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29 September 2006

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

Dear Mr Sullivan

Parliamentary Joint Committee: Inquiry into the structure and operation of the superannuation industry

Please find attached the submission to the above Inquiry from the Industry Super Funds Network. Please contact me on 03 9657 4321 if you require further information.

Yours sincerely

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INDUSTRY SUPER FUNDS NETWORK SUBMISSION

PARLIAMENTARY JOINT COMMITTEE

INQUIRY INTO THE STRUCTURE AND OPERATION OF THE SUPERANNUATION INDUSTRY

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INDUSTRY SUPER FUNDS NETWORK SUBMISSION

PARLIAMENTARY JOINT COMMITTEE
INQUIRY INTO THE STRUCTURE AND OPERATION OF THE SUPERANNUATION INDUSTRY

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1. Introduction

The Industry Super Funds Network's submission will address the following Terms of Reference: 1, 2, 4, 5, 6, 11, 12 & 15 and will address consistency of regulatory treatment in any other relevant matters. We will also make some general comments about the industry super funds and about the structure and operation of the superannuation industry.

We welcome the opportunity this Inquiry affords to address key issues facing the Australian retirement system. In particular, the Inquiry must address the concerning issue of the inappropriate use of sales commissions.

We urge the Committee to make the members of superannuation funds the key focus of this Inquiry, and to provide a system which maximises the quality of their retirement.

We contend that the single most important issue for members of Australian super funds is ensuring they are able to maximise their level of retirement savings. A mandated, uniform system of measurement of fund performance will help them make this crucial decision.

The Industry Super Funds Network recommends the "net benefit to member" measure for this purpose as the most appropriate and effective measure. It is the only one that includes all returns and costs together and then expresses the result as a dollar figure.

1.1 About the Industry Super Funds Network

The Industry Super Funds Network is a division of Industry Fund Services Pty Ltd (IFS) set up to address issues and projects of collective concern to shareholders and clients of IFS. IFS is a proprietary company which is owned by eight industry super funds and is in the process of being merged into Members Equity Bank Pty Limited. Members Equity Bank is owned by 40 large industry super funds.

Currently one of the projects undertaken by the Industry Super Funds Network is to convene the Industry Funds Marketing Campaign which is run on behalf of 17 industry super funds and includes the "Compare the Pair" television commercials, a PR service and other paid advertising.

1.2 Background of industry super funds

Prior to 1983 only 39% of the working population (and 25% of women and "blue collar" employees) had superannuation. Most of the existing schemes were not portable, had strict vesting rules and were generally restricted to public servants and senior management.

Industry super funds began to proliferate in the 1980's following campaigns led by the Australian Council of Trade Unions (ACTU). In 1992 compulsory super was introduced, where employers were required to make mandatory contributions for their employees. Peak union bodies and employer organisations had an interest in ensuring that these superannuation payments were protected from the high fee and commission products which then typified the retail market.

Industry super funds unbundled the superannuation value chain separately outsourcing administration, funds management, asset consultancy and insurance and driving down costs within the industry. This has become a defining feature of many industry super funds.

Over the past 20 years industry super funds have developed into sophisticated, competitive providers of retirement income products. Industry super funds have a unique structure:

- They are mutual in character.
- They are governed by trustee boards specifically representing employees and employers – typically these trustees are appointed by, on the one hand, the ACTU and/or unions and, on the other, by employer associations. A two-thirds majority is necessary for all decisions.
- They have lower average fees.
- They typically do not pay sales commissions.
- They have adopted innovative investment strategies.

The Industry Super Funds Network contends that these differentiating factors have led to the outperformance of industry super funds that is consistently reported by superannuation industry ratings agencies.

SuperRatings research shows that, as at 30 June 2006, on average, industry super funds could deliver 26% more retirement dollars to their members, compared to retail master trusts. This result is calculated using existing fee levels and projections over 40 years, to give an indication of the potential impact of fee differentials between the two sectors. The modelling does not include investment outperformance and excludes certain fees charged by master trusts, including contribution fees, entry fees, exit fees, contribution fees and other advisor fees and so arguably the actual difference would be greater in some cases.[1]

The modelling undertaken by SuperRatings demonstrates that belonging to an industry super fund over a 40-year working life could mean having $138,009 more at retirement measured in today's dollars.

Independent surveys conducted by SuperRatings also demonstrate the investment outperformance of industry super funds over retail master trusts.

