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

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This Submission is supplementary to the submission made by Industry Funds Forum (**IFF**) to the Parliamentary Joint Committee on Corporations and Financial Services (**the Committee**) Inquiry into the Structure and Operation of the Superannuation Industry (**the Inquiry**).

A number of issues have arisen since the date of our original submission and our appearance before the Committee. These issues have been raised in the written and oral submissions made to the Committee and/or members of the Committee, and IFF regards some of them as requiring clarification or warranting further comment for the Committee's consideration.

1 What our Supplementary Submission Addresses

- Trustee Structure
- The Role of Advice
- The Role of Trustees in Member Investment Choice
- Promotional Advertising
- Not-For-Profit/Related Party Transactions

2 Trustee Structure

In the course of the hearings a number of issues were raised including:

- Should there be a requirement for industry superannuation funds to have an independent chair?
- Should there be a requirement that all directors of a superannuation funds be elected by members?
- Is union involvement in the nomination of directors appropriate?
- Is there a need to upgrade the fit and proper test for trustees of superannuation funds given the significant amounts of money now involved in superannuation?

IFF makes the following responses to these issues:

2.1 Boards of Directors

IFF submits that industry superannuation funds have effectively functioning Boards of Directors which is clearly evidenced by the obvious lack of problems which have arisen in relation to this sector of the superannuation industry. This is despite the high level of supervision and scrutiny to which industry superannuation funds are subjected.

2.2 Equal Representation

The current legal requirement under the *Superannuation Industry (Supervision) Act* 1993 (**SIS**) for equal representation on trustee Boards was an industry fund initiative. To require all directors of superannuation funds to be elected by members would result in significant costs which would be borne by the members of all those funds.

Equal representation allows Boards:

- to provide members with a voice at Board level;
- to be representative of members' interests; and
- to have access to directors with specific skills needed to meet the fit and proper requirements.

Equal representation does not prevent the appointment of independent directors.

In order to satisfy the fit and proper test imposed on trustee boards as it currently stands, it would be extremely difficult to meet all of the requirements imposed on Boards if Directors could only be sourced through member elections.

IFF submits that the current equal representation model strikes the proper balance between:

- representing member interests; and
- access to the independence and skills needed to manage and administer a superannuation fund and satisfy the legislative requirements.

The selection of Directors requires a careful analysis of skills across the Board as a whole and appointments are made on the basis of that skills analysis.

The fit and proper test imposed on directors of superannuation funds is extremely onerous and exceeds that imposed on company directors or trustees involved in the insurance industry, including the requirement for ongoing education. It is a structure that has served the superannuation industry well and there would be nothing to be gained by removing it.

IFF submits that the equal representation model adopted in Australia has been extremely effective and the history and performance of the funds which have adopted this model speaks for itself. The effectiveness of the model is also recognised internationally and for all these reasons should not be changed.

3 Term of Reference No. 4 - The Role of Advice in Superannuation

The Financial Planning Association of Australia Ltd (**FPA**) and IFSA in their written and oral submissions to the Committee provided a considerable amount of evidence regarding:

- the value of advice to consumers;
- the regulatory burden imposed by the Financial Services Reforms (**FSR**) and how that impedes the provision of cost effective financial advice.

3.1 Introducing materiality threshold for financial advice

(a) Issues raised by FPA

The FPA has requested the Committee to establish a materiality threshold to apply before the obligation to provide a statement of advice (**SOA**) is triggered. The rationale being that this is part of the FPA's efforts to make advice on consolidation of superannuation accounts more affordable, while protecting the clients' interests. Advice on amounts that fall below the materiality threshold would therefore be exempt from the FSR requirements which were specifically put in place to protect the interests of consumers.

(b) IFF response

Almost 80% of Australians are not receiving financial advice. Although many members are likely to benefit from quality financial advice that is in their interests, easy access to advice should not be at the expense of consumer protection or quality not conflicted advice.

FSR provides consumers with a number of important protections and although IFF supports responsible reduction in the complexity of how those protections are achieved and administered, it does not support a reduction in consumer protection. The complete removal of those protections under a certain dollar threshold will disadvantage the most vulnerable members of our society for whom those protections are most needed.

Those with small amounts to invest are invariably those who are:

- not financially literate;
- low income earners; and
- the least able to withstand under-performing investments based on inappropriate financial advice.

3.2 Default Investment Option

(a) Issues raised by FPA

In submissions to the Committee FPA argued that members in industry superannuation funds are predominantly invested in the default investment option, which the FPA claims retards their investment performance and, in addition, members are under insured. In particular IFF notes the following comments in FPA's written submission:

> "*By way of comparison…several of the large industry funds, REST and HOSTPLUS … disclosed that 99% of members are invested in their default or balanced option, due to the apparent absence of individual advice. Whilst in the current market returns on these funds have been quite good, it must be suggested that at least a percentage of those members would have been better off having received advice and placed in less conservative strategies such as Australian share funds or emerging market funds where returns have been up to 50% higher in the current economic environment. In these cases the benefits of receiving professional financial planning advice would most likely result in a greater retirement payout.*"
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> "*Voluntary superannuation contributions on their own, even in so called "low fee, no commission" funds will not in the absence of professional financial planning advice necessarily achieve retirement goals and may*

even place those goals at risk by inappropriate asset selection and inadequate insurance protection."

"Whilst mandating a minimum level of life insurance cover from the "default" superannuation fund may go some way to addressing this problem, it also raises concerns. In particular, without sufficient education or advice members may believe that the mandate of minimum levels represents sufficient cover. In reality this will often not be true."

(b) IFF response

IFF accepts that the majority of members of industry funds are invested in the balanced investment option (which is also usually the default investment option). However, it strongly refutes the claim that this necessarily leads to the conclusion that none of these members have not actively chosen that particularly investment strategy or that they have not done so after obtaining the advice of a financial planner. This is supported by research conducted by Cbus in 2003 to examine the needs and participation of members in Member Investment Choice.

It is important to consider this issue in the context of how a default investment option works. The default investment option by its nature requires a member to do nothing to invest in it. Consequently members who are invested in the default option may be there because they:

- failed to address the issue at all;
- were apathetic as to where their funds were invested; or
- actively considered all the investment options and determined that the balance option was the most suitable for them.

In the latter case the inaction of the member is not indicative of a failure to choose but rather the reverse, i.e. the member chose to remain in the balanced option. This may or may not have involved receipt of financial advice.

3.3 Balanced Investment Strategies

Many members are advised or make a decision to invest in the balanced investment option on the basis that this is the best investment strategy for them based on their risk tolerance, age, financial commitments and exposure to other asset classes such as property or shares.

Balanced investment strategies vary from superannuation fund to superannuation fund depending of their approach to asset allocation. A number of industry superannuation funds have a significantly higher exposure to growth assets in their balanced investment option (which is generally their default option) than the typical balanced investment strategy, which tends to have a more conservative asset allocation.

Trustees of industry superannuation funds develop an investment strategy for the default to suit the demographics and member profile of their particular fund. This is done with the full knowledge that many members will not take advice and may not actively choose an investment option. It is also consistent with the trustees' responsibility under SIS to formulate an investment strategy that has regard to the whole of the circumstances of the fund.[1] Industry superannuation funds encourage members to take reliable financial advice from reputable financial planners who are not conflicted by commissions, so they can make active well informed choices concerning their superannuation investment.

There is no evidence to support the ill informed statements by FPA. In fact all the evidence is to the contrary and shows that industry funds have outperformed the majority of

[1] Section 52(2)(f) SIS

superannuation funds over the short and long term. Further there is no evidence to support the wildly irresponsible statement by FPA that members who are in the balanced option (by choice or default) have suffered 'retarded investment performance'.

3.4 Remuneration of Financial Planners

(a) Issues raised by FPA

FPA has also submitted that the way in which a financial planner is remunerated is of little consequence to the consumer and that commissions are a sound basis for paying for ongoing advice. In particular, IFF notes the following comments:

> "*FPA believes that this specific disclosure and agreement of the cost of financial planning advice is the crucial element in maximising transparency and so addressing conflicts around remuneration which the planner may receive from the product manufacturer. The method of payment is a secondary issue and could occur through an up front payment, periodic debit or via the product.*
>
> *Where the financial planning advice fee is paid by the product, FPA does not see this as commission because the amount had been agreed by the client and they can vary or terminate it. Any payments to the financial planner, even where they relate to advice, if they do not meet these requirements must be disclosed as commission. The FPA recommends as best practice that the amount of ongoing commission be disclosed at least annually to the client.*"

Senator Murray raised the possibility of planners being labelled so consumers can better understand any relationships they have with a product provider. Senator Chapman proposed the use of labels such as "tied", "franchisee" and "independent", stating that consumers could be more impacted by "tied" planners' lack of independence than how they are remunerated.

The response of the FPA to this suggestion was that any such relationships were disclosed in the Financial Services Guide (**FSG**). Presumably if the materiality threshold proposed by FPA were adopted the FSG would not be provided to those investing below the threshold.

(b) IFF response

IFF submits that financial advice needs to be on a fee for service basis to protect consumers and help address real, potential or perceived conflicts of interest between the interests of consumers and the self-interest of financial advisers remunerated on a commission basis.

By prohibiting payment of commissions to financial advisers concerning advice on compulsory superannuation contributions and products many of these problems would to a large extent disappear. This approach is widely recognised within the superannuation industry as a feasible and reasonable solution to many of these problems. It is also supported by the record of evidence given to the Committee in this Inquiry by David Love, who at the time was Manager of the Investor Protection Unit in the Corporations and Financial Services Division of Treasury.

Mr Love stated:

> "The Government's position, which has been stated by the parliamentary secretary, …that if you have commissions, there should be a connection between the value of the advice given and how much you are paying for it through the commission. The real difficulty comes when you have things like trailing commissions, where there does not seem to be any connection between the value of the advice provided and how much the adviser is being remunerated."

4. Terms of Reference 5 and 6 - Role of Trustees in member investment choice (MIC)

4.1 Issues raised by FPA

FPA and the Investment and Financial Services Association (**IFSA**) expressed great concern about the impact of APRA's Superannuation Circular II.D.1 *Managing Investments and Investment Choice* (March 2006) on the basis that it undermines the Government's policy objectives for introducing fund choice.

In its submission to the Committee the FPA argues that the Trustee of a superannuation fund should be obliged to consider the financial advice received by an individual member, and that any trustee that interferes with an investment selection on this basis would be contravening its legal obligations:

> "FPA is therefore concerned that parts of the Circular, particularly paragraphs 48 and 49, can be read as requiring trustees to ignore the advice given to a fund member by a professional financial planner. While it is the role of the trustee to determine the suitability of an investment at the fund level, it is neither appropriate nor necessary for a trustee to supervise individual investments under "investment choice". A strong argument can be made that any trustee unilaterally interfering with those selections would in fact be acting in contravention of their legal obligations."

The FPA has recommended regulatory changes to require a trustee can take into account individual financial planning advice given to a member concerning his or her superannuation.

4.2 IFF response

The role of the Trustee is to determine and manage the overall investment strategy for the fund, for each of the investment options it offers to its members. Members should be educated and provided with sufficient clear information about each of those investment strategies to assist them in understanding how they work, and the differences between them including the associated risks. This can and often does include the trustee facilitating access to professional financial advice or a recommendation that members should consider their need for professional financial advice to assist them in selecting an investment strategy that suits their needs and risk profile.

Under the *Superannuation Industry (Supervision) Act 1993* (**SIS**) a trustee must formulate and give effect to an investment strategy that has regard to the *whole* of the circumstances of the fund.[2] A beneficiary or class of beneficiaries can give directions to the trustee only in relation to a strategy to be followed by the trustee concerning investment of a particular asset or assets of the fund provided the direction is given in accordance with the SIS regulations.[3] There is no basis on which a superannuation fund could take account of the individual situation of a member. Nor can it take account of any financial advice that member may have been given. A trustee has an obligation to manage the fund and its investment strategies for all members of the fund as a whole.

A member is free to seek financial advice and is encouraged by most funds to do so, when selecting an investment option.

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[2] Section 52(2)(f) SIS
[3] Section 52(4) SIS, regulation 4.02 SIS regulations

FPA's proposal for legislative amendment to require a trustee to take account of individual financial planning advice given to a member is misconceived and inconsistent with the responsibilities of a trustee.

5. Term of Reference No. 11 – Should promotional advertising be at the cost of the fund and therefore its members

Senator Chapman has asked a number of questions on this issue.

In their written and oral submissions to the Committee on this term of reference the FPA and IFSA make the following statements:

5.1 Issues raised by FPA

- Any general advertising by a fund does not meet the "sole purpose" test under SIS[4] because "it is not directly related to any of the core purposes of a fund".
- General trust law does not "on the face of it" authorise a trustee to reimburse itself for the cost of general advertising as it is not part of normal administration activities of the trustee.
- Where advertising costs are borne directly by the fund they should be clearly disclosed to members in the fund's annual financial reporting.
- The advertisements of the industry funds were unfair because they failed to disclose that the higher fees charged by retail master trusts including a fee for advice. Consequently the industry fund advertisements do not compare "apples with apples".
- The advertisements send a message that advice is not important.

5.2 Issues raised by IFSA

- That APRA's letter to trustees of 14 March 2005 had introduced confusion about what promotional advertising was permissible and that legislation was needed to clarify this situation.
- Mr Gilbert in his oral submission to the committee noted:
    - In relation to the industry superannuation fund advertisements that the benefits of the "economies of scale argument" needed to be demonstrated and to date this has not occurred.
    - In response to the claim that economies of scale result in lower costs to all members he asked:
        - Will members who have left the fund be refunded an amount due to the fact that the advertising was misspent?
        - Who refunds the money, and where does the money come from?
    - Retail master trusts pay for advertising out of the entity which is receiving the management expense ratio (i.e. the parent company that offers services to the superannuation fund), and not out of members' funds.
    - That IFSA wants a level playing field.

[4] Section 62 SIS

5.3 IFF response

(a) All superannuation funds must be free to advertise to inform and educate existing and potential members so they can make informed choices in a choice environment.

(b) Advertising plays an important role in product differentiation, branding and membership, and to a less extent recruitment, and retention strategies. Industry fund members have benefited from economies of scale, which have resulted in low cost administration, insurance and other benefits, as well as product innovation and design.

(c) The cost of advertising by any fund is ultimately borne by the members. It is either a direct cost to the fund or part of the expenses paid by the fund.

(d) The advertisements used as part of the joint industry fund marketing initiative have been approved by ASIC after extensive scrutiny. Whilst there have been unsubstantiated claims from some competitors about them being misleading these have proven to have no basis.

(e) In response to the questions raised by Mr Gilbert IFF would pose some questions of its own:

Question: How do parent companies that pay for advertising out of “their own funds” get those funds?

Answer: Ultimately from their client – the member.

IFF agrees there should be a level playing field but suggests that one already exists. All funds are required disclose their expenses, including advertising.

6. Term of Reference No. 12 – Meaning of “Not for Profit” and Related party transactions

Senator Chapman also asked many questions on this term of reference. The implication being that there are undisclosed relationships with related parties who profit from services provided to “not for profit” industry superannuation funds.

6.1 Issues raised by FPA

FPA has stated that full disclosure is needed for all dealings with related parties.

6.2 Issues raised by IFSA

IFSA said that in relation to the “not for profit sector “ultimately someone makes a profit where there are related party service providers.

6.3 IFF Response

IFF submits that this issue is relevant across the superannuation industry. The retail master trusts, like other superannuation funds pay fees to a myriad of service providers including:

- internal or external administrators;
- group life insurers;
- fund managers;
- asset consultants;
- accountants;
- actuaries;
- solicitors.

All of these services providers make a profit from providing services to the superannuation industry. The fact that a “not for profit” superannuation fund uses the services of some of these service providers who consequently profit from that exercise, does not mean the “not for profit” fund derives a profit.

Transparency and disclosure are the key requirements to deal with this issue and the current regulatory requirements covering these areas are more than adequate.

(a) “all profits belong to members’”

This term of reference seeks to define what is meant by ‘all profits belong to members’ on the basis that:

- some sectors of the superannuation industry are allegedly confused about what this phrase means; or
- the perception that the funds using this phrase to describe themselves are some how trying to confuse consumers.

Quite simply the phrase “all profits belong to members” means that there is no fund promoter or sponsor who is making a profit from their association with the fund, and that all profits are held by the fund or the Trustee and they ultimately belong to the members of the fund.

As indicated above all superannuation funds purchase services from organisations that make a profit, and this profit is part of the cost paid by members to manage the fund.

(b) Related service providers

Some industry funds have established their own service providers through companies that are owned by the fund. Consequently the profits made by these service providers ultimately benefit the members of the fund that owns the service provider. The reason for this approach is obvious. Without this structure fees and costs paid to the service provider are paid by the fund and members bear that cost without deriving any benefit other than provision of the service paid for. The profits earned by the service provider benefit only the shareholders of the service provider.

By establishing their own service providers some industry funds have been able to reduce some of the profits that would otherwise go to third party service providers, often leading to increased returns to members. This structure also ensures that the fund can have a greater role in setting the priorities, standards and values for these service provider companies and provide services to the fund as and when needed, rather than just the services that are more profitable.

Funds utilising these services do so under commercial contract arrangements. Funds undertake an evaluation of the quality and cost of the services in awarding such a contract, compared to other service providers in the market. This ensures that the best interests of members maintained and that the service providers in question remain competitive. The end result is provision of services on a cost effective basis by a service provider that shares the fund’s core values and objectives.

This is also consistent with Section 109 of SIS which requires investments to be either at arm’s length, or where this is not the case that the terms and conditions of the transaction are no more favourable to the other party than those which it is reasonable to expect would apply if the trustee were dealing with the other party at arm’s length in the same circumstances. Therefore these types of arrangements are expressly recognised by SIS.

Ultimately members pay for all services regardless of who provides the service. If the service is provided by an entity that is wholly owned by the fund then members share in the profits made by the service provider that would otherwise go to a third party.

This model has proven to be instrumental in driving down the cost of services and resulting in the highly competitive costs charged by industry superannuation funds to its members. There is no evidence to support any claim that the services provided by these entities negatively impact on members.

All relationship with related parties are disclosed to members and the regulators.

IFF submits that the corporate structure of any retail master trust which is part of a group of companies will reveal similar arrangements within that group. For example the large life companies may own a funds management company, trustee company and an administrator. These services may be utilised by the trustee provided they meet the requirements of Section 109 of SIS.