strengthen Australia's Anti-Money Laundering/Counter Terrorism Financing (AML/CTF) system and bring it into line with international standards has left the industry awaiting the final version of the AML/CTF Bill and Rules to see what further changes to superannuation fund process and procedure it will bring.

Federal Secretariat

Level 19
Piccadilly Tower
133 Castlereagh St
Sydney NSW 2000

PO Box 1485
Sydney NSW 1005
Tel: (02) 9264 9300
Fax: (02) 9264 8824

- Submissions were made to the House of Representatives Standing Committee on Economics, Finance and Public Administration, which held an Inquiry into Improving the Superannuation Savings of People Under 40.

- Since May, consultations with Treasury on how the 2006 Budget proposals for simplifying superannuation will be implemented have been ongoing.

ASFA recognises the need for ongoing critical examination of the superannuation supervisory legislation and the industry itself. ASFA has been an active participant in the regulatory developments outlined above as well as the numerous reviews of superannuation detailed in the Appendix of this submission. It is difficult to assess the long-term success or otherwise of many of these recent changes given the scale and recency of these change. The time may be coming when it is appropriate to permit the sector to focus more time and resources on improved retirement outcomes and less on implementing new and complex law.

In this context ASFA provides below comments on each of the specific terms of reference of the inquiry of the Committee.

If you have any questions or comments on this submission, please feel free to contact me on 02 9264 9300 or by email manderson@superannuation.asn.au.

Yours sincerely,

Dr Michaela Anderson
Director of Policy and Research

Federal Secretariat

Level 19
Piccadilly Tower
133 Castlereagh St
Sydney NSW 2000

PO Box 1485
Sydney NSW 1005
Tel: (02) 9264 9300
Fax: (02) 9264 8824

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1. Whether uniform capital requirements should apply to trustees

Capital requirements are long established in the prudential regulation of certain financial products, particularly among banks and insurance companies. These requirements have historically existed for numerous reasons relevant to the development of those sub-sectors including to ensure that these institutions meet the financial promises made to depositors and policyholders and to establish the bona fides of the providers, by requiring them to demonstrate financial substance and placing their own capital at risk.

Capital requirements have also existed for superannuation fund trustees that attain public offer status. The capital requirements did not necessarily require the trustee to hold the capital – these requirements can be met through other arrangements including through a custodian or other approved arrangements.

Under the SIS Act, the RSE licensing regime establishes a number of trustee licence classes. One such class established in the legislation is the public offer entity licence (subsection 29B(2)). The law further permits other classes to be established and they have been deemed non-public offer and extended public offer.

Subsection 29D(1) of SIS sets down the circumstances for granting an RSE licence. This includes 29D(1)(g) that states:

> *in a case where the application is for that licence of a class that enables a trustee that holds a licence of that class to be a trustee of a public offer entity subject to any condition imposed under subsection 29EA(3) - APRA is satisfied that the application is a constitutional corporation that meets the capital requirements under section 29DA.*

Section 29DA of the *Superannuation Industry (Supervision) Act 1992* sets down the broad requirements for licensees of Registered Superannuation Entities (RSEs) in respect of their capital requirements. To grant a licence, APRA must be satisfied that:

1) the corporation's ***net tangible assets*** is equal or greater than the amount prescribed by regulations ($5 million) or

2) the corporation is entitled to an ***approved guarantee*** that is equal or greater than the amount prescribed by regulations ($5 million) or

3) the corporation meets the requirements through a combination of ***net tangible assets*** and an ***approved guarantee*** ($ 5 million) or

4) the corporation meets its requirements through ***custody*** of the fund's assets.

Therefore capital requirements can be satisfied a number of ways: direct holding of the net tangible assets; approved guarantee; a combination of approved guarantee and net tangible assets; or meeting the custodian requirements.

Net Tangible Assets

Net Tangible Assets were previously defined in Regulation 3A.04 of the *Superannuation Industry (Supervision) Regulations* but since 1 July 2006 has been defined in Superannuation Guidance Note SGN 150.1 (Capital requirements – net tangible assets).

At paragraph 10 of SGN 150.1, net tangible assets are defined as:

> *(T)he total assets of a constitutional corporation, less total liabilities of the corporation, less any intangible assets reported in the corporation's book of accounts, calculated on the basis of assets and liabilities as they would appear if, at the time of calculation, a balance sheet were made up for lodgement as part of a financial reports under Chapter 2M of the Corporations Act 2001 (Corporations Act) on the basis that the corporation is a reporting entity, but where:*
>
> - *total liabilities include all payables to related parties as defined by AASB 1017 Related Party Disclosures and Part 2E.2 of Chapter 2E of the Corporations Act 2001;*
>
> - *total assets does not include: any receivables from related parties as defined by AASB 1017 Related Party Disclosures and Part 2E.2 of Chapter 2E of the Corporations Act 2001; any assets which are subject to any charge that secures the liability of a person other than the corporation, to the extent of the value of that charge; any assets to which the corporation is not legally entitled or which are not held in the name of the corporation; and which any illiquid assets that are not capable of being converted into cash in the short term.*

The main difference between the current and the pre 1 July 2006 definition of net tangle assets is that total assets now does not include illiquid assets, in other words assets not capable of being converted into cash within a month.

Approved Guarantee

A public offer RSE licensee can also meet the capital requirements through the use of an approved guarantee. The approved guarantee can cover all or part of the $5 million (along with net tangible assets).

One of the changes as a result of the RSE licensing reforms was for APRA to impose minimum standards on guarantees. This has been by way of determination under section 11E of SIS.

The minimums of an approved guarantee include:

- Guarantee given by an ADI
- Unconditional
- Fixed for a term of at least five years
- Guarantor cannot be indemnified out of the assets of the fund

Custody

In lieu of the $5 million, either through net tangible assets and / or an approved guarantee, the public offer RSE licensee can meet the custody requirements. The custody requirements are set down as licence conditions under section 29EA of SIS.

These conditions include:

- The RSE licensee must maintain $100,000 of cash or cash equivalents
- The custodian must be appointed under a written agreement
- Only one custodian may be appointed per registrable superannuation entity
- Requirements on the RSE licensee to notify APRA in particular situations including if the licensee becomes aware of any problems that jeopardies the safety of the assets or intends to change the custodian

As well, the RSE license and the custodian are required to meet APRA's Cross Industry Circular No. 1 "Custodian Requirements for APRA Supervised Entities". These include:

- That the custodial services be provide on an arms length basis
- Custody contracts executed in Australia
- Board sign off of custodial agreements
- APRA supervised entity to monitor and assess custodian's performance, including regular checks and seeking information from custodian
- Insurance and indemnification requirements
- Reporting and record keeping requirements

Recent Policy Review of Capital Requirement Obligations

In October 2001, the Superannuation Working Group (SWG) established by the then-Minister for Financial Services, Joe Hockey, examined a number of potential changes to improve the safety of superannuation. One matter that was supported by the SWG in its Final Recommendation was uniform capital requirements for all superannuation fund trustees.[1]

Throughout the Superannuation Working Group (SWG) process, ASFA opposed public offer capital requirements being extending to non public offer funds. The Government chose to accept the status quo and reject the SWG's recommendation. This decision was widely applauded by industry.

ASFA would argue that, over the past few years, international debates concerning the role of capital in financial services regulation have tended to increasingly support our position and that other regulatory developments, in particular superannuation trustee licensing, have rendered uniform capital requirements increasingly redundant.

There is an increasing recognition in the international policy debate that capital requirements are, at best, a crude mechanism for regulating conduct in financial services.[2] Indeed, the Basel II reforms for deposit-taking institutions have been premised on developing capital requirement standards for banks more in line with actual risk exposure.

[1] It is unclear whether the reference to "uniform capital requirements" in the Terms of Reference of the current Inquiry is the same. We are assuming it is in the absence of any further clarification.
[2] Gerard Caprio and Patrick Honohan (1999) "Restoring Banking Stability: Beyond Supervised Capital Requirements", *Journal of Economic Perspectives*, Vol. 13, No. 4, pp. 43-64.

Extending identical and onerous capital requirements to all superannuation or pension funds is virtually without precedent anywhere in the OECD and fundamentally undermines superannuation provided as an employment benefit. This would primarily impact on the corporate fund sector, and to a lesser degree on industry funds. Any dramatic changes in this area could signal the death knell for such funds. In particular it would significantly push up compliance costs for those funds. Such a suggestion seems at odds with the Government's current concern over reducing the regulatory burden on business.

Further, with no intention of making a profit on the running of their superannuation fund – it is difficult to imagine sponsoring organisations (be they an employer, employer association or trade union) putting up the capital. The employer-sponsor(s) may provide capital for some funds, but many employers will be unwilling to tie up scarce capital for such a purposes and the only other capital available is the members' money. Instead it is likely existing arrangements would be wound up, to the detriment of individual members and industry competition.

Reduction of risk

Capital requirements are a crude mechanism for preventing operational and governance risk. Operational and governance risks, particularly of larger funds, where the impact of a loss would be greater, need to be dealt with before they happen. This is the premise of the current superannuation trustee licensing regime. APRA regulated trustees have subjected themselves, at considerable expense to their members, to a rigorous and demanding licensing procedure. Trustee licensing requires trustees to address the multitude of risks faced in running a superannuation fund. Trustees are required to have policies on governance ("fit and proper"), outsourcing and adequacy of resources (including human, technological and financial resources). As well, trustees are required to develop and maintain detailed risk management documentation.

All of these policies and procedures are subject to external auditing as well as review by the regulator. Changes need to be notified to APRA and all breaches need to be reported. As a result, APRA should have a highly detailed "real time" impression as to the risk profile of the 300 plus APRA-regulated superannuation fund trustees.[3] These provide more precise and timely mechanisms for identification and mitigation of operational and governance risks than capital.

[3] ASFA, however, is of the view that breach reporting requirements to APRA are not appropriate and should only require the reporting of material or significant breaches. See section 9 of this submission for more detail.

Bona fides

The other traditional rationale for capital requirements is to establish the bona fides of the provider. As part of trustee licensing, superannuation trustees have had to subject themselves to "fit and proper" requirements. These requirements are highly prescriptive. All responsible officers of the trustee, that includes all trustee directors and senior managers of the funds, must subject themselves to police checks, bankruptcy checks and other character checks. The responsible officers must also collectively demonstrate possessing the knowledge, skills and experience to operate a superannuation fund as well as commit to on-going training requirements. APRA is to be informed of all changes in respect of responsible officers and has sweeping powers to remove and replace individuals it deems unsuitable.

The equal representation requirements for non-public offer funds are also a critical aspect of fund governance that help ensure that fund assets are managed and invested correctly and as such help address agency and governance risks.

Rectification of Operational Risk Events

Capital can be used to rectify operational risk events after they have occurred. However, operational risks come in all shapes and sizes, particularly in an industry as diverse as superannuation. A computer problem in one fund may cost a few hundred dollars to fix while another may cost millions.

Maintaining capital to address operational risk events ignores that many (if not most) administrative tasks in superannuation are outsourced. It is the trustee's job to ensure that any service provider (eg administrator, custodian) has appropriate risk management policies and procedures. The trustee due diligence on selecting a service provider would also look to their capital and insurance cover.

For these reasons, ASFA has rejected the use of mandatory capital requirements for all superannuation funds as ineffective and inappropriate. Further, the ability for public offer funds to satisfy the capital requirements through net tangible assets, approved guarantee or custodial arrangements provides necessary flexibility. The enhancements to the standards in all these areas as a result of superannuation trustee licensing should provide considerable comfort.

ASFA instead has supported the development of appropriate processes to assess a fund's preparedness against the specific operational and governance risk concerns of the regulator in both public offer and non-public offer funds.

Capital for Operational Risk Rectification

As noted above, ASFA is of the view that capital requirements are effectively redundant for the purposes of reducing risks on an up-front basis and for determining bona fides. The current superannuation trustee licensing requirements are a far more effective mechanisms for dealing with these risks.

We do recognise that the remaining basis for requiring capital for all funds – rectification of operational risk events – may be worth discussing within the context of a wider and more considered debate about operational risk rectification. We would support consideration of effective and targeted regulatory requirements for trustees to adopt measures to facilitate correction and compensation.

Operational risk can arise in many forms. Examples include errors in fund and tax accounting, errors in performance calculation and reporting, mis-allocation and late allocation of unit pricing or crediting

rates, failed and late trades, errors in member transactions, errors in trust deeds and other legal documents, failed due diligence processes and errors in disclosure and advertising.

The example of any pricing errors that might occur when a superannuation fund makes use of unit pricing illustrates such avenues. These might include drawing on the resources of other entities, as where the mis-pricing occurs as a result of provider error, trustees would be entitled to seek reimbursement from the provider for the cost of any compensation paid by the trustee where the error cannot be otherwise corrected. It is therefore essential that the respective liabilities of the trustee and service provider(s) for the financial consequences of any mis-pricing are clearly addressed in the contractual arrangements between the parties.

Trustee liability insurance might also provide cover for the trustee (or the fund) in case of trustee error. However, generally payment under such insurance requires a third party claim on the fund or trustee as trigger for activation of the policy; and in the absence of any class action it is unlikely that members would have sufficient knowledge to initiate such claims. In negotiating insurance, trustees need to ensure they understand and accept the limitations of cover.

After the trustee has considered the risks faced by the trustee and identifies a residual risk in respect of operations, trustees should have the option of building a 'compensation reserve' within the fund to finance compensation that cannot be recovered in any other way. While such a reserve could also be built within the trustee entity, through a small 'trustee fee', maintaining the compensation reserve within the fund ensures that the money is not lost to the fund should it not need to be called on.[4]

To minimise operational risk, trustees and their service providers also need to have proper documentation and a clear audit trail, with proper reporting to the compliance committee and board. Regular internal audit and external audit testing of procedures also forms part of the appropriate response by trustees and funds to the operational challenges, both at the time procedures are established and on an ongoing basis. In essence, prevention of problems developing is even more important than processes for providing compensation.

All of these approaches need to build upon current practices within funds.

Capital requirements and SMSFs

Requiring trustees of Self Managed Superannuation Funds to meet a uniform capital requirement, which appears to come within the proposition being raised in this part of the terms of reference, would lead to a devastation of the SMSF sector. Very few of the over 300,000 SMSFs would be able to, or would want to, meet such a capital requirement. In addition it is not clear why a capital requirement would be necessary in a fund where each member is a trustee. This suggestion seems fundamentally at odds with the Government's current concern over reducing the regulatory burden on business, and in particular concerns over the impact on small businesses and sole traders.

Equally, requiring the trustees of Exempt Public Sector Funds to meet a capital requirement may be difficult for the Commonwealth to legislate even if it wanted to.

[4] Many ASFA members have expressed a view that ASIC and APRA take different, and at times, irreconcilable views on reserves. The view expressed is that APRA sees reserves as a useful part of good prudential management but ASIC sees reserves as denying members the full benefits of investment returns.

RECOMMENDATION No. 1

That uniform capital requirements should not be introduced for superannuation trustees.

RECOMMENDATION No. 2

While we believe that the current capital and licensing requirements are appropriate, if the Government, Treasury, APRA and/or ASIC have specific concerns over operational risk events then these should be raised with industry for discussion and resolution.

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

Due to constitutional considerations, superannuation funds are required to be constituted as a "constitutional corporation" or to provide an "old age pension". The majority of trustees are constituted as companies.

There is currently no obligation for trustees to be constituted as a "public company". We take it that when the Committee makes use of the term "public company" it is referring to a company so defined in the *Corporations Act 2001*. This definition is a company other than a proprietary company.

The main differences between a proprietary company and a public company are as follows:

- A proprietary company can have as few as one director but a public company must have at least three directors (section 201A of Corporations Act 2001);
- A proprietary company must have at least one shareholder but can have no more than 50 – a public company must similarly have at least one shareholder but has no maximum;
- A public company cannot use "Proprietary" or "Pty" in its name; and
- A public company is able, but not required, to raise funds from the public under Chapter 6D of the Corporations Act and is able, but not required, to list on a stock exchange – a proprietary company cannot raise funds or list.

There are a number of different obligations on public companies and proprietary companies. Public companies are generally required to hold an Annual General Meeting of shareholders (unless they have only one shareholder). Public companies also have additional requirements in respect of auditor appointment but SIS has auditor appointment requirements generally in excess of these.

There are also different reporting obligations to ASIC for each type of company. A proprietary company does not have to lodge its constitution with ASIC when it registers but a public company is required to do so. Sole director proprietary companies also have specific requirements in the *Corporations Act 2001* in respect of powers to negotiate instruments, reimbursement of expenses and reappointment.

There are currently just over 300 trustees licensed by APRA, catering for around 560 funds. The majority of these trustees have been constituted as proprietary companies, a minority are unlisted public companies, and there are a very few trustee entities made up of natural persons. Often sponsoring entities are listed public companies or foreign corporations listed in another jurisdiction, for instance a sponsoring employer, organisation or parent entity. Based on a reading of entries in the APRA Register, it would appears as though proprietary companies are commonly used in all sectors of the superannuation industry – retail, corporate and industry funds all appears to use these structures.

Requiring all trustees to be public companies appears to be at direct odds with the sole purpose requirements in the SIS Act and the expectation that a superannuation fund trustee not operate a business. APRA in its general conditions for public offer Responsible Superannuation Entity licensees places restrictions on the business or commercial activity that can be undertaken by such a licensee. Subject to certain exceptions, such a licensee must not engage in any business or commercial activity unless that activity is in its capacity as trustee of registrable superannuation entities. This severely restricts the class of public companies able to be superannuation fund trustees, and also indicates that

the regulator considers that in itself being a public company does not guarantee good governance of a superannuation fund.

Requiring trustees to reconstitute as public companies would have a minimal regulatory impact and would likely impose significant costs on funds. The only possible changes would be the requirement to hold a shareholder Annual General Meeting. However there is no AGM requirement if there was only one shareholder. Some auditor appointment and financial statement requirements that apply to public companies that are slightly more onerous than those on proprietary companies but are generally below what is required in the SIS regime.

It is not clear to ASFA that there would be any advantages in requiring all trustees to be public companies. It would not provide any greater security, disclosure or transparency of operations. It would not impose greater responsibilities on the directors if they were directors of a public company. The mandatory "fit and proper test" for the trustee of a superannuation fund is tougher than anything required for company directors. The SIS Act and Regulations impose many other mandatory governance requirements which are also beyond the requirements for public companies.

The main reason a company would structure itself as a public company rather than a proprietary company would be to permit the company to have more than 50 shareholders, to raise capital and to list on a stock exchange. While many organisations that sponsor or are parent entities of superannuation fund trustees may be listed companies, ASFA is aware of only one trustee that is itself listed. Indeed, in the vast majority of cases a trustee listing itself on a stock exchange would, with the exception of the relatively limited cases where the trustee only carries on a business of being a trustee, seem in direct contravention of SIS requirements for the trustee itself to not operate as a business.

Current fund governance arrangements work well for those retail, industry, corporate and public sector funds making use of proprietary limited companies, other unlisted companies, or natural persons. Many of these funds through the composition of their trustee board have both employer and member representatives, and this has contributed to the strength of their management.

As well, requiring all trustees to be listed public companies would lead to major disruption in the sector given that most trustee entities would need to be replaced. This would especially be the case in the SMSF sector, where most such funds would need to be wound up as a relatively small proportion of such funds would wish to convert to being a Small APRA Fund making use of a licensed trustee that is a public company. As well, it would not make sense or indeed be possible to require the trustee of an Exempt Public Sector Fund to be a public company.

In summary, ASFA is not aware of any advantages that would flow from requiring all trustees to be public companies given *Corporations Act* requirements, how superannuation fund trustees are structured and how they relate to sponsors or parent entities. Given that there would be substantial costs and questionable policy benefits, ASFA would not support any proposal requiring all trustees to be public companies.

RECOMMENDATION No. 3

Legislation should continue to allow superannuation trustees to be either public companies, proprietary limited companies or real persons.

3. The relevance of Australian Prudential Regulation Authority standards

APRA does not issue standards for superannuation trustees. APRA does, however, have power under section 332 of the SIS Act to issue modification declarations that 'modify' specific provisions of that Act and related SIS regulations.

APRA does issue Superannuation Circulars that enable it to provide guidance in relation to the interpretation of the SIS Act, the SIS regulations, and related matters. These Circulars can provide useful guidance. There is no need to make compliance with Circulars mandatory or to provide APRA with the power to make mandatory standards. APRA has ample power to direct trustees through the existing licensing mechanisms.

As well, APRA has the ability to influence a wide range of behaviours of the funds and trustees that it regulates. In particular the licensing process obliges trustees to meet a variety of requirements before they were able to obtain (and retain) a Responsible Superannuation Entity (RSE) licence. This has involved both documentation of what trustees and funds do, and additional actions by trustees.

Key documents that APRA has required applicants to produce include:

- Fit and Proper Policy
- Adequate Resources Policies
- Outsourcing arrangements
- Risk Management documents

Trustees have been required to demonstrate fitness (in terms of the collective skill, experience and knowledge of the trustees or trustee directors), propriety (the honesty and integrity of each relevant individual involved.) The fit and proper policy of each trustee also is required to specify the training policy, minimum competency standards, procedures for testing claims of relevant individuals, and processes for removing those who no longer satisfy the requirements.

APRA's definition of propriety is a very strict one. Impropriety extends beyond being a formally disqualified person, and may include evidence of a previous breach of statutory duty, being uncooperative with regulators or the courts, engaging in improper business practices, or having been reprimanded or disqualified by a professional body. It may also include failure to manage personal debts satisfactorily, or actual or potential conflicts of interest that interfere with independence or probity.

In demonstrating access to adequate resources, trustees need to demonstrate that they have:

- Appropriate financial statements and budgets
- Financial management procedures
- Business plans
- Custodial and outsourcing agreements (when relevant).

Trustees also have to demonstrate they have required technological resources, including:

- Information and other systems
- Security and privacy measures
- Information integrity measures
- Disaster recovery and business continuity plans

In regard to human resources it is necessary to demonstrate the existence of:

- Staff recruitment, training and performance management plans
- Succession plans
- Policies that encourage proactive risk management and regulatory compliance

There also are a variety of requirements concerning documentation and substance of outsourcing arrangements.

Trustees also have to develop a Risk Management Strategy (RMS) for the operations of the trustee, and a Risk Management Plan (RMP) for each superannuation fund under the trustee's control.

The RMS must set out how the trustee will identify, monitor and manage risks to the trustee, including risks relating to governance, outsourcing, and potential theft and fraud. The RMP must set out how the trustee will deal with risks to the fund, including investment strategy, financial position and outsourcing.

In each case the trustee must:

- Identify all material risks
- Assess risks on the basis of likelihood and impact
- Outline strategies and risk management tools for dealing with the risks
- Describe internal oversight and reporting arrangements

It would be difficult to argue that any of these requirements are not relevant to a fund. The more difficult question is whether the licensing requirements are set at too high (or low) of a level for superannuation funds. At this stage it remains too early to answer that question. Judgement is only really possible once the new requirments have been in place for at least a year or two.

RECOMMENDATION No. 4

That the relevance and content of APRA licensing requirements for superannuation funds be reviewed after they have been in place for a period of at least two years

In addition to the APRA licensing requirements and guidance such as Superannuation Circulars, the Government (but not APRA) is able to apply a variety of other standards to superannuation funds,

approved deposit funds. Retirement Savings Accounts and Pooled Superannuation Trusts. Some of these relate to the prudential supervision of these entities, while others are designed to further retirement income policy goals, such as restricting access to benefits to those that have retired after reaching preservation age.

This standard setting power is set out in the Superannuation Industry (Supervision) Act 1993:

31 Operating standards for regulated superannuation funds

(1) The regulations may prescribe standards applicable to the operation of regulated superannuation funds (***funds***) and to trustees and RSE licensees of those funds.

(2) The standards that may be prescribed include, but are not limited to, standards relating to the following matters:

(a) the persons who may contribute to funds;

(b) the vesting in beneficiaries in funds of benefits arising directly or indirectly from amounts contributed to the funds;

(c) the amount of contributions that a fund may accept;

(d) the circumstances in which a fund may accept contributions;

(e) the form in which benefits may be provided by funds;

(f) the actuarial standards that will apply to funds;

(g) the preservation of benefits arising directly or indirectly from amounts contributed to funds;

(h) the payment by funds of benefits arising directly or indirectly from amounts contributed to the funds;

(i) the portability of benefits arising directly or indirectly from amounts contributed to funds;

(j) the levels of benefits that may be provided by funds and the levels of assets that may be held by funds;

(k) the application by funds of money no longer required to meet payments of benefits to beneficiaries because the beneficiaries have ceased to be entitled to receive those benefits;

(l) the investment of assets of funds and the management of the investment;

(m) the number of trustees, and the composition of boards or committees of trustees, of funds;

(ma) the requirements relating to fitness and propriety for RSE licensees of funds and trustees of funds;

(n) the keeping and retention of records in relation to funds;

(o) the financial and actuarial reports to be prepared in relation to funds;

(p) the disclosure of information to beneficiaries in funds;

(pa) the disclosure of information by a trustee of a fund who is a member of a group of individual trustees to the other trustees in that group;

(q) the disclosure of information about funds to the Regulator;

(r) the disclosure of information about funds to persons other than beneficiaries or the Regulator;

(s) the financial position of funds;

(sa) the outsourcing arrangements relating to the operation of funds;

(sb) the adequacy of resources (including human resources, technical resources, and financial resources) of, or available to, trustees of funds;

(t) the funding and solvency of funds;

(u) the winding-up of funds.

33 Operating standards for pooled superannuation trusts

(1) The regulations may prescribe standards applicable to the operation of pooled superannuation trusts (***trusts***) and to trustees and RSE licensees of those trusts.

(2) The standards that may be prescribed include, but are not limited to, standards relating to the following matters:

(aa) the circumstances in which units in trusts may be acquired;

(a) the ownership and disposal of units in trusts;

(b) the investment of assets of trusts and the management of the investment;

(ba) the requirements relating to fitness and propriety for RSE licensees of trusts and trustees of trusts;

(c) the persons who may be trustees of trusts;

(d) the number of trustees, and the composition of boards or committees of trustees, of trusts;

(e) the keeping and retention of records in relation to trusts;

(f) the financial and actuarial reports to be prepared in relation to trusts;

(g) the disclosure of information to unit-holders in trusts;

(h) the disclosure of information about trusts to the Regulator;

(i) the disclosure of information about trusts to persons other than unit-holders or the Regulator;

(j) the financial position of trusts;

(ja) the outsourcing arrangements relating to the operation of trusts;

(jb) the adequacy of resources (including human resources, technical resources and financial resources) of, or available to, trustees of trusts;

(k) the funding and solvency of trusts.

34 Prescribed operating standards must be complied with

Standards must be complied with

(1) Each trustee of a superannuation entity must ensure that the prescribed standards applicable to the operation of the entity are complied with at all times.

Offence

(2) A person who intentionally or recklessly contravenes subsection (1) is guilty of an offence punishable on conviction by a fine not exceeding 100 penalty units.

Note: Chapter 2 of the *Criminal Code* sets out the general principles of criminal responsibility.

Validity of transaction not affected by contravention of (1)

(3) A contravention of subsection (1) does not affect the validity of a transaction.

APRA also issues Superannuation Circulars that provide guidance on how APRA interprets the law.

When the Superannuation Working Group inquiry into the Safety of Super was being conducted, ASFA supported the retention of the process for standard setting by way of regulation, rather than any direct power for APRA to make standards. The Association continues to support this process.

4. The role of advice in superannuation

Despite numerous attempts at clarification by the Australian Securities and Investments Commission (ASIC) and others, the boundaries between information, general advice and personal advice remain uncertain. Notably the definition of "financial product advice" is very broad and captures a considerable portion of the communications between a superannuation fund trustee and a member.

This definition has affected superannuation fund trustees that want to educate and inform their members about both superannuation generally and features of their fund. All too often trustees have had to modify or suspend educational materials or activities for fear such initiatives constitute "financial advice". In the context of ASIC's approach to enforcement, caution has been paramount.

Increasingly, superannuation fund trustees are acquiring Australian Financial Service Licences (AFSLs) from ASIC. As such the concerns over the definition of advice are less to do with providing unlicensed advice than they are with offering advice and triggering the various requirements to provide appropriate disclosure documentation in a timely manner.

ASFA considers that superannuation funds should be able to communicate with members on features of the fund without such communications being considered advice. This might also include defined benefit funds seeking to provide examples of how benefits are calculated. Overall any communication aimed at explaining internal features of the fund should be permissible without such communications being considered advice. In addition, alerting a member to matters such as the government co-contribution scheme or the tax advantages of salary sacrifice should be seen as education and not advice. We are pleased that reforms in these areas are being progressed by the Government through the Corporate and Financial Service Regulation Review process.

The FSR refinement (regulation 7.1.33H) enabling product issuers to discuss features of their own product without the need for a licence is of some assistance. However, the concession does not extend to general education about superannuation, for instance explanation of salary sacrifice. Further, many superannuation fund trustees now hold AFSLs and are not able to use this exemption.

There remain other difficulties with the concession, as it is often the administrator, not the trustee, who is discussing the fund's features. Thought should be given to extending the regulation 7.1.33H concession to those authorised to act on behalf of the trustee as well.

Any redefinition of advice, including general advice, needs to be targeted where there are genuine consumer protection issues at stake. Encouragements to invest discretionary monies or switch products must be caught within the advice definition.

Similarly, communications suggesting specific investment choices where the costs and investment risks are borne by the customer / member should be considered advice.

RECOMMENDATION NO. 5

ASFA recommends that a new definition of financial advice be developed that better enables funds to discuss internal features of the fund and to educate members about superannuation, including preservation and taxation issues.

The regulation of personal advice has also proven problematic for superannuation funds. Members often want further information regarding the range of options they have within the fund, for example, about investment choice or additional insurance cover. The moment that the member starts providing information about their personal circumstances, the Statement of Advice (SoA) requirements are triggered, even if they only want information. The SoA process, with its fact find process, is time consuming and inappropriate in some situations. Members asking a superannuation fund about insurance or investment options within a fund should either not require an SoA to be produced or else a short-form document should be provided.

However, ASFA strongly believes that any changes to the SoA requirement must be carefully done. Extending relief too far is hazardous, particularly if it involves a person moving between funds. The decision of an individual to join a new fund, acquire a new product or transfer or rollover significant amounts of money from one fund to another must require significant investigations of the member's current benefits and costs and should ordinarily require the provision of an SoA.

RECOMMENDATION NO. 6

ASFA recommends that the SoA requirements be refined to enable limited advice provision to members on investment and insurance choice options within a fund. ASFA does not support significant reduction or removal of current SoA requirements in product recommendation or switching situations.

The obligation to provide an SoA when offering a large employer with superannuation-related advice (including advice on remuneration policy) also places significant and unnecessary demands on superannuation funds and service providers.

Providing a large multi-national employer with an SoA in these situations is an unintended outworking of the law. This is further compounded by the SoA content requirements, including ASIC guidance, which is premised on an individual receiving advice from an adviser. These requirements are inappropriate for an employer in an advice situation.

RECOMMENDATION No. 7

ASFA recommends either modification of the wholesale client test to exclude large employers and / or modification of the SoA content requirements to better suit the situation of a large employer.

ASFA considers that there is scope for further assistance to individuals in their planning for retirement.

In this regard, a concern raised by the OECD in its recent report Ageing and Employment Policies: Australia was the “general lack of information about the size of future superannuation entitlements” (p. 29). This is consistent with ANOP survey findings which indicate that when pressed about how good an idea the respondent had about likely income in retirement, around 75 per cent of those aged 30 to 39 indicated that they really did not know, with only 8 per cent indicating that they had a good

idea. Providing information about future superannuation entitlements based on current behaviours may assist in better informed decision-making by individuals, including decisions to make additional contributions, thus addressing future adequacy.

The ANOP polling conducted in September 2005 indicates that there would be a high level of community support for such information being provided. Around half of those surveyed indicated that they would be very interested in their superannuation fund providing them with an indication of what they will have in retirement based on their current contributions. Interest in these type of projections was highest amongst younger members of the workforce, who also indicated that they were not very well informed about their likely eventual retirement savings and retirement incomes.

The OECD suggested Australia consider adopting a modification of the "orange envelopes" currently used in Sweden. In Sweden, employer contributions to both social security and funded individual retirement accounts are made to a central Government agency, the Premium Pension Agency (PPM), which then distributes the latter contributions to funds chosen by the individual.

Using this data, the PPM issues the "orange envelopes" annually to every participating Swedish citizen. This notice contains information about both their present benefits and future benefits as projected using a set of standardised assumptions. These projections are done using a number of scenarios for the individual (for example with different income growth, real returns and retirement ages) and indicate the likely income the individual would receive as a result. As noted in the OECD report "(t)he main reason for these projections is to increase the knowledge among people about the size of their future entitlements, how their pensions are determined and what is affecting them" (p. 91).

This type of centralised, individualised projection would be difficult in the Australian context. However, the concept could be applied if superannuation funds were given greater capacity to provide benefit projections to members.

In the United Kingdom there is actually an obligation on funds to provide such projections to members on an annual basis. From 6 April 2003, an annual illustration (Statutory Money Purchase Illustration in the parlance of the UK legislation) must be given to scheme members of most approved pension schemes providing benefits on a money purchase basis (the equivalent of our accumulation schemes). The supporting legislation is the Occupational and Personal Pension Schemes (Disclosure of Information) Amendment Regulations 2002.

The main principle behind the legislation is to help individuals plan for their retirement and to encourage long term savings. The calculation basis is defined in a technical memorandum that was prepared after consultation with the Faculty of Actuaries. In particular, the pension illustration must be prepared in "real terms", allowing a direct comparison of the projected outcome with the member's present day income and cost of living. Most elements of the calculation are prescribed, but there is some scope to allow for the individual's personal circumstances. Investment returns may be adjusted to reflect the scheme's investment strategy, but are subject to a cap of 7 per cent per annum. Use of illustrations in real terms avoids "phone number" type projections of future benefits, and also avoids any suggestion of a benefit promise. An example of such an illustration based on the United Kingdom approach is set out in the box below. Though a lump sum final benefit is used in the example below, consideration should also be given to permit illustrations that provide a retirement income.

Mr Person under 40 superannuation fund statement

This statement is a guide to the amount of superannuation that you might get when you retire. In this statement we refer to this as an "illustration". It is shown in today's prices and is not a promise or guarantee that your superannuation will be the amount shown. This is because it is based on a number of assumptions.

Please read the notes on the back of the statement. They explain more about the way your illustration has been calculated, the assumptions that we have made and what will decide how much your final superannuation benefit will be.

Your name: Mr Person under 40
Your date of birth: 1 March 1970
The name of your superannuation scheme: The really beaut super fund
The date you joined the scheme: 10 September 1995
The effective date of this illustration: 1 July 2005

Contributions paid into your super in the year ended 30 June 2005: $5,400

The value of your superannuation so far: $36,000

- Your future superannuation balance
- To illustrate your possible future superannuation balance we have assumed that:
- your retirement date is 30 June 2035
- you will continue to have employer contributions at the compulsory rate of 9% until your retirement date

The estimated superannuation balance when you retire is: $311,000

Currently, ASIC Policy Statement 170 places strong restrictions on the use of prospective financial information. These restrictions, combined with concerns over future legal action by disgruntled members, results in the provision of benefit projections by funds being rare.

RECOMMENDATION No. 8

ASFA recommends that the Government pursue reforms that would permit superannuation funds to provide benefit projections to individual members on a standardised basis as part of their annual reporting to members.

5. The meaning of member investment choice

Trustees of superannuation funds have the legal responsibility to formulate investment strategies for their fund. They often draw on the opinions of advisers of various sorts. Along with investment advisers, the opinion of actuaries might also be sought in the case of a defined benefit fund.

Individual members also will have a role, particularly through the exercise of choice of investment option when this is offered. Even in this case, trustees have a role in selecting the options presented to members and in selecting the individual investments that make up blended investment options such as "balanced" or "growth".

According to data from APRA, in 2000-01 around 520 funds offered between 2 and 5 choices, 140 offered between 6 and 50 choices, and 23 funds offered more than 50 choices. More recent data show the incidence of investment choice by fund sector, and an apparent increase in the offering of investment choice to the point where it is the norm for large funds. Most superannuation assets in defined contribution superannuation are in funds with investment choice, and most assets in such schemes are in the default option (Table 1). The main exception is in the retail sector, where advisers and financial planners play a very significant role in the exercising of investment choice by individuals.

Table 1 – Incidence of investment choice as reported to APRA

Fund type	Corporate	Industry	Public sector	Retail	Total
Proportion of funds offering investment choice	34%	79%	56%	77%	45%
Proportion of sector assets in funds with choice	84%	98%	84%	89%	89%
Average number of options	4	9	6	61	
Proportion of assets in default option in funds with investment choice	70%	70%	85%	45%	

Source: APRA Annual Statistics, June 2005, issued April 2005

A more limited survey of funds carried out by Chant West Financial Services for the Investment and Financial Services Association which was published in June 2005 indicates that in the retail sector wrap-style products typically have 150-300 investment options, plus a wide range of direct shareholdings, while traditional master trusts offer between 20 and 70 options for both personal retail products and retail corporate master trusts. In comparison the average for industry funds was 12, for in-house corporate funds it was 5, and for public sector funds it was 7.

The proliferation of investment options might be in part due to attempts by funds to meet consumer demand for greater control. The providers of retail superannuation products, which are largely distributed through financial planners, have to also take into account the needs and preferences of financial planners.

Financial planners often prefer to construct a client specific investment mix. Different planning groups will have different views in regard to investment managers. Having a large number of investment options on the investment choice menu allows for a greater number of planners to make use of the product.

In the absence of involvement of financial planners there are actually grounds for believing that the more investment choices that are available, the less likely a member is to actively exercise a choice. Research into consumer behaviour indicates that more choice above a certain level can lead to greater confusion and uncertainty, and this applies whether it is types of jam on offer, or investment options within a superannuation fund.[5]

However, a range of factors will influence the active exercise of investment choice. The take-up of investment choice varies from fund to fund, depending on the nature of the options available, how the investment options are marketed or presented to members, the suitability of the age based or more general default option in place, the level of investment education provided to fund members, and the age, education levels and other characteristics of the membership itself.

The default option in many accumulation funds, that is the investment mix when no choice is made, is often a balanced investment portfolio that contains a range of shares, property, bonds, and cash investments using a variety of investment managers. In a few funds the default option is age based, so for members near retirement age the default might be an investment mix which is capital guaranteed or has a relatively heavy exposure to bonds and cash.

In terms of the options commonly offered by funds, "growth assets" are generally taken to be share and property investments where there is the likelihood of growth in the capital value of the investment along with dividends or other income. "Defensive assets" or "capital secure assets" are investments such as government bonds, corporate debt and cash at bank. However, it should be noted that there is no sharp dividing line between what is described by its sponsors as a growth fund and what is described as a balanced fund. It is all a matter of a degree. A more conservative growth fund may not be that much different from a slightly aggressive (in investment terms) balanced fund. However, there may be moves to more uniformity in descriptions with the requirement for funds to produce fee examples for their investment choice which is closest to 70% growth assets and 30% defensive assets.

In the case of Self Managed Superannuation Funds (SMSFs) all members are trustees, and all trustees are members, so at least nominally investment decisions are made by members. This is most likely the case in practice in most instances as well, as the investment portfolios of such funds resemble typical portfolios of individuals with similar levels of assets investing outside the superannuation environment. Shares in a few companies, direct residential property, term deposits and retail like managed investments feature in the investment portfolios of such funds. There is often only limited diversification in such portfolios.

[5] S S Iyengar and M R Lepper (2000) "When Choice is Demotivating: Can One Desire Too Much of A Good Thing", *Journal of Personality and Social Psychology*, Vol. 79, No. 6, pp. 995-1006.

In terms of aggregate figures, the overall asset split of SMSFs differs from larger funds in two respects. SMSFs have only a small proportion (2% or so in aggregate) of their investments in overseas assets (approximately 25% overseas in larger fund defaults), and cash accounts for over 20% of assets (approximately 7% cash in larger fund defaults). There has been some debate over the validity of that latter figure. Some argue that it is misleadingly high, as the 30 June figure for such funds reflects contributions going in just before the end of the tax year, with this eventually being invested in other investments.

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

APRA recently updated its guidance for trustees of APRA regulated funds on managing investments and investment choice. The updated version of the APRA circular is now available on APRA's website.

While the APRA circular covers a range of investment related issues for APRA regulated funds, the sections of it dealing with investment choice have perhaps attracted the most interest from trustees and their advisers

APRA appears to interpret the SIS legislation in the following way:

- The provision of member investment choice does not remove the need for trustees to ensure that the fund's investment strategy or strategies comply with the legislative requirements.

- Section 52 of SIS should be read and complied with in its entirety. Trustees accepting a member direction are not relieved of their duties to formulate an investment strategy that has regard to the whole circumstances of the fund.

- In particular, trustees need to ensure a reasonable liquid and properly diversified fund.There were a number of concerns with the consultation drafts of the revised circular and ASFA was very involved in following these concerns up with APRA. The final version is less prescriptive, and has been modified to take into account some of our concerns. However there are still concerns in the sector about how member investment choice is regulated.

There is a view in the industry that SIS does not adequately deal with current realities such as member investment choice and the emergence of new types of investments, and so should be updated. However, at the moment and in the absence of any imminent changes to SIS, the sector has to operate within the strictures of the legislation having regard to any guidance provided by APRA. In an earlier draft version of the investment circular, APRA argued that offering members with unlimited access to narrow strategies would mean that the trustee was not in control of the fund's overall asset allocation. The allocation would depend on the decisions of individual members. In that case, it would be difficult for the trustee to demonstrate compliance with SIS, particularly in respect of whole fund liquidity and diversification.

The final version still expresses APRA's concern, but couches it in terms of risk management by the trustee. Trustees should identify possible risks, then devise treatment plans. Examples of risks include:

- The possible risk to the fund's liquidity and diversification if a large proportion of members choose the same narrow investment option. This is probably not very likely for funds where most members are in a diversified default, but it could be an issue for some funds.

- More likely is that members could make poor choices, leading to reduced retirement income. This could possibly lead to legal action against the trustee.

While the draft document stated that it was not prudent to offer undiversified choices without restriction, the final version states that APRA would find it difficult to conclude that a trustee was acting in the best interests of members if it made available a range of narrow or risky choices without

regard to the proportion of the account balance invested. This could potentially lead to possible difficulties for trustees in meeting their obligations as interpreted by APRA.

However there is a recognition in the APRA circular that a range of tools might be used to manage the risk. These include quantitative limits and the provision of regular advice on the benefits of diversification, the latter of which funds almost without exception would already be doing.

The circular makes the point that trustees cannot abrogate their responsibility by requiring members to seek financial advice. While this may be an appropriate view, the problem remains that members taking advice often wish to diversify their assets on a whole of portfolio basis. If they have a heavy concentration to e.g. property and cash elsewhere, they may want their super to be in just shares.

The circular states that it is not appropriate for trustees to take into account investments outside superannuation. The justification is the SIS requirement that investment strategies must be developed in a whole fund context. While this is legally correct, it could lead to sub-optimal outcomes, with some members being forced into a less diversified position overall.

Given the emergence of member investment choice, it is reasonable to assume that the individual is voluntarily taking on some responsibility, in particular the investment risk, when making a choice other than the default. The trustee should be expected to conduct itself appropriately under its obligations and to very carefully consider both its default and its investment choice offerings. However, the trustee cannot be expected to be fully responsible for all of the investment risk faced by the member that actively makes a choice. This is consistent with the concept of fund choice of empowering the individual member. As well, this issue is even more pronounced in a situation with member directed investments, such as a Small APRA fund.

Clearly, the SIS legislation was developed in a context where there was little if any member investment choice. While APRA and funds can continue to operate within its confines in this area, there may be a case for reconsidering specific SIS obligations to better accommodate the existence of member investment choice.

RECOMMENDATION No. 9

That the Government consult with the superannuation sector to ensure a better integration between member investment choice and the current SIS obligations.

7. The reasons for the growth in Self Managed Funds

There have been a variety of reasons for the growth in the number of Self Managed Superannuation Funds (SMSFs) and in the aggregate assets held by such funds. These have to do with both supply and demand factors. The strength of various drivers of behaviour vary over time and as a result, while the number of SMSFs continues to grow, the rate of growth has decreased over the last year or two. Basically SMSFs have grown in number because they meet needs, or perceived needs, in the market.

Currently the aggregate number of SMSFs is growing by between 15,000 and 20,000 a year, compared to growth by 25,000 to 30,000 a year between 2002 and 2004. That the growth rate for creation of SMSFs should eventually tail off is not really surprising, as there comes a point when the potential market for such funds becomes relatively saturated. Generally a substantial account balance is required to make such a fund viable, and there is only a limited stock of Australians with such account balances over, say $200,000, or the ability to build up such a balance in a relatively short period.

The number of SMSFs ceasing operations has also picked up to some extent, with 3,377 exits in the 2004-05. Reasons for a SMSF being wound up include the death of the only member, or the burden of running the SMSF proving excessive for a trustee or trustees of the fund.

On the supply side, amendments to the *Corporations Act* have both increased and clarified regulatory constraints on accountants and others who have traditionally played a role in the establishment of SMSFs. While accountants have a limited exemption from *Corporations Act* licensing and provision of advice requirements for their actions regarding the establishment of a SMSF, that exemption does not extend to the provision of advice about moving a superannuation balance from another fund. An accountant in most instances would need to be ASIC licensed in order to suggest that a client consolidate their superannuation in a SMSF. Given that for most individuals it would be necessary to consolidate other existing superannuation balances in order to make a SMSF viable, and that many accountants are not ASIC licensed, this places a significant constraint on any advice or selling process in regard to the establishment of a SMSF.

Action by the Australian Taxation Office and ASIC has also had a substantial impact on promoters who established SMSFs in order to facilitate early and unlawful release of superannuation benefits. The prosecution of and imposition of penalties (including jail terms in some cases) on such promoters is likely to have led to a diminution in the number of funds being set up for that purpose. However, the number of SMSFs being used for early release has always been a very small proportion of the total number of SMSFs.

In regard to demand side factors, ASFA has in the past commissioned surveys of the population which have provided data on the extent of choice of fund in the community, the type of funds selected, and the reasons for choosing a fund.

The survey results indicate that only a small proportion of fund members exercise choice of fund, with an even smaller proportion choosing a SMSF. Out of those surveyed by ANOP for ASFA in 2005, during the first three months of the operation of choice of fund legislation 7% changed funds (Table 1). However, only 4% of the sample chose a new fund as a conscious act of choice, as 2% of respondents went to a new fund because it came with a new job, and 1% changed because of closure of the old employer fund.

Table 2: Incidence of Changing Funds

	Fund Sector, Oct '05				
Whether Changed Last 3 Months:	**Oct '05 %**	**Retail %**	**Industry %**	**Public Sector %**	**Corporate** %
Yes, Have changed funds	**7**	7	11	3	-
No, Haven't changed	**93**	93	89	97	100

Source: ANOP 2005 National Survey of 25-64 Year Olds in the Workforce

The incidence of choice of a Self Managed Superannuation Fund was relatively low in the period concerned. Under 0.5% of the sample selected a SMSF during the period covered by the survey, with around 4% in total of those surveyed in a SMSF having joined such a fund in a prior period.

In terms of fund destinations following exercise of choice, industry funds were marginally more popular choices than retail, but both types of fund were chosen by just under 2% of the sample. Dominant reasons for choosing a new fund, apart from a change in job, were fees, consolidation of accounts, and pursuit of better investment returns, in that order.

The relatively low incidence of choice of a SMSF has also been confirmed by the experience of clearing houses that have been established to forward superannuation contributions from employers to multiple funds. In the case of one large clearing house, Investment Link, less than 0.1% of the employees that Investment Link processed contributions for, chose a SMSF. In the cases where a choice was made, most of the SMSFs receiving contributions were established rather than recently formed entities.

Some caution is needed in interpreting these results due to the relatively small number of recorded movements from one type of fund to another. However, the drift to SMSFs at this stage appears to be lower than was anticipated prior to the introduction of choice of fund. It has been observed that growth in SMSFs often follows a period of depressed investment returns, potentially as a result of individuals thinking they can "do better themselves". In this regard, higher investment returns of large funds in recent years on top of increased constraints on those selling this option, together with more community awareness of the obligations attached to running your own SMSF appear to be keeping the numbers of new SMSFs down for the moment. The misadventures of some SMSFs in regard to their investments in certain vehicles, such as debt instruments, have likely increased the relative attractiveness of use of large, established superannuation funds compared to undertaking your own investments.

The 2005 ANOP survey results indicate that of those in the population who have already established a SMSF or are considering doing so, the main reasons for this (in descending order of importance) were:

- Have more control, more flexible.
- Self employer, own business.
- Lower fees.
- Returns, better performance.

For those individuals with no interest in establishing a SMSF the main reasons for this were:

- Lack of knowledge, no expertise or skill.
- No time, too busy, other priorities.
- Too difficult, too hard, complicated.
- Happy with current fund, no point.

Consistent with this, SMSFs will continue to be attractive to individuals who wish to have more control than is possible through the structure of most large superannuation funds and/or those who are suspicious of institutional investors. They also will be popular with those who wish to hold the real property of their own business as part of their superannuation investments. SMSFs have also been popular in the past with those wishing to put in place strategies to deal with a Reasonable Benefit Limit and/or to establish a complying pension in order to obtain some Age Pension as these strategies were difficult to undertake or were costly using other types of fund. However, proposed changes to the Age Pension means test along with the package of proposed changes to the taxation of superannuation announced in the May 2006 Budget means that such strategies in a number of instances are no longer needed.

The use of some SMSFs in illegal early release schemes highlights the need for scrutiny of these entities; this in turn highlights the regulatory challenges presented by such a large number of entities.

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

The demise of defined benefit funds has perhaps been overstated as numerous examples remain, with some still open to new members.

Table 1 provides details of the split between defined benefit and accumulation schemes in other than small funds. There is also another $208 billion in 317,000 or so Self Managed Superannuation Funds and Small APRA Funds. These funds have less than five members, and generally have only one or two members. These funds by their very nature are accumulation funds, although there are a relatively few SMSFs that provide their members in retirement with a defined benefit pension.

Table 3 - Benefit Structure (for funds with more than 4 members)

	Accumulation	Defined Benefit	Hybrid	Total
Member Accounts (000's)	*17,941*	*604*	*8,747*	*27,292*
Assets ($b)	*271.0*	*19.3*	*253.2*	*543.5*
Funds	*876*	*88*	*360*	*1,324*

Source: APRA Annual Statistics, June 2005, issued April 2006

Data for the top 50 listed companies in Australia indicate that the majority of those companies have defined benefit obligations to their employees, with the total of such liabilities exceeding $50 billion in 2002 (Fitch Ratings, 2003). This suggests that the bulk of the liabilities of the private sector hybrid schemes in the table above relate to defined benefit elements given that the assets of private sector pure defined benefit schemes were only $9.7 billion in 2002.

A number of companies have also transferred their defined benefit superannuation schemes to other providers. For instance, one retail corporate master trust has reported that of the 73 sub-plans that it conducts, 31 are defined benefit plans.

Nevertheless, the figures suggest that there are not a lot of pure defined benefits in the hybrid schemes, which would include corporate master trusts with assorted sub-plans. While some of these hybrid schemes involve a mix of benefits (such as a defined benefit in retirement and an accumulation benefit on resignation) many of them are schemes with different divisions. Long closed divisions or not generally available divisions might provide defined benefits, with the majority of members and assets in new divisions which are essentially defined contribution arrangements.

In the case of public sector superannuation schemes it is not unusual for the closed defined benefit division or divisions to be largely or wholly unfunded, with actual money and assets in the defined contribution division. For these public sector schemes the matching of pension liabilities generally is with the ability of the government concerned to collect taxes in the future rather than with income from any set of financial assets.

There are a number of reasons for the preponderance of accumulation assets and members. Accumulation schemes have been the more practical option for most of the new entrants to superannuation, particularly for individuals who regularly move between jobs. Employers have also been increasingly wary of taking on investment risks and increasingly reluctant to pay more in contributions than required by the Superannuation Guarantee (SG). Most defined benefit schemes involve contributions that equal or exceed the maximum SG rate.

Similar concerns related to the cost, complexity and contingent liabilities of defined benefit schemes have led to their closure to new members in many other countries as well.

9. Cost of Compliance

Trustees and funds face considerable compliance costs as the result of both the SIS legislation and Corporations Act obligations. We are pleased that the Government is displaying a commitment to reducing compliance costs and further improving regulator performance, transparency and accountability through the Corporate and Financial Service Regulation Review process, as well as the Government's response to the Business Regulation Taskforce.

The full extent of compliance costs is not easy to quantify, but ASFA is currently undertaking research on this topic and will be releasing the results at the ASFA National Conference in Perth in November 2006. This research will draw on a variety of sources, including a survey of superannuation trustees conducted by researchers at the Queensland University of Technology in mid-2006. That survey focuses on the member costs and benefits that trustees experienced in the Registrable Superannuation Entity licensing process.

The ASFA research will extend that by looking at the current and prospective costs of the regulators, ASIC and APRA, and the costs to trustees and funds of complying with ASIC requirements.

Preliminary work indicates that the various compliance costs are considerable. The direct and indirect costs of trustees obtaining their initial APRA licence are likely to have been in excess of $50 million. Ongoing costs of APRA and ASIC recovered through the supervisory levy are running at an amount in excess of $42 million a year, with this increasing each year despite a fall in the number of trustees and funds being supervised. Direct ongoing compliance costs of funds on top of these other costs are likely to be running at an amount of more than $100 million a year in aggregate. There also are other substantial indirect costs, such as additional printing and distribution costs associated with extensive and at times excessive disclosure material for consumers.

More recently, ASFA estimated that the Budget proposal changes, though generally positive, will cost the superannuation industry upwards of $50 million to implement. It is crucial for Government, parliamentarians, bureaucrats and regulators to realise that regulatory change, even positive regulatory change, carries costs.

We would like to explore two topic areas that have been on-going concerns for ASFA; the complexity of current legislation, in particular the Corporations Act, and the need for better co-ordination of APRA and ASIC.

Complexity of Legislation

One concern that ASFA has previously raised has been the increasing complexity of legislative design. Increasingly, legislation is supplemented by regulations as well as other instruments and guidance. While ASFA recognises that the use of regulations can often be effective in quickly addressing short-term problems, the resultant regulatory structure can be unnecessarily complex.

To illustrate, as part of completing an APRA Annual Return, the trustees of a superannuation fund must attest to their compliance with particular sections of the Superannuation Industry (Supervision) Act 1993, the Financial Sector (Collection of Data) Act 2001 and the Corporations Act 2001. One such section is section 1017D(3A) of the Corporations Act 2001. However, when one consults the Corporations Act 2001, this section does not appear. Instead, it resides in the Corporations

Regulations 2001, Schedule 10A, Part 12, Item 12.1. All throughout Schedule 10A there are provisions where sections of the Act are inserted or amended to suit particular circumstances.

A similar practice has been the growing use of legal instruments, such as Class Orders, by ASIC to modify the Corporations Act 2001. An example of this is Class Order CO 04/1030, issued on the 14 October 2004. This deals with in-use notices for certain superannuation PDSs and inserts a new section 1015DA into the Corporations Act 2001.

There is no cross-reference of these inclusions in any commonly used consolidated version of the Corporations Act 2001. As such, a person consulting a consolidated version of the Corporations Act 2001 available on ComLaw or through CCH would not be aware that subsection 1017D(3A) or section 1015DA even existed if they hadn't also consulted the regulations and Class Orders.

While changes to regulations involve Executive Council and are theoretically easier to track, the use of Class Orders is more problematic. In 2004, ASIC issued 86 Class Orders, a rate of nearly one Class Order every four calendar days. Class Orders are available through the ASIC website and the FRLI component of the ComLaw website, however there is no proper indexing and both sites remain difficult to navigate.

Need to Co-ordinate Dual Regulations

Dual licensing and dual regulation of superannuation funds is a challenging area for superannuation funds and the respective regulators. For example, superannuation funds must now satisfy both regulators in respect of competency, conflicts of interest, breach reporting and the like. The requirements are similar but in many cases slightly different. This imposes considerable and unnecessary compliance costs on funds, some of which are detailed below.

Superannuation funds have expressed concern that the breach reporting requirements for them as AFS licence holders are different from those expected from them under as the RSE licensing regime under the *Superannuation Industry (Supervision) Act 1993*. We are pleased that the Government has decided to progress this matter through the Corporate and Financial Services Regulation Review process. We are looking forward to a swift resolution of this matter. Below is a summary of the differences.

Table 4 – Breach Reporting Requirements – APRA & ASIC

	RSE Licensee (APRA)	**AFS Licensee (ASIC)**
Obligations that if breached are reportable	Most limited range of laws but includes risk management strategies and plans	Includes all of legislation reportable by RSE licensee except Financial Institutions Supervisory Levies Collection Act. Also includes other legislation including Superannuation (Resolution of Complaints) Act.
Likely breaches	Not reportable	Reportable but very narrow definition of "likely" in section 912D(1A)
Insignificant or trivial breaches	Reportable	Not reportable
Time to	As soon as practicable and	As soon as practicable, and in any event

	RSE Licensee (APRA)	AFS Licensee (ASIC)
report	in any event within 14 days after becoming aware that the breach has occurred.	within 5 business days, of becoming aware of the breach or likely breach.
Content of report	A notice setting out "particulars" of the breach	A report "on the matter"
Offence if fail to report	50 penalty units	50 penalty units or imprisonment for one year or both

Source: Jim Boynton (2005) "What Happens if You Have Got it Wrong? Breach Reporting, Relief Applications and Enforcement Issues" 2005 Superannuation Lawyers Conference, Hobart.

The above table is based on the legislative regime. Administratively, APRA has introduced a *de facto* materiality threshold within the reporting of breaches to the risk management plan or strategy, given that these documents are only to deal with material risks. However, no such materiality threshold exists for reporting of breaches to the range of laws listed.

Leaving aside the issue that APRA's materiality approach only deals with a limited area (risk), APRA introduces the "materiality" threshold at a different point than in the Corporations Act regime. Materiality is established in aspects of the APRA regime when the risks are established and before the breach occurs. In the Corporations Act regime, the breach occurs and then its materiality is determined after the breach occurs. There is an inconsistency in the approaches of the two regulators that creates significant difficulties for the many funds operating in both regimes. In addition, different reporting time frames and different content requirements for breach reports create unnecessary inconsistency and impose additional compliance costs.

While ASFA would be very happy to discuss the actual nature of a consistent regime – consistency must be paramount. Ideally any consistent regime would:

- remove the obligation to report "likely", trivial or insignificant breaches at a particular point;
- have a reporting trigger based on knowledge of the breach and determination of its significance;
- have a standard reporting time frame;
- have regard for a standard list of relevant legislation to report breaches of;
- have standardised content for reporting of breaches; and
- have standard penalties.

We are pleased that the Government has indicated that it will address inconsistencies between the ASIC and APRA breach reporting requirements. Such differences impose unnecessary costs on members and need to be addressed.

10. The appropriateness of the funding arrangements for prudential regulation

Funding arrangements for the prudential regulation of superannuation have been examined by a number of official inquiries in recent years. These include the Wallis Committee, the November 2000 Productivity Commission Inquiry into Cost Recovery, and the November 2002 Review of Financial Sector Levies conducted by the Treasury. This submission draws on material presented by ASFA to these earlier inquiries.

The case for levies on APRA regulated superannuation funds essentially flows from the fact that they are required to be subject to prudential supervision and other regulatory controls, and this involves not insignificant public expenditures.

The need for supervision of superannuation funds is clear. As indicated in Box 1, there are a number of characteristics of superannuation that justify this treatment. Similar considerations have also led to insurance companies and authorised deposit-taking institutions being the subject of supervision. This has applied in many other jurisdictions in addition to Australia. However, Australia is relatively unusual in having a "twin peak" structure of regulation (APRA and ASIC) covering all prudentially supervised institutions. Other jurisdictions generally have sector specific regulators, or one regulator covering all issues.

While the rationale for prudential regulation is clear, it remains difficult to identify to what degree the regulated industry and/or the wider community benefit from such regulation and consequently who should bear the regulatory cost.

In particular, the underlying rationale of the current supervisory levy and its public policy justification have not been subject to discussion in recent years. When the supervisory levy for superannuation funds was first introduced, the user pays nature of the arrangement was not subject to any conjecture in public service circles. The then Insurance and Superannuation Commission (ISC) in its circular No 24 stated that the Government believed that it was fair that superannuation funds, and indirectly their members, should bear the full cost of supervising their access to taxation concessions, rather than having that cost borne by the general body of taxpayers. The fact that these two groups were only marginally different in their composition was not addressed.

The Senate Select Committee on Superannuation in its May 1993 report "Super Supervisory Levy" gave attention to that assertion in the light of evidence available at that time, including the nature of the then functions of the ISC. The ISC conducted a range of activities, including annual return processing, audit of funds, administration of reasonable benefit limit (RBL) system, enquiries, policy advice and development of legislation, and education. Responsibility for the RBL system subsequently moved to the Australian Taxation Office. We note that some of the significant reasons put forward for industry funding of ISC such as policy development and education for the public and industry are now not undertaken by APRA.

A number of submissions to that enquiry suggested that as Australia approached universal superannuation coverage there was a case for meeting the costs of the ISC from consolidated revenue. While this was not endorsed by the Senate Select Committee, the Committee recommended that the costs of administering the RBL system should not be recouped through the supervisory levy. The Committee also believed that there was some question as to the appropriateness of the levy recouping policy and legislation costs.

The current levy arrangements have their genesis in recommendations of the Wallis Committee, whose recommendations also led to the formation of APRA and ASIC. The recommendations proposed, with relatively little discussion and not much dissent from organisations providing submissions that, charges be made by the regulators for services that are directly provided with general expenses being recovered by way of a levy on relevant financial institutions.

This inquiry provides an opportunity for further consideration of the basis of the levies, and how they can be best applied to superannuation funds. The submission addresses in turn the activities of each of the bodies for which cost recovery is sought through the levy arrangements.

APRA

The core activities of APRA in regard to superannuation, as indicated in the APRA Annual Report, are:

- the licensing of superannuation funds,
- requiring trustees to meet appropriate governance standards,
- requiring trustees to have an investment management strategy,
- conducting periodic on-site reviews of funds and consultations with trustees,
- encouraging trustees to correct non-compliance or unsound practices, including taking of enforcement action, and
- liaising with industry organisations and specialists to keep abreast of market developments and communicate regulatory changes and concerns.

It is arguable that each of these activities provide benefits to superannuation funds and/or fund members and as such are appropriately funded from levy proceeds rather than from consolidated revenue. However, a number of the activities help support public confidence in the operation of the compulsory superannuation system and in the overall stability of an important part of the Australian financial system. It also is arguable that this provides grounds for a level of financial support by taxpayers generally given that the population of superannuation fund members and the population of personal taxpayers is very similar. Compulsory superannuation covers the vast bulk of employees, and tax concessions for superannuation encourage involvement in the system by the self employed.

Consistent with the findings of the Productivity Commission Inquiry Report of August 2001 into Cost Recovery by Government Agencies there is a case for certain APRA expenses to be met out of consolidated revenue. These include the costs of reporting to Parliament, briefing Ministers and responding to their correspondence, and undertaking financial reporting. A number of information products produced by APRA, including *APRA Insight* and the *Annual Superannuation Bulletin* and the *Quarterly Superannuation Performance* statistics, also appear to have the characteristics of information products that the Productivity Commission considers should be taxpayer funded rather than subject to user charges or be funded out of industry levies.

ASIC

One difficulty in evaluating whether activities of ASIC should be funded by way of the levy arrangements is that very little information is provided by ASIC on the nature of its superannuation related activities outside the operation of the Superannuation Complaints Tribunal. There remains poor accountability for the amounts of the levy proceeds that are involved.

Both in Australia and in other countries consumer protection and market integrity functions are sometimes funded out of consolidated revenue and sometimes from sector specific levy arrangements. ASFA has no strong objection to funding such functions by government agencies relating to superannuation from levies rather than general taxation.

There is a case for ASIC's public education activities relating to superannuation to be financed out of consolidated revenue rather than such costs being attributed to superannuation funds.

As well, there is a question of overlap in functions between APRA and ASIC. This will increase, as all superannuation funds have had to obtain a license from APRA (under the Safety in Super proposals) and many have obtained or will have to obtain a license from ASIC (to meet FSRA requirements).

In regard to the operations of the Superannuation Complaints Tribunal (SCT), ASFA has no objection to them being funded by way of an industry levy. Such funding arrangements are not uncommon for dispute resolution mechanisms for specific sectors, although it should be noted that other more formal dispute resolution mechanisms such as the Federal and State courts receive considerable subsidies and are only on a very partial user pays basis. There are significant public benefits from dispute resolution in the sector that are wider than the specific interests of the parties to a dispute. In this context it should be noted that around a quarter of the cases of the SCT relate to disputes concerning the distribution of death benefits. These disputes are basically between competing beneficiaries rather than being a dispute between a claimant and a superannuation fund. Such disputes when relating to the distribution of estates rather than superannuation are generally dealt with by the Courts having regard to provisions of laws relating to Testators Family Maintenance.

ATO

The rationale for the operation of the lost members register maintained by the Australian Taxation Office being funded from industry levies is not clear. It could be argued that the operation of the register underpins the operation of the Superannuation Guarantee system of compulsory superannuation as much as it bolsters the efficiency of funds, and as such should be funded out of consolidated revenue.

The activities of the ATO relating to lost members and inactive accounts were funded out of consolidated revenue prior to the establishment of APRA and the new levy arrangements. As well, it is not clear that the ATO devotes this level of resources to the operation of the register. ASFA understands that the figure of $2.3 million per annum that applied for a number of years was based on an initial ATO assessment of costs prior to the register coming into operation. This amount appears to have been derived from what it would cost to handle 160,000 phone inquiries and 80,000 written applications, but actual inquiries appear to be around one-fifth of that level for much of the period that the ATO has received funds derived from the levy.

At an apparent cost to the sector of about $50 an inquiry and about $250 for each person matched with a fund balance there appears to be scope for greater efficiency if this is what it actually costs the ATO,

or lower levies to reflect actual costs. The amount allocated to this function implies that each staff member has in the past dealt with fewer than five inquiries each working day. It is probable that the ATO activities are much more efficient than this, and that the amount allocated to the ATO should be substantially reduced. In this context it should be noted that recent initiatives by the ATO are based on funds directly interrogating the database and/or providing details of new fund members by way of data interchange. These are relatively low cost methods for the ATO as well as being more effective than member initiated inquiries. While the number of inquiries has dramatically increased as the result of a joint superannuation industry/ATO public campaign directed at lost members, ATO costs have not necessarily increased to any marked extent.

However, rather than decreasing the amount the ATO has increased the amount recovered from the sector for the lost members register through allocating a range of head office overheads to the function. An amount of $3.8 million a year is now recovered.

Apart from this amount appearing to be higher than commercially justified, the case for funding the lost member register activities out of consolidated revenue is strengthened by the fact that the Commonwealth benefits from significant levels of payments made by employers and the subsequent issue of Superannuation Guarantee vouchers. A significant proportion of such vouchers are not claimed for some time, and some will never be claimed. This results in a financial benefit for the Commonwealth.

RECOMMENDATION No. 10

That the Government ensures transparency and accountability in the process of setting the supervisory levies.

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

A trustee deducts fees from the superannuation fund in order to pay for a variety of operating expenses. Wherever costs are deducted from, either directly from the members' account or from a fee that's paid to a related entity that itself pays for the advertising, ultimately the member pays.

Promotional advertising is a legitimate expense that may be met from such fees. Advertising and promotion are essential features of any competitive market. To restrict or essentially ban the ability to advertise (particularly banning some but not all in the marketplace from advertising) severely undermines the ability of the market to operate freely and properly.

Different sectors of the industry have chosen different avenues for promotion and distribution. If promotional advertising were to be banned, it would severely constrain not for profit funds, eroding their growth if not undermine their existence. As a result, the overall industry could be fundamentally restructured, in favour of those providers that use other means for promotion and distribution.

APRA Superannuation Circular No III.A.4 "The Sole Purpose Test" states that as a guiding principle "there should always be a reasonable, direct and transparent connection between a particular scheme feature or trustee action, and the core or ancillary purposes". Whether there is a breach of the sole purpose test in any instances therefore has to take into account the specific expenditure incurred and in light of the specific circumstances of the particular fund.

Guidance for funds on the use of promotional advertising has been provided by a letter from APRA to all trustees of APRA regulated superannuation funds dated 14 March 2005 regarding advertising by funds. Further clarification on this issue was given in comments made by Mr Stephen Glenfield, a General Manager in APRA's Specialised Institutions Division at the March 2005 CMSF Conference. Mr Glenfield said that while advertising that was solely directed towards recruiting members in the new choice environment might be deemed to breach the sole purpose test, this would not necessarily be the case when the advertising fulfilled other, associated purposes. He said those other associated purposes could include informing existing members of the benefits they were receiving or any new services that would be made available.

He was reported as saying that "existing members of superannuation funds must get something for it to be justifiable under the sole purpose test," and that "what we'd ask trustees to do is demonstrate what benefits existing members receive from such advertising." Mr Glenfield said he would have expected that trustees would have made an appropriate business case for approving such advertising "because, ultimately, the trustees of a fund need to determine whether a campaign will benefit its members".

The sole purpose test and other SIS requirements are important features of our current legislative regime. It is highly unfortunate that these requirements appear to have been misunderstood and used by some to argue that some funds should be restricted from advertising. ASFA does not see the need for, and does not support any change to, the current legislative arrangements in this regard.

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

Superannuation funds use a wide variety of descriptors of themselves in their promotional material. Some funds have chosen to use terms such as "not for profit" and "all profits to members" in their promotional material. The concept of "not for profit" is common across a wide range of industries, is not new and is well understood in the community.

These meaning of the phrase in the context of its use in the superannuation sector is best established by reference to actual examples of its usage (the concepts are not defined in the SIS legislation, nor in the Corporations Act).

One such example is the SelectingSuper website, where it is stated:

> Industry funds often describe themselves as 'not-for-profit', meaning their fees generally match their costs as they do not seek to make a profit for any shareholders. On the other hand, master trusts - because they are commercial funds - must try to make a profit, and so they have to charge fees that are more than their costs.

If any such terms are misleading or deceptive, ASIC has the power to commence enforcement action against the relevant AFSL holder or product issuer.

13. Benchmarking Australia against international practice and experience

ASFA takes as its starting point in its comments on this particular terms of reference that there is broad political and community support in Australia for a three pillar system for retirement income along the following lines:

- provision of an adequate public safety net (the Age Pension) funded out of general revenue;
- compulsion of self-provision based on a set level of contributions for those in the labour force at the very least; and
- encouragement of self-provision (by way of superannuation or other savings preserved until retirement) for those in the labour force and others.

These principles have achieved support amongst the public, major political parties and stakeholders in the superannuation sector.

It also needs to be emphasised that Australia has a world class retirement income system which is the envy of many other countries. While in retrospect the notion of compulsory employer contributions for the vast bulk of employees seems entirely sensible, it was a courageous decision at the time for the parties involved. Equally, the Age Pension in Australia has been remarkably successful in providing for poverty alleviation amongst the aged, while at the same time remaining affordable in an aggregate sense. A commitment to Australia's three pillar system is now accepted as bi-partisan policy and the structure is regarded as world best practice.

Policymakers in other countries have looked long and hard at the Australian retirement system in the hope that they can replicate our institutional arrangements at least in part in their own countries given that Australia has been a front-runner in terms of reforms. ASFA regularly receives delegations from other countries interested in the characteristics of retirement provision in Australia and how our system of both compulsory and voluntary contributions operates. These delegations have had a very wide geographic spread, with visitors from both North and South America (including the USA), Asia, Eastern Europe and Western Europe (including the UK).

Australia's arrangements for saving for retirement have also been given considerable attention in publications of the OECD, the World Bank and the IMF. For instance, in 2004 review of Australia, Directors of the IMF Executive Board observed "the means-tested publicly provided age pension, the mandatory private superannuation scheme, and the tax incentives for additional voluntary saving provide a suitable framework for retirement income support over the longer term, while limiting the fiscal burden." In a 2005 report into Australia's ageing policies the OECD said Australia's superannuation guarantee system was one area where the country was well ahead of other nations in trying to provide sufficient incomes to retired people.

The Government's recent Budget proposals together with existing policies will go a long way to achieving affordable and adequate retirement incomes in Australia. However, one area where Australia may be down the international rankings is in regard to retirement income adequacy. Australia's retirement income system delivers relatively good protection against poverty, but current and even prospective replacement rates of income and expenditure in retirement are not high by international standards. There would appear to be both scope and need to boost effective net

contribution rates to superannuation so as to improve outcomes. A range of policy measures are likely to be required to achieve this.

It also needs to be emphasised that Australia has a three pillar system for retirement income, not a system for provision of additional social and private expenditures as is the case in, say, Singapore. One of the reasons our retirement income system has achieved what it has is that its focus is on retirement income. Compulsory savings arrangements which can be used for purposes as diverse as housing, aged care, unemployment benefits, health costs etc run the risk of spreading themselves too thin.

In regard to the operating costs of the private component of the retirement savings system in Australia, international comparisons are difficult. Both retirement savings products and methods of charging differ between countries. In some countries the remuneration of financial planners is bundled into the fees attached to retirement savings products, while in others the two are quite separate. Differences in distribution arrangements, the average size of funds, the maturity of the system, restrictions on entry, allowable range of investments, average account balances and target markets also complicate comparisons. There are numerous traps for both new and old players in developing comparable estimates.

However, most of the difference between countries in fees and costs appears to be attributable to differences in costs associated with distribution. Administration activities and wholesale investment costs do not appear to differ markedly between countries, but there can be consequences from the average level of member account balances varying from country to country.

There is evidence that Australian investment costs for mandates in some asset ranges and classes are comparable to those in the United Kingdom and the USA. In those countries charges on investments of the order of $200m to $300m are usually of the order of 0.4% to 0.6% per cent for active managers or multi-manager specialist structures with different managers for different asset classes. Similar fees are readily available in Australia. Performance based fees are increasingly being used in Australia and are a means of reducing investment fees even further.

In regard of operational efficiency, Australian superannuation funds match up with some of the best in the world. Mike Heale, Partner, Cost Effective Management Inc, based in Toronto, Canada gave a presentation at the ASFA 2005 National Conference on the how well Australian superannuation funds compared with funds in other jurisdictions. Mr Heale found that Australian superannuation fund service levels were better than similar levels found in the US, Canada and the Netherlands. Anecdotally, we have found that the Australian superannuation industry is seen as a world leader in a number of areas including administration, member communication, technology and investment innovation.

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

Compensation due to employer insolvency

Employer insolvency has the potential to most significantly impact on members of defined benefit superannuation funds, particularly where the plan is not fully funded at the date of insolvency. To a lesser extent, members of accumulation schemes will be impacted to the extent that compulsory superannuation guarantee contributions remain unpaid at the date of insolvency.

In this context ASFA does not support the use of other superannuation fund members' benefits to compensate for the failure of an employer. ASFA considers that as a matter of principle any scheme to provide compensation for the failure of an employer's business should be funded by employers, not superannuation funds and their members.

In overseas jurisdictions, notably the USA, where compensation funds have been established to deal with the funding of defined benefit plans where an employer becomes insolvent, the presence of such arrangements has created a moral hazard. Typically these compensation schemes are in a state of collapse due to the number of claims and the considerable under funding of defined benefit plans. Accordingly, ASFA does not support the creation of a compensation fund. ASFA considers that a better approach is the development of a proper funding model that is legislated and enforced by a vigilant regulator.

In respect of insolvent employers with liabilities in respect of outstanding superannuation, ASFA supports:

- The granting of any required additional powers to the ATO to pursue outstanding SG for employees and former employees,
- The inclusion of unpaid superannuation within the employee entitlement ("GEERS") system;
- Restrictions on Deeds of Company Arrangement being used to reduce employee superannuation entitlements.

ASFA considers that as superannuation is part of an employee's remuneration package, where the employer is insolvent an appropriate level of compensation is 100% of any unrecoverable superannuation entitlement.

Compensation due to theft and fraud

ASFA supports the existence of a compensation regime for members of APRA regulated funds such as that under Part 23 of the *Superannuation Industry (Supervision) Act 1993* ("SIS"). Public confidence in superannuation is increased through the provision of:

- Independent complaint procedures that can investigate and resolve most matters of complaint;
- Trustee or professional indemnity liability insurance to cover certain areas of operational risk;

- Availability of compensation arrangements dealing with matters such as loss due to fraudulent activity, theft, or acts of gross incompetence or dishonesty.

The compulsory nature of superannuation demands a high degree of community confidence in the integrity of the system. Indeed the compulsory nature places a higher expectation of confidence in the superannuation system than would be expected from other financial products or services.

Superannuation, unlike some other financial products, has benefited from having a robust set of mechanism to deal with instances of loss, particularly access to the Superannuation Complaints Tribunal (SCT) and payments under Part 23 of the Superannuation Industry (Supervision) Act 1993 ("SIS").

It needs to be acknowledged that the payment of compensation to one party often involves a redistribution of benefits from other fund members or other funds. Where the members bear all of the cost, any additional cost or levy impacts directly on their retirement benefits.

The scope and nature of the compensation for loss payments therefore need to be limited to those cases where breaches of the SIS or the Financial Sector Reform legislation have occurred and the Fund or adviser is unable to make payments as a result of fraudulent behaviour. Currently, this is covered by Part 23 of the SIS Act.

ASFA's supports the ad hoc nature of Part 23 in that compensation has to be applied for, with a Ministerial decision required in each case. In general, these provisions have proven robust when dealing with situations such as the losses incurred by members of funds that had Commercial Nominees (CNAL) as a trustee, though some changes could be made to improve effectiveness and timeliness.

In terms of the level of compensation paid, ASFA considers that unlimited compensation would create a moral hazard and that limits should be set on the amount of compensation available. ASFA also considers that limits are needed to protect members of other funds who are effectively paying the compensation.

In the pre-Budget environment, ASFA supported the replacement of the 90 per cent compensation cap with a sliding scale. If this proposal were accepted, compensation would be paid on the basis of the losses of individual members within the fund, as follows:

- 100 per cent compensation for losses incurred on amounts up to an individual member's tax-free threshold (indexed, currently $135,590);

- 80-90 per cent compensation for losses incurred on amounts between an individual member's tax-free threshold and an individual member's pension RBL (indexed, currently $1,356,291); and

- no compensation paid in respect to losses incurred on amounts above an individual member's pension RBL.

Following the implementation of the 2006 Budget proposals, ASFA recommends 100 per cent compensation up to the tax free threshold and 80-90 per cent for losses incurred above that amount.

For ease of administration, there would only be consideration of amounts within the fund affected, with no consideration of superannuation held by a member in other funds or other assets of the member.

It is ASFA's view that post-retirement income products provided by superannuation funds regulated by APRA are generally catered for within the current scheme. Compensation under Part 23 should be payable in respect of superannuation funds issuing income stream products such as superannuation pensions and allocated pensions.

A person taking their lump sum outside of the superannuation system, as is often the case, and investing it in a non-superannuation managed investment, property or other asset or scheme, should remain outside of the Part 23 protections. It would be inequitable for the members of superannuation funds to be levied to pay compensation for fraud or loss in areas not bound by the stringent superannuation regime.

Consistent with this position, ASFA does not consider that members of Self Managed Superannuation Funds should be eligible to receive compensation from such arrangements, or to pay levies to finance compensation. Where the trustee and the member are one and the same there is no rationale for compensation to be paid in regard to any action taken by a trustee.

RECOMMENDATION No. 11

That the Government consider reforms to the treatment of superannuation in an employer insolvency situation and the payment of compensation in the event of theft and fraud in line with the revised ASFA proposals.

15. Any other relevant matters

ASFA of course would be more than willing to respond to any additional questions the Joint Committee might wish to raise.

Appendix

It is ASFA's view that the superannuation industry, and the SIS Act in particular, have been under almost continuous review and change since its introduction in 1993.

For instance (and this is not a complete list), the Senate Select Committee and its predecessors examined options for allocated pensions (March 1994), super and housing (May 1994), superannuation regulations (August and November 1994), the Superannuation Guarantee (February 1995), allocated pensions (June 1995), superannuation and broken work patterns (November 1995), the Superannuation Complaints Tribunal (April 1996), investment of superannuation monies (December 1996), retirement savings account legislation (March 1997), superannuation surcharge legislation (March 1997), restrictions on early access to superannuation (September 1997), choice of fund (March 1998), choice of superannuation fund (November 1999), family law and superannuation (March 2001), enforcement of the Superannuation Guarantee (April 2001), prudential supervision and consumer protection (August 2001), early access to superannuation (January 2002), investing superannuation funds in rural and regional Australia (February 2002), taxation treatment of overseas superannuation transfers (July 2002), choice of fund (November 2002), financial assistance funding of compensation (March 2003), and planning for retirement (July 2003).

Other significant inquiries include the Superannuation Working Group that delivered its final report on Options for Improving the Safety of Superannuation in March 2003, the Productivity Commission reported on its review of the SIS Act and certain other superannuation legislation in December 2002, and the Auditor-General delivered his performance audit report on APRA's Prudential Supervision of Superannuation Entities in September 2003. There have also been reviews of both the supervisory levies and compensation for fraud and theft levies paid by superannuation funds. Sections of the SIS legislation dealing with disclosure by funds have also been reviewed and revised, moving into the Corporations Act under the responsibility of the Australian Securities and Investments Commission.