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[1] **Assumptions**: starting account balance $50,000, initial salary $50,000; 2.5% inflation rate; 3.5% salary increase per annum; 9% Superannuation Guarantee contributions; no additional salary sacrifice or voluntary contributions; 15% contributions tax; employer asset sizes accumulated at 11.6% per annum; investment return of 7.225% as per ASIC model (gross of taxes and fees at 8.5%) but with taxes of 15% deducted; explicit costs deducted from members' accounts (eg member fee) subject to a 15% tax allowance; contribution fees, entry fees, exit fees, additional advisor fees are excluded from calculations; starting age 25 and retirement age 65; employer asset size $150,000.

- *For the year to 30 June 2006*: Seven of the top 10 public offer funds, in terms of net returns (returns less fees and tax), are industry super funds. Two are for profit retail funds.
- F*or the three years to 30 June 2006*: Seven of the top 10 public offer funds, in terms of net returns (returns less fees and tax) are industry super funds. Two are for-profit retail funds.
- *For the five years to 30 June 2006*: **The top 10** public offer funds, in terms of net returns (returns less fees and tax), are industry super funds.

The five-year figures demonstrate that the low fee, no commission, "run only to profit member" model of industry super funds, allied to the representative trustee structure delivers stronger investment returns at lower cost to members. [2]

The table below includes the funds over one, three and five years. The industry super funds are highlighted. Telstra Super is a not for profit public offer fund.

One Year to 30/06/06	Three Years to 30/06/06	Five Years to 30/06/06
Westscheme	MTAA Super	MTAA Super
MTAA Super	AMIST	AMIST
Zurich	STA	CARE Super
STA	Westscheme	ARF
ARF	AMP	HOSTPLUS
Telstra	ARF	REST
AMP	Telstra	Equipsuper
CBUS	Zurich	Westscheme
AGEST	CBUS	STA
LUCRF	LUCRF	HESTA

1.3 Net benefit

Industry super funds contend that a 'net benefit to member' measure is the most appropriate standard by which to compare super funds.

Under the auspices of the Industry Super Funds Network, research is commissioned to measure the 'net benefit' to members of industry super funds and retail master trusts.

The net benefit to member studies demonstrate the dollar amount of growth in the member's account - where growth is contributions plus investment earnings less all fees and taxes.

These studies have been performed every quarter, by leading researchers SuperRatings and Rainmaker Information, since the beginning of 2004. Every study has shown over every timeframe tested that industry super funds, on average, have outperformed retail master trusts, on average.

The net benefit measure captures the effect of fees and commissions paid and investment performance. This consideration of earnings and costs together, and the expression of these results in dollar terms, makes net benefit the most relevant and understandable measure for members.

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[2] Source: SuperRatings 50 Balanced Index, 30 June 2006

The Industry Super Funds Network believes that the net benefit measure should be tested and reported by all superannuation product providers. Governments, public companies and other organisations are judged on their net performance - whether it is net profit or their budget position - and the industry super funds believe that superannuation performance should be judged in the same way.

After all, it is net performance that is ultimately credited to members' accounts.

We submit that the Committee considers making 'net benefit to member' the industry standard for ratings houses and super funds and made available through the ASIC web site.

2. Term of Reference 1: Uniform capital requirements

We submit that no changes to current capital requirements are necessary or justified.

Under SIS legislation and the RSE licensing regime, trustees of public offer super funds are required to hold $5 million in net tangible assets and/or approved guarantee, or alternately trustees can have all their assets held by a custodian under a written agreement which complies with APRA Standards. Trustees of non-public offer funds do not have to satisfy any capital or net tangible assets requirements.

Capital requirements imposed on superannuation funds are primarily a risk management tool. APRA, in its Capital Adequacy Operating Standard, states that the purposes of capital requirements are to provide financial resources to act as a buffer against risk, evidence of a commitment on behalf of the trustee to their superannuation business, and act as an incentive upon the trustee to manage their business well.[3]

There can be no question that the trustees of industry super funds are committed to the superannuation business. Industry super funds have all now been in operation for over a decade and the sector has demonstrated extraordinary growth and sophistication.

Another reason for capital adequacy is to act as an incentive upon the trustee to ensure that the super fund is well run. Trustees of industry super funds can demonstrate a track record of good management of their funds. Indeed, the industry super fund sector can point to being a market leader in many areas of management, including driving down costs across the industry to benefit members (particularly in the area of wholesale investment management costs), pioneering investment in alternative assets and corporate governance and sustainability practices. Furthermore, the trustees of super funds already undertake their responsibilities in accordance with the significant duties imposed under the SIS Act and principles of trust law (which are appropriately onerous). These legal duties, which impose personal liability in the event of breach, supplement the capital requirements to ensure effective and appropriate management of super funds.

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[3] APRA, Superannuation Guidance Note 150.1 Capital Requirements – net tangible assets, July 2004, p.5

The final stated purpose of capital adequacy is to act as a buffer against risk. In the evolution of the superannuation industry, growing complexity of operations, investments and product offerings have significantly increased the number and scale of risks to which funds are exposed. Nonetheless, we submit that the current regulatory environment is adequate and that no alteration to the capital requirements imposed on industry super funds is justified.

The typical industry super fund business model is based on the outsourcing of core functions. This delivers economies of scale and access to expertise at a lower cost to members. Most industry super funds outsource their administration, investment, asset consultancy and insurance functions. As such, any substantial error that caused loss to members is likely to be the result of an error made by an external party (either administrator, custodian or asset consultant) and covered by their insurance which is required in material contracts between the fund and these service providers (pursuant to the APRA Outsourcing Operating Standard). An error caused by the fund would be protected through trustee liability insurance. Many industry super funds also have fidelity insurance to cover theft and fraud.

Further, recent changes to the regulatory environment through the introduction of the APRA licensing regime, has imposed a uniform and comprehensive system of risk management across all superannuation funds and required all funds to demonstrate the adequacy of their resources (including financial resources). The licensing process also imposed significant expense on funds (including time spent by the board/senior management and other compliance costs) and caused a major contraction in the number of funds on offer in the market with only about a quarter of APRA regulated funds successfully obtaining a licence[4]. The application process was rigorous and expensive and only those trustees committed to their superannuation business were successful in obtaining a licence. The Adequacy of Resources Operating Standard required trustees to demonstrate on an ongoing basis that the resources allocated to the management of the fund were appropriate. The Risk Management Operating Standard required funds to develop extensive risk management plans which identify, quantify and remove, reduce or mitigate the risks faced by trustees in conducting their superannuation businesses. There has therefore been significant recent alteration to the regulatory environment which tackles the management of risk and appropriate resources of super funds. We therefore submit that further changes to capital requirements are unnecessary.

We therefore submit that there is no justification for altering the capital requirements for industry super funds.

3. Term of Reference 2: Whether all trustees should be required to be public companies

The trustees of industry super funds have utilised a variety of corporate structures. In some cases, the trustees of industry super funds have been incorporated as public companies.

[4] APRA Press Release, “New superannuation licensing era commences”, 4 July 2006, No 06.34 - Of 1,200 Superannuation Trustee existing at the commencement of the 2 year transitional period on 1 July 2004, only 325 obtained a licence.

However, we do not believe that it is necessary to mandate that superannuation trustees be public companies. Superannuation funds are highly regulated under the SIS legislation, and so many of the additional requirements imposed upon public (as opposed to proprietary) companies are, where they are appropriate, already practised by industry super funds. For instance, the Corporations Law imposes additional requirements on the directors of public companies in relation to the way conflicts of interest are managed; similarly, as part of the RSE licensing process, funds were required to set down policies to deal with conflicts of interest faced by trustee directors and key executive staff.

Ultimately, we believe that a decision about the appropriate corporate structure is a matter for the trustee directors. We submit that mandating that all trustees become public companies will cause additional expense to fund members with no countervailing benefit.

4. Term of Reference 4: The role of advice in superannuation

The Industry Super Funds Network submits that the major issue that requires reform in relation to advice in the superannuation industry in Australia is the payment of sales commissions to financial advisors.

Industry super funds believe that appropriate financial advice and education is critical. The Industry Super Funds Network believes that most practising financial planners are well meaning. However, the system under which they are employed and operate within is one geared not to genuine advice but to sales.

We strongly believe that commission-based remuneration should be banned in relation to compulsory superannuation payments because:

- It causes a significant, direct conflict of interest which has a negative impact upon the quality of advice given to consumers;
- Disclosure is insufficient to deal with the problem of commissions as most consumers do not understand what is being disclosed; and
- Trail commissions significantly eat into retirement savings.

4.1 Commissions cause a direct conflict of interest and result in advice which is not in consumers' best interests

Industry super fund proponents have long argued that financial planners remunerated by commission suffer a direct conflict of interest and this has a deleterious effect on the quality of advice consumers receive from commission-remunerated planners.

If commissions dominate the advisory industry, then products not paying commissions will rarely be recommended even if they are superior (indeed such products will not appear on the advisory firm's "approved product list"). Differential percentage commissions will inevitably encourage some advisors to favour high cost products even where they are inferior (the extreme example being Westpoint).

Recent research and investigations by ASIC have provided unequivocal proof that when planners or advisors are paid by commission, they make recommendations which are often not in the best interests of those being advised. ASIC published its "Shadow Shopping Survey on Superannuation Advice' (Shadow Shopping Survey) in April 2006, which reported on monitoring conducted by ASIC in the first seven months of super choice. The Shadow Shopping Survey revealed widespread and systemic problems in the financial advising industry, problems which were significantly exacerbated where advisors were paid by commission. In summary ASIC found that:

- "Advice that was clearly or probably non-compliant was about six times more common where the advisor had an actual conflict of interest over remuneration. Where the advisor had a conflict over remuneration, 28% of the advice clearly did not have a reasonable basis and a further 7% probably did not. In contrast, where the advisor did not have a conflict, the percentages were 5% and 1% respectively. Non-compliant advice was three times more likely where the advisor recommended an associated product … The major problems in those cases involved advice to switch to higher fee funds with no countervailing benefits (eg from government, corporate or industry super funds to retail funds) or loss of important insurance cover through fund switching."[5] (our emphasis)
- "16% of advice clearly did not have a reasonable basis in some respect and a further 3% probably did not have a reasonable basis. Key problems were where the advice was not appropriate for the client's needs in some respect, or the advisor had not made sufficient inquiries to assess appropriateness. Advice that was non-compliant or probably non-compliant came from 24 different licensees, including several large firms. The proportion of poor advice remained higher than we consider acceptable, because it was well beyond what could be explained by non-systemic human error".[6]
- "… analysis suggests that the advice that was clearly or probably non-compliant was likely to leave consumers significantly worse off."[7]

The Shadow Shopping Survey therefore revealed that one-third of the financial advisors who had a choice between providing reasonable advice or receiving his or her commission, chose to earn his or her commission and give the consumer advice that did not have a reasonable basis.

Following the Shadow Shopping Survey, ASIC undertook an investigation into AMP Financial Planning Pty Ltd (AMP) and selected a random sample of files in which recommendations were made to switch superannuation products into AMP products. These recommendations were made by "Platinum Planners", who achieved this designation according to criteria, including higher business and advisory skills coupled with higher revenue and compliance ratings.

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[5] ASIC, Shadow Shopping Survey, p.8
[6] Australian Securities & Investments Commission, "Shadow Shopping Survey on Superannuation Advice, An ASIC Report, April 2006, SSS, p.7
[7]ASIC, Shadow Shopping Survey, p.9

ASIC formed a view that "… disclosure of a reasonable basis for advice was inadequate in approximately 45% of files reviewed."[8] Furthermore, ASIC found that during the period of the investigation, 93% of all new investment and superannuation business resulting from the advice of AMP planners was invested in AMP platforms or products.[9] Further, ASIC has stated that the practices evidenced in the AMP case are not atypical in the industry.[10]

We submit that in the AMP case, the Committee can see an illustration of the manner in which commission-based remuneration distorts the advice given to unsuspecting consumers. While consumers would probably assume that recommendations are made in his or her own financial interests, in fact, a commission based model means that there are instances in which it is the financial interests of the planner or advisor which take primacy.

While consumers believe they are paying advisors for professional advice, financial planners are actually paid a sales commission by the financial institution which employs them or which provides the product. Most financial planners do not recommend that consumers consider putting their superannuation in an industry super fund, despite the fact that this would in many cases provide the best retirement outcome for consumers. The structure of commissions ensure that they promote good sales rather than good advice and we submit that recent investigations by ASIC demonstrates that current legislative obligations fail to adequately protect consumers.

Further, the Industry Super Funds Network notes that there has been recent media coverage of 'shelf fees' – the practice of 'for profit' superannuation platforms charging a fee to fund managers for inclusion on their approved lists. According to reports this can take the form of a fee or a rebate. This practice further diminishes the potential for Australians to gain unbiased advice from a financial planner whose recommended list is driven less by the quality of the fund manager but more the preparedness to pay to be included on the approved list. Further, a situation where a tied advisor earns a commission from recommending an underlying fund manager that is on a platform because of a shelf fee should be deeply concerning to this Committee.

Accordingly, we submit that the legislative obligations which govern the provision of financial advice should be urgently reformed to increase the professional duties imposed on financial advisors and ban commissions on SG superannuation payments.

4.2 Disclosure is insufficient to deal with the 'problem' of commissions

The Investment and Financial Services Association (IFSA) commissioned research from Newspoll in relation to superannuation. The results of this research, which were released on 27 July 2006, included the following two findings:

- 43% of respondents did not know that their employer was legally required to make contributions to their superannuation; and
- 36% did not know the correct amount. [11]

[8] Enforceable Undertaking between ASIC and AMP Financial Planning Pty Ltd, p.5
[9] Enforceable Undertaking between ASIC and AMP Financial Planning Pty Ltd, p.6
[10] Enforceable Undertaking between ASIC and AMP Financial Planning Pty Ltd, p.6
[11] 'Newspoll confirms need for improved financial literacy', IFSA Media Release, 27 July 2006

This research adds to considerable recent research which reveals the poor levels of financial literacy among the Australian population.[12] Given these poor levels of financial literacy, we submit that disclosure is a totally inadequate antidote to the conflict of interest caused by commissions. Many consumers are likely to struggle to make sense of complex fee arrangements, let alone fully comprehending the compounding effect of high fees and trail commissions.

The same joint Parliamentary Committee that has called this current Inquiry concluded, following its hearings on 13 June 2006 (Hansard reference J9461), that "when assessing the problem of poor super advice, the committee recognises the complex interplay between the level of commission on offer to advisors, the possible effect that has on the advice given … and significantly, the financial literacy of the general public when choosing how to invest their savings". The Industry Super Funds Network agrees with this conclusion and its obvious implication that, as stated, disclosure is not sufficient in managing conflicts of interest.

The inadequacy of disclosure to remedy problems associated with commission-based payments to financial advisors is noted by ASIC in the Shadow Shopping Survey.

- Survey participants were rarely able to tell whether they had received poor advice, including whether the advice was likely to leave them worse off. In cases where we could see that the advice clearly lacked a reasonable basis, 85% of consumers still felt satisfied with the advice. This is generally not surprising since consumers are generally seeking professional advice in the first place.
- SOAs generally disclosed the advisor's conflicts of interest. However, we were not comfortable that all consumers could use this information to adequately judge whether the conflicts had influenced, or had the potential to influence, the advice. Anecdotal evidence gave us the impression that the typical consumer did not readily appreciate the impact that various types of conflict could have on the quality of advice they were given.
- While disclosure is a critical part of consumer protection, this survey suggests that it can only play a limited role in protecting consumers from inappropriate or conflicted advice."[13]

Furthermore, ASIC noted:

> It is clear from the survey that there was a higher risk of inappropriate advice where either the advisor received commission-based remuneration or the advisor recommended a product from an associated company. Licensees and advisors have traditionally relied heavily on disclosure to manage these conflicts. *However, disclosure (even where comprehensible) is not, by itself, always an adequate response if the conflict still leads to advice that is inappropriate or compromises the client's interests.*[14] (our emphasis)

[12] See for example, the ANZ Survey of Adult Financial Literacy, November 2005, www.anz.com.au
[13] ASIC, Shadow Shopping Survey, pp.11-12
[14] ASIC, Shadow Shopping Survey, p.13

We further note that in other professional settings such as law and medicine, advisors are not permitted to work in the face of conflicts of interest. The reason for this is because conflicts of interest will inevitably compromise the advice provided. It is inconceivable that financial institutions operating in the retail consumer environment of financial planning be allowed to continue to operate in the face of such blatant conflicts of interest.

4.3 Commissions significantly erode retirement savings

Commissions, and in particular trail commissions, significantly erode retirement savings. Trail commissions are funded by the fund manager deducting a payment which would typically range between 0.4 – 1% of invested funds and paying this amount to the advisor for the entire period that the client remains in the product. The ongoing nature of this commission means that it eats into the client's savings and is magnified by the impact of compound interest. As noted by ASIC on its consumer website FIDO, a fee difference of 1% could equate to a 20% difference in retirement savings.

Given the erosive effects of percentage-based fees notionally charged by advice, the Industry Super Funds Network recommends that commission based charges for advice funded from the superannuation product should be banned.

4.4 Conclusion

It is often claimed by the financial planning community that commissions are necessary as many consumers who need advice are not in a position to pay for the advice "up front". We would make three points in relation to this claim.

- Firstly, there is no obligation for ongoing advice or service to be provided in order for the planner to earn the trail commission on an ongoing basis.
- Secondly, we do not accept that most Australians require detailed financial advice on superannuation. The average Australian has an account balance of $25,800[15]. While they may need education and perhaps some limited assistance in relation to matters such as investment choice selection and maintaining appropriate insurance, a full scale financial plan (let alone ongoing advice for their entire working life) is unlikely to be justified. Claims made by the financial planning industry that the absence of ongoing advice will lead Australians to having insufficient superannuation to retire upon is self serving and not backed up by the 'net benefit' evidence already included in this submission.
- Finally, the consumers who are unable to pay upfront commissions would also be unlikely to be able to afford to have their retirement incomes eroded by trail commissions. A fee for service model provides a fair and transparent method of paying for advice which is less likely to erode a consumer's ultimate retirement benefits.

[15] APRA, Annual Superannuation Bulletin June 2005 (issued 20 April 2006), p.13

5. Terms of Reference 5 & 6: The meaning of member investment choice and the responsibility of the trustee in a member investment choice situation

Most industry super funds offer their members a number of investment choices. Industry super fund trustees offer their members well-researched and structured investment options. The options are typically variants of stable, balanced and growth options. Some funds also permit members to invest a proportion of their savings in specific asset classes (for example international shares).

Member investment choice and super choice are of course unrelated. Choice of super fund allows over five million Australians to choose their super fund. Thus employees are able to choose a fund that offers them no choice, a few choices or literally hundreds of choices.

Given that upwards of 80% of super fund members remain in the default fund offered by their super fund (this number is over 90% in some major industry super funds) investment choice is not likely to prove a major determinant in fund choice. It is important to recognise therefore that the vast majority of Australians are not seeking, or exercising member investment choice.

Experience in the US would suggest that this is not a bad thing. A trend among some US employers has been to reduce the number of investment options offered to their employees in their 401(k) plans.

Research conducted by the Centre for Retirement Research at Boston College found that the majority of participants had undiversified portfolios with either none of their savings in local equities or virtually all of their account in local equities. Its conclusion is that given the investment choices made "most participants face the risk of ending up with inadequate retirement income or exposing themselves to large swings in the value of their assets".[16]

Behavioural finance theory suggests, among other things, that people:

- Are easily confused by complex choices or too many options;
- Put too much weight on the recent past and short term results; and
- Overestimate the impact/probability of loss compared to the prospect of gain.[17]

In this context super trustees play a critical role in assisting their members to achieve their retirement income goals. The role of industry super fund trustees includes:

- Appointment/termination of an asset consultant;
- Setting the investment strategy for the fund, including asset allocation and having regard for, among other things, risk and return, diversification and liquidity;
- Selection and appointment/termination of fund managers (this is often undertaken by an investment committee in conjunction with the asset consultant);
- Ongoing monitoring of the strategy.

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[16] Centre for Retirement Research at Boston College, Investment Returns: Defined benefits vs. 401(k) plans by Alicia H Munnell et al, September 2006

[17] Rice Walker Actuaries 'Analysis', April 2006

Asset consultants undertake substantial research of fund managers and economic and market trends. This information is used to inform their advice to trustees and the subsequent decisions. Individual fund managers make decisions regarding the buying and selling of individual stocks.

Members of industry super funds benefit from these resources, which are well beyond the time and means of most individuals. Members get access to a highly diversified portfolio of growth and defensive assets, typically with an emphasis towards growth assets. The results, as noted elsewhere in this submission, speak for themselves.

Given the high proportion of members that remain in the default option (whether by choice or inertia), the role of trustees remains critical to the ongoing viability of the Australian superannuation system.

6. Term of Reference 11: Whether promotional advertising should be a cost to the fund, and therefore to its members

"I just saw the industry fund ad on Channel Nine here at the ABC in Adelaide. It's quite a good ad, good on them – get out there and advertise and try and keep their membership base or attract new members, but that's what it's about. They should be able to compete."
- Nick Minchin, Minister for Finance and Administration, 22 May 2005[18]

Over the past few years and increasingly since the advent of Choice of Fund, industry super funds have undertaken marketing campaigns of the industry super fund brand and their own fund's brand. The Industry Super Funds Network submits that:

- Promotional advertising is necessary to educate and inform members in the competitive choice of fund environment and is an operational cost to funds;
- The bulk of promotional advertising is undertaken by the major financial institutions; and
- Promotional advertising is a critical strategy to achieve and retain economies of scale.

Further, APRA clarified in early 2005, prior to the introduction of choice, that expenditure on advertising by a super fund was consistent with the sole purpose test.[19]

6.1 Promotional advertising in the choice of fund competitive environment

While industry super funds have been prominent in the period immediately prior to and following the introduction of Choice, there has also been significant advertising activity by retail funds, banks and other institutions offering superannuation products. Irrespective of the super fund structure (ie for profit or not for profit), marketing expenses (like any another expenditure) is a cost ultimately borne by members of the fund.

[18] Press release from the Minister for Finance and Administration of a transcript of an interview with Barrie Cassidy on the ABC "Insiders" program, 22 May 2005
[19] Letter to all Trustees of APRA Regulated Superannuation Funds, from Ross Jones, 14 March 2005

Industry super funds are committed to investing in a prominent, ongoing marketing campaign as the cost associated with these activities is justified by the benefits that are delivered to members. In particular, advertising in the current competitive environment is essential in order to retain and acquire members and participating employers. Retention and acquisition of this business is key to retaining/building scale, which impacts significantly on the unit costs per member of running a super fund. If membership is lost or not built, unit costs increase. Indeed, the requirement to build scale is the factor most likely to maximise the benefits delivered to existing members in the long term.

In an industry super fund, where trustees have one purpose, which is to deliver maximum retirement payouts to members, the only possible benefit of advertising and increasing the size of the funds advertised is to benefit the members, given the "run only to profit members" basis of industry super funds.

Within the current competitive environment of choice of fund, advertising is an essential area of expenditure - as essential as funds spent on investment advice, or proper administration of the fund. Advertising is a key factor in the growth exhibited by industry super funds; in the APRA Annual Superannuation Bulletin it was noted that the industry super fund sector has shown the largest growth during the year to June 2005, with assets increasing by 27.4%.[20]

6.2 Comparative data on promotional advertising expenditure

We submit that many of the complaints made by our competitors in relation to the "Compare the Pair" campaign are motivated by the great success of the campaign rather than concern for the legitimacy of the expenditure.

Furthermore, the amount that industry super funds spend on advertising is much less than the amounts spent by retail funds and financial planners or institutions. In the monitoring of advertising undertaken by ASIC from July 2004 to November 2005, industry super funds represented only 7% of advertising, whereas financial planners dominated with a 38% share of the market and retail funds held a 22% share.

It should also be noted that the lion's share of distribution costs associated with the promotion of master trust products are not reflected in advertising spend (unlike industry super funds). Master trusts spend much more on paying commissions, for which members also ultimately bear the cost. For instance, the AMP Annual Report reveals that AMP spent $24 million on advertising and marketing and $360 million on commissions in the 2004/05 financial year. While some of this expense would relate to non-superannuation products, it demonstrates the reliance master trusts have on sales commissions to distribute their product.

Advertising is also a legitimate method by which industry super funds can educate their existing membership and it appears, to date, that the message is getting through.

The two key areas of expenditure which are impacted by scale are administration and funds management.

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[20] APRA, Annual Superannuation Bulletin, June 2005 (issued April 2006) p.5, www.apra.gov.au

The economies of scale in relation to fund administration are very high at all known levels of membership. That is, other things being equal, there will be significant benefit in terms of reducing the cost per member for each additional member recruited. Clearly this is a function of the substantial fixed costs associated with fund administration. These fixed costs include:

- Systems technology – the cost of building, acquiring or licensing a system to specialise in the Australian superannuation regulatory environment is substantial, as is the cost of its maintenance and adaptation for the many legislative and regulatory changes which occur in that environment. These costs must be spread over a very large membership base in order for the most efficient and service oriented technology solutions to be provided and continually updated.
- Compliance – a substantial part of compliance involves fixed legal costs and fixed costs of time in dealing with regulators.
- Similarly, there are economies of scale in dealing with the outsourced provision of ancillary services such as audit, legal, accounting, quality reviews and the like.
- There are certain fixed costs associated with maintaining a trustee office comprising, as a minimum, a board of trustees and a fund secretary.
- To provide an indication of the extent of economies of scale, the cost per member per week charged by Superpartners, Australia's largest administrator of industry super funds, for its smallest client is 136% of that charged for its largest clients. And, please bear in mind that Superpartners' smallest client is quite large by superannuation industry averages.

The relationship between scale of funds under management and investment charges is also probably fairly well known. As an indication, for a standard active Australian shares mandate, costs can range from below 0.3% of assets under management to almost 2%, with the largest factor being the size of the mandate. Typically a mandate of $10 million or less would, as a minimum, attract a fee of 0.5-0.6% and could be much higher, whereas typically mandates in excess of $100 million will be closer to 0.3% at least at the margin.

In addition, there are fixed costs associated with asset consulting and other specialist investment advice. In extreme cases, smaller funds are simply unable to afford asset consultants, even though they would benefit from asset allocation, manager selection and other advice.

It is also well established that certain asset classes which exhibit extremely strong long-term performance such as private equity and infrastructure investments are largely inaccessible to even medium size funds due to research and transactional costs associated with these asset classes. As a general rule, our experience demonstrates that funds under $1 billion of assets under management are unlikely to be able to significantly benefit from a presence in alternative asset classes, whereas funds over, say, $4 billion are able to access such asset classes as emerging market equities, global private equity and direct property, thus potentially enhancing long-term returns and/or reducing volatility.

7. Term of Reference 12: The meaning of the concepts "Not for Profit" and "All Profits go to Members"

Industry super funds have utilised terms such as these in their marketing materials as it is a valid point of differentiation with commercially run funds. Industry super funds which participate in the collective "Compare the Pair" marketing campaign use the term "run only to profit members" which we believe best describes the difference between industry super funds and commercially run superannuation providers, which within their fee structure must generate an amount to satisfy the dividend payments due to shareholders.

Industry super funds believe that the difference between the for profit/run only to profit members sector goes beyond the fees charged to fund a shareholder dividend - maximising the members' benefits underpins all the activities of an industry super fund.

We note that several commentators have recently pointed to the fact that some industry super funds make use of service providers in which they invest.

As industry super funds grew, they identified many areas where the services they were obtaining from third party providers were overpriced or underperforming. As a result, industry super funds have used their collective scale to renegotiate the terms on which business is conducted in the industry or to create businesses which aim to provide superior service delivery to the funds or their members or provide services at a lower cost. Some of these collective vehicles also provide investment opportunities for the funds.

Where these collective vehicles are owned by the industry super funds, profits which are generated are returned to the superannuation funds, either through dividend payment or capital appreciation and are disclosed in the funds' annual reports along with all the other fund investments.

Consequently, industry super funds have contributed to the reshaping of the landscape of the financial services industry, and have been responsible for driving down costs particularly in the wholesale sector.

We do not agree that investing in collective vehicles is in any way inconsistent with the "run only to profit members" principle.

Furthermore, it seems some of our competitors take issue with the use of the term "run only to profit members" because industry super funds engage the services of commercially run external service providers which profit from that business. It is ludicrous to suggest that industry super funds are not entitled to use such terms because businesses providing funds with services generate a profit from that business.

We submit that a reasonable comparison is the health insurance industry, which includes a number of for profit and not for profit providers. A number of these health insurance companies (nib, HCF, AHM and GMHBA which collectively have over 1,800,000 members) promote their not for profit status, distinguished by their not paying dividends to shareholders.

Any recommendation by this Committee to disallow the term 'not for profit' or appropriate marketing terms such as 'all profits to members' would, consistently applied, require no for profit health insurance companies and indeed the charitable sector to also cease using the term. This is patently absurd.

The terms 'not for profit' or 'run only to profit members' are meaningful because the core objective of industry super funds is to maximise the benefits paid to members rather than contribute to the bottom line of a parent company.

8. Term of Reference 15: Any other relevant matters

8.1 Consistency of regulatory treatment

With the heightening of competition in the superannuation industry brought about by the introduction of fund choice, it is more important than ever that administrative fairness is applied. In particular, uniformity of approach by regulators in relation to licensing, auditing and general supervision of superannuation funds is of considerable importance. Not only do these processes involve substantial direct cost to funds, they also are extremely influential in affecting the way in which funds operate in the marketplace and can impact significantly on the ability of funds to compete.

We are aware that APRA has stated that it has taken steps internally to promote uniformity of supervision. However, in practice, we believe it is difficult to achieve. This may in part be a result of having, as we understand it, separate divisions of APRA responsible for the supervision of different types of funds. Again, as we understand it, superannuation funds operated by commercial institutions such as the banks and major financial service companies, are not separately supervised by the division of APRA which is devoted to the licensing, auditing and supervision of industry super funds. Rather, those funds are left to that part of APRA concerned with the general prudential supervision of the parent institutions. In practice we believe this results in far less direct supervision of commercially operated superannuation funds than is the case for industry super funds. Further, we would draw particular attention to the need for much closer supervision of the eligible rollover funds operated by commercially motivated institutions. These funds compete with AUSfund whose trustee is Industry Funds Investments Ltd (IFI) and, in our view, are so inferior in performance and services as to warrant special attention by the regulator. We find it difficult to believe that the disparity in standards could continue if those funds were subject to the same licensing and supervisory processes applicable to IFI/AUSfund.

Related to the above, we believe it is important that the Committee give consideration to the question of the potential conflict which arises for trustees of commercially operated funds by virtue of the fact that they are selected by the parent company whose objective in operating the fund is to provide earnings for the shareholders of the parent company. This gives rise to an obvious conflict or potential conflict of interest for the trustees who are frequently also executives of the parent company. It is important that the members of these funds, as well as the trustees themselves, are clear about the way in which the trustees manage that potential conflict. Further, given the degree of competition between funds, it is also important that the standards applicable to trustees in the not for profit sector are uniformly applied to the trustees of these commercially driven funds or, if that is not possible, then for the differences to be clearly enunciated and published so that employers and employees have full knowledge of the standards required of different trustees